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Securities Law Alert

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January 2019

Supreme Court: Grants Certiorari to Consider Whether Section 14(e) Claims for Misrepresentations or Omissions in Connection With a Tender Offer Require a Showing of Scienter

On January 4, 2019, the Supreme Court granted certiorari to consider whether scienter is a requirement for a claim of a misstatement or omission in connection with a tender offer under Section 14(e) of the Securities Exchange Act of 1934 ("Exchange Act").[1] *Emulex Corp. v. Varjabedian*, No. 18-459. The Second, Third, Fifth, Sixth and Eleventh Circuits have held that plaintiffs must plead and prove scienter in order to prevail on a claim alleging a misstatement or omission under Section 14(e).[2] But in *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018) (Murguia, J.), the Ninth Circuit found that "the first clause of Section 14(e) [which addresses misstatements and omissions] requires a showing of only negligence, not scienter." The court reasoned that "the text of the first clause of Section 14(e) is devoid of any suggestion that scienter is required."

The Ninth Circuit observed that the five other circuits to address this question based their decisions "on the shared text found in both Rule 10b-5 and Section 14(e)."[3] However,

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–*The Legal 500* 2018

1. Section 14(e), titled *Untrue statement of material fact or omission of fact with respect to tender offer*, provides:

   > It shall be unlawful for any person to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

   15 U.S.C. § 78n(e). Section 14(e) was added as an amendment to the Exchange Act pursuant to the Williams Act, which was enacted in 1968.

2. *See SEC v. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004); *Adams v. Standard Knitting Mills*, 623 F.2d 422 (6th Cir. 1980); *In re Digital Island Secs. Litig.*, 357 F.3d 322 (3d Cir. 2004); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974); *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973).

3. Rule 10b-5(b), titled *Employment of manipulative and deceptive devices*, provides in relevant part:

   > It shall be unlawful for any person, directly or indirectly . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.

the Ninth Circuit found that "important distinctions exist between Rule 10b-5 and Section 14(e) . . . that strongly militate against importing the scienter requirement from the context of Rule 10b-5 to Section 14(e)." The court explained that Rule 10b-5(b)'s scienter requirement is based not on the text of that rule but rather on the language of Section 10(b), pursuant to which Rule 10b-5 was promulgated. The court noted that in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court recognized that Rule 10b-5 could be read as imposing only a negligence standard, but held that the rule requires scienter because it was promulgated pursuant to Section 10(b), which permits regulation of only "manipulative or deceptive devices." The Ninth Circuit reasoned that "Section 14(e) differs fundamentally from Section 10(b)" in that the SEC may regulate non-fraudulent conduct under Section 14(e). The court further found that the legislative history of the Williams Act, pursuant to which Section 14(e) was enacted, also "supports a negligence standard."

Rather than reading the first clause of Section 14(e) consistently with Rule 10b-5, the Ninth Circuit found that Section 14(e) should instead be "interpreted harmoniously" with Section 17(a)(2) of the Securities Act of 1933 ("Securities Act"), which contains "nearly identical text" and "serve[s] similar purposes."[4] The Ninth Circuit explained that in *Aaron v. SEC*, 446 U.S. 680 (1980), the Supreme Court held that scienter is not a requirement for a Section 17(a)(2) claim, and that the same standard should apply to Section 14(e).

The Supreme Court is expected to resolve the circuit split on whether scienter is required for misstatement or omission claims brought under Section 14(e). Petitioners, as well as the Chamber of Commerce as amicus curiae, have raised the larger question of whether there is any basis for inferring a private right of action under Section 14(e). This issue was not raised before or addressed by the Ninth Circuit, and thus the Supreme Court may decline to reach it. The Court will hear the case later this term. A date for oral argument has not yet been set.

4. Section 17(a)(2) provides in relevant part:

> It shall be unlawful for any person in the offer or sale of any securities . . . to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

15 U.S.C. § 77q(a)(2).

Second Circuit: Reverses Dismissal of an ERISA Action Alleging Breach of the Duty of Prudence Based on the Plan Defendants' Failure to Issue an Early Corrective Disclosure in the Company's SEC Filings

On December 10, 2018, the Second Circuit reversed dismissal of an ERISA action against the fiduciaries of a technology company's employee stock ownership plan ("ESOP"). [*Jander v. Ret. Plans Comm. of IBM*, 910 F.3d 620 (2d Cir. 2018) (Katzmann, C.J.)]. Plaintiffs claimed that the Plan defendants breached their duty of prudence by failing to disclose inside information concerning the overvaluation of one of the company's business divisions. The Second Circuit found plaintiffs adequately alleged "that a prudent fiduciary in the Plan defendants' position could not have concluded" that "early corrective disclosure" of the impairment of the overvalued business, "conducted alongside the regular SEC reporting process," would have done more harm than good to the fund. The Second Circuit further held that the dismissal of plaintiffs' parallel securities fraud action for failure to adequately allege scienter did not preclude plaintiffs' ERISA action, because no heightened pleading standard analogous to the Private Securities Litigation Reform Act ("PSLRA") applies to ERISA claims.[5]

Plaintiffs Adequately Alleged that a Prudent Fiduciary Could Not Have Concluded that Disclosing the Overvaluation Would Have Done More Harm Than Good

In *Fifth Third Bancorp v. Dudenhoeffer*, 134 S.Ct. 2459 (2014), the Supreme Court held that in order "[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

5. On January 18, 2019, the Second Circuit denied defendants' petition for a rehearing. Defendants have indicated that they intend to file a petition for certiorari.

harm the fund than to help it."[6] Later in its decision, the *Fifth Third* Court instructed that "lower courts faced with such claims should also consider whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases . . . or publicly disclosing negative information would do more harm than good to the fund." The Second Circuit in *Jander* observed that the *Fifth Third* Court's first articulation of the "more harm than good" test "suggests that courts ask what an average prudent fiduciary might have thought," while the Court's "latter formulation appears to ask . . . whether *any* prudent fiduciary could have considered the action to be more harmful than helpful." The Second Circuit stated that it was "not clear which of these tests determine whether a plaintiff has plausibly alleged that the actions a defendant took were imprudent in light of available alternatives."[7]

The Second Circuit found it unnecessary to resolve this question because the court found plaintiffs "plausibly [pled] a duty-of-prudence claim even under the more restrictive 'could not have concluded' test." First, the court found that "the Plan defendants allegedly knew that [the company's] stock was artificially inflated through accounting violations." Second, the court deemed it significant that two of the Plan defendants "had primary responsibility for the public disclosures that had artificially inflated the stock price." The court found plaintiffs plausibly alleged that "disclosures could have been included within [the company's] quarterly SEC filings and disclosed to the ESOP's beneficiaries at the same time in the Plan defendants' fiduciary capacity." Third, plaintiffs cited economic analyses demonstrating that the longer a fraud is concealed, the greater the reputational harm the company suffers and the larger the ultimate stock drop. The court found that "[w]hile these economic analyses will usually not be enough on their own to plead a duty-of-prudence violation, they may be considered as part of the overall picture." Fourth, because plaintiffs alleged that the market for the company's stock was efficient, the court found no basis for a prudent fiduciary to "fear an irrational overreaction to the disclosure of fraud."

Finally, the Second Circuit found it "particularly important" that the company was "likely to sell the business and would be unable to hide its overvaluation from the public at that point." The court noted that "[i]n the normal case, when the prudent fiduciary asks whether disclosure would do more harm than good, the fiduciary is making a comparison only to the status quo of non-disclosure." Here, "however, the prudent fiduciary would have [had] to compare the benefits and costs of earlier disclosure to those of later disclosure—non-disclosure [was] no longer a realistic point of comparison." The court explained that the company ended up making a $1.5 billion payment to the buyer of the business at issue, "the announcement of which constituted a corrective disclosure to the public markets in this action." The Second Circuit determined that the allegations concerning the sale of the business "tip[ped] the scales toward plausibility."

The Dismissal of Plaintiffs' Parallel Securities Fraud Action Did Not Preclude Plaintiffs' ERISA Suit

The Second Circuit also considered "the relevance, if any, of the parallel securities fraud suit" which the district court had dismissed for failure to adequately allege scienter. Defendants contended that "allowing [plaintiffs'] ERISA claim to go forward on essentially the same facts would lead to an end run around the heightened pleading standards set out in the [PSLRA]." The Second Circuit held that the dismissal of the securities fraud action was "not preclusive" as to the ERISA action "because the PSLRA does not apply to ERISA actions." The court explained that plaintiffs in ERISA actions "are accusing defendants only of violating a fiduciary duty of prudence, which does not carry the same stigma" as an action for fraud.

6. Please click here to read our discussion of the Supreme Court's decision in *Fifth Third*.

7. In *Amgen v. Harris*, 136 S.Ct. 758 (2016), the Supreme Court found that the Ninth Circuit incorrectly held that plaintiffs adequately alleged a duty of prudence claim based on inside information. The *Amgen* Court stated that the Ninth Circuit "failed to assess whether" plaintiffs "'plausibly alleged' that a prudent fiduciary in the same position 'could not have concluded' that the alternative action would do more harm than good." The Second Circuit in *Jander* observed that *Amgen* could be read as an endorsement of the *Fifth Third* Court's "could not have concluded" formulation of the "more harm than good" test. Alternatively, the court noted that *Amgen* could also be viewed as holding simply that "allegations about why an alternative action would do more good than harm must appear in the complaint itself." Please click here to read our discussion of the Supreme Court's decision in *Amgen*.

The Second Circuit reasoned that "ERISA and the securities laws ultimately have differing objectives pursued under separate statutory schemes designed to protect different constituencies." The court stated that "[i]f plaintiffs do begin to abuse ERISA in the way Congress felt they have abused the securities laws, then Congress can amend ERISA accordingly."

The Second Circuit emphasized, however, that the dismissal of the securities fraud action was not entirely irrelevant to plaintiffs' ERISA action. While the court found plaintiffs "plausibly allege[d] that the Plan defendants had the requisite knowledge of overvaluation to raise fiduciary responsibilities," the court instructed that plaintiffs "may not allege directly or indirectly that the Plan defendants committed securities fraud."

Seventh Circuit: SLUSA Precludes State-Law-Based Securities Fraud Class Actions Even If the Proposed Class Consists of Fifty or Fewer Members

On January 24, 2019, the Seventh Circuit held that the Securities Litigation Uniform Standards Act ("SLUSA") precluded a state-law-based securities fraud class action brought on behalf of a class consisting of fewer than fifty proposed members. [*Nielen-Thomas v. Concorde Inv. Svcs.*, 2019 WL 302766 (7th Cir. 2019) (Flaum, J.)]. The Seventh Circuit found that "SLUSA's 'covered class action' definition includes any class action brought by a named plaintiff on a representative basis, regardless of the proposed class size." The court explained that an "obvious implication" of its "interpretation is that no putative securities class actions that are based on state law and otherwise meet SLUSA's requirements (they involve a covered security, allege a misrepresentation in connection with that security, *etc.*) can proceed in either federal or state court under SLUSA." In reaching its decision, the Seventh Circuit emphasized that "Congress envisioned a broad construction" of SLUSA. *Id.* (quoting *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71 (2006)).

SLUSA provides that a "single lawsuit" constitutes a "covered class action" if, *inter alia*, "(I) damages are sought on behalf of more than 50 persons or prospective class members," or "(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated." 15 U.S.C. § 78bb(f)(5)(B)(i). The court found that while "there is overlap between" Subparagraphs (I) and (II), "each subparagraph has a separate meaning." The court explained that "Subparagraph (I) includes in its scope all actions brought by groups of more than fifty 'prospective class members,'" as well "single lawsuits brought by groups of more than fifty 'persons' without any 'prospective' or 'representative' caveat on their plaintiff status." Subparagraph (II), on the other hand, "includes any action brought as a putative class action in the traditional Rule 23 meaning of the term." The court determined that "Subparagraph (II) includes all putative class actions that otherwise meet the relevant requirements in scope, regardless of the proposed class's size."

The Seventh Circuit recognized that under this construction, "a putative class action in which the proposed class exceeds fifty members could be 'covered' under both Subparagraph (I) and Subparagraph (II)." The court noted that "this redundancy is not unusual or problematic." The court explained that "this reading gives separate effect to both subparagraphs so that each covers something the other does not." Subparagraph I encompasses lawsuits brought on behalf of more than fifty plaintiffs that are not styled as class actions. Subparagraph II "includes all putative class actions with fifty or fewer proposed class members."

The Seventh Circuit reasoned that interpreting SLUSA to "preclude all [state-law-based securities fraud] actions brought using the class-action device, not just classes alleged to include more than fifty people," comports with "SLUSA's enactment history and legislative purpose."[8] The court explained that "Congress passed these amendments to combat a specific problem—litigants were attempting to circumvent the PSLRA's barriers to federal securities class actions by filing their class actions under state law instead." The Seventh Circuit explained that "[t]his purpose could be easily frustrated if plaintiffs bringing a state-law securities class action could simply allege that they represented a class of no more than fifty people." Absent SLUSA preclusion, "such suits could proceed through the courts until discovery identified the entire class of plaintiffs." If it turned out that "the actual class could include more than fifty persons, . . . by that time the abuses that the PLSRA sought to prevent would have already taken place."

Tenth Circuit: Pursuant to Section 929P(b) of the Dodd-Frank Act, the Conduct and Effects Tests Govern the Extraterritorial Reach of SEC Enforcement Actions

On January 24, 2019, the Tenth Circuit held that the conduct and effects tests codified in Section 929P(b) of the Dodd-Frank Act govern the extraterritorial reach of SEC enforcement actions brought under Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. [*SEC v. Scoville*, 2019 WL 302867 (10th Cir. 2019) (Ebel, J.)]. Enacted less than a month after the Supreme Court's decision in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010), Section 929P(b) amended the Exchange Act and the Securities Act to provide that district courts have jurisdiction over extraterritorial SEC enforcement actions brought under Section 10(b) of the Exchange Act or Section 17(a) of

the Securities Act if the conduct and effects tests are met.[9]

Prior to the *Morrison* decision, courts applied the conduct and effects tests to determine whether they had jurisdiction to hear extraterritorial securities fraud actions. The *Morrison* Court found that the extraterritorial reach of Section 10(b) is a merits question rather than a jurisdictional question. The *Morrison* Court determined that Section 10(b) does not apply to extraterritorial securities fraud actions, and repudiated the conduct and effects tests. The Court instead held that Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."

On March 28, 2017, the District of Utah found that *Morrison* does not limit the extraterritorial reach of SEC enforcement actions brought under Sections 10(b) and/or 17(a). *SEC v. Traffic Monsoon*, 245 F. Supp. 3d 1275 (D. Utah 2017). The court stated that Section 929P(b) reflected "a congressional intent that, in actions brought by the SEC, Sections 10(b) and 17(a) should be applied to extraterritorial transactions to the extent that the conduct and effects test can be satisfied." The court acknowledged that "the plain language of Section 929P(b) did not explicitly

8. The Seventh Circuit acknowledged that there have been "statements by both the Supreme Court and the Seventh Circuit indicating that class actions brought on behalf of fewer than fifty persons are not covered by SLUSA." For instance, in *Cyan v. Beaver County Employees Retirement Fund*, 138 S.Ct. 1061 (2018), the Court stated that "[a]ccording to SLUSA's definitions, the term 'covered class action' means a class action in which 'damages are sought on behalf of more than 50 persons.'" The Seventh Circuit found that these statements were all dicta because "[t]he Supreme Court and the Seventh Circuit in these cases did not have the opportunity or need to opine on the contexts in which Subparagraphs (I) or (II) could apply."

9. Section 929P(b) of the Dodd-Frank Act added the following language to both the Exchange Act and the Securities Act:

> The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of [either Section 10(b) of the Exchange Act or Section 17(a) of the Securities Act] involving—
>
> (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
>
> (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

15 U.S.C. §§ 77v(c) (Securities Act), 78aa(b) (Exchange Act).

overturn the core holding of *Morrison*." However, the court assumed that this omission was due to the fact that "*Morrison* was issued too late in the legislative process to reasonably permit Congress to react to it." The court also deemed it immaterial that Section 929P(b) addressed only the jurisdiction of federal courts to hear extraterritorial SEC securities fraud enforcement actions, rather than the substantive reach of Sections 10(b) and 17(a). The court reasoned that "the prevailing view of the law prior to *Morrison* was that satisfying the conduct and effects test was essential to the jurisdiction of a court to adjudicate a dispute arising under Section 10(b)." The court explained that it did "not presume that Congress intended Section 929P(b) to be a nullity."

In *Scoville*, the Tenth Circuit affirmed the

District of Utah's decision. The Tenth Circuit found it "clear that Congress affirmatively and unmistakably directed that" the antifraud provisions of the securities laws "apply extraterritorially in an enforcement action." Although Section 929P(b) addressed "the jurisdictional provisions of the securities acts," the Tenth Circuit determined that "Congress undoubtedly intended that the substantive antifraud provisions should apply extraterritorially when the statutory conduct-and-effects test is satisfied." The Tenth Circuit based this conclusion on "the context and historical background surrounding Congress's enactment of those amendments," including the title of Section 929P, *Strengthening Enforcement by the Commission*.

Applying Section 929P(b) to the case before it, the Tenth Circuit found that the SEC could bring an enforcement action under Sections 10(b) and 17(a) because the defendant "conceived and created" the relevant entity in the United States, and "created and promoted" the relevant investments while residing in the United States. The court also noted that the servers hosting the website of the entity at issue were located in the United States.

Middle District of Tennessee: Denies Class Certification Where Defendants Rebutted the *Basic* Presumption of Reliance With Evidence of Lack of Price Impact

In *Halliburton Co. v. Erica P. John Fund,* 573 U.S. 258 (2014), the Supreme Court held that although "plaintiffs need not directly prove price impact to invoke the *Basic* presumption" of classwide reliance, defendants may "defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price." On January 18, 2019, the Middle District of Tennessee found that defendants successfully rebutted the *Basic* presumption with evidence of lack of price impact. *Grae v. Corrections Corp. of Am.*, 2019 WL 266674 (M.D. Tenn. 2019) (Trauger, J.). The court further held that plaintiffs could not invoke the *Affiliated Ute* presumption of reliance for omissions because the "core" of plaintiffs' allegations concerned what the company "said, not what it failed to say." The court denied plaintiffs' motion for class certification on the grounds that individual questions of reliance would predominate over common questions.

Plaintiffs Cannot Demonstrate Price Impact Based on the Materialization of a Risk If the Market Was Already Aware of That Risk

At issue in the case before the court were allegations that a private prison operator and its executives failed to disclose quality issues with its contract prisons. On August 11, 2016, the DOJ's Office of Inspector General issued a report (the "OIG Report") detailing significant quality concerns with contract prisons, including prisons operated by defendants. The OIG Report had no impact on the company's stock price. A week later, the Deputy Attorney General issued a memorandum (the "Yates Memorandum") recommending that the federal government's Bureau of Prisons ("BOP") begin "reducing—and ultimately ending—[its] use of privately operated prisons." Through competing expert analyses, the parties disputed whether the stock price drop following the release of the Yates Memorandum demonstrated that the alleged misrepresentations had any price impact.

At the outset of its analysis, the court emphasized that "the Supreme Court has left little doubt that the court must consider evidence of a lack of price impact as a basis for overcoming the *Basic* presumption at the class certification stage." The court found "the presence of the OIG Report complicate[d] the issue of price impact considerably." The court explained that "[i]f the market learns the truth about an underlying risk to a company prior to the risk's materializing, then materialization has no concealed truth to reveal." The court stated that "[t]he value of the company's shares still might go down—but that reduction in value would be due to the damage done by the materialized risk itself, not the market's having been in the dark about the risk's existence or severity."

The court determined that any investor who read the OIG Report "would have been well-apprised of the fact that there was evidence of significant quality issues with the BOP's contract prisons, including, specifically," defendants' prisons. The court concluded that "[t]here was no concealed truth, then, left for the Yates Memorandum to disclose." The court found that "[a]ll that the [Yates] Memorandum revealed was the ensuing policy decision." The court therefore held that plaintiffs could not rely on the stock drop following the Yates Memorandum to demonstrate price impact.

The court acknowledged that defendants' evidence was "not an ironclad demonstration, beyond a reasonable doubt, that [the company's] allegedly false or misleading statements and omissions had no price impact." However, the court found the evidence "enough for [defendants] to prevail with regard to whether the court [could] rely on the *Basic* presumption to simplify and universalize the issue of reliance."

Plaintiffs Cannot Invoke the *Affiliated Ute* Presumption Because the Complaint Alleged Misleading Statements

Plaintiffs alternatively argued that they should be entitled to rely on the presumption of reliance set forth in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). The *Affiliated Ute* Court held that "positive proof of reliance is not a prerequisite for recovery" where plaintiffs' claims "involv[e] primarily a failure to disclose." Plaintiffs in *Grae* contended that their case centered on the company's "failure to disclose the many deficiencies that led to the erosion of its relationship with the BOP."

The court explained that "the distinction between misleading statements and misleading disclosures is not always crystal clear, because, in the securities fraud context, it is often what one says that determines whether one has an obligation to disclose." The court found that "[t]here is . . . a tension between the test for determining whether a defendant had a disclosure obligation and the test for whether to apply *Affiliated Ute*." This is because "[t]he disclosure case law looks at statements and omissions together, as complementary parts of a single truth or falsehood." Application of the *Affiliated Ute* presumption, on the other hand, "requires the court to pick one or the other—to decide whether a case is 'primarily' about statements or about omissions—even if a case may, in a sense, be wholly about both." The court concluded that "[t]he only way out of this seeming conundrum . . . is to construe the scope of *Affiliated Ute* narrowly, or, at least, narrowly enough to avoid creating an exception that swallows the rule."

Here, the court found that the complaint was "replete with allegations of specific false or misleading statements." The court acknowledged that the company "could have inoculated itself by disclosing more accurate information about the many deficiencies" concerning its contract prisons. However, the court stated that "[s]ome version of that premise . . . is true about every affirmative falsehood—every lie can be corrected by the truth." The court reasoned that any "version of *Affiliated Ute* that reached this case would be so broad that it would threaten the viability of reliance as an element of securities fraud altogether" and "would not be consistent with the limited purpose of the rule recognized by the Supreme Court."

The court emphasized that its ruling should not be read as a determination that defendants were "forthright in their statements about the quality of their facilities." Rather, defendants had "merely shown that, based on the Supreme Court's current case law regarding reliance in securities fraud cases, the situation at issue here is one for which reliance must be shown individually, rather than collectively."

This edition of the
Securities Law Alert was edited by
Susannah S. Geltman
sgeltman@stblaw.com / +1-212-455-2762,
Paul C. Gluckow
pgluckow@stblaw.com / +1-212-455-2653,
Linton Mann III
lmann@stblaw.com / +1-212-455-2654,
and Jonathan K. Youngwood
jyoungwood@stblaw.com / +1-212-455-3539.

Simpson Thacher

New York

Brooke E. Cucinella
+1-212-455-3070
brooke.cucinella@stblaw.com

Paul C. Curnin
+1-212-455-2519
pcurnin@stblaw.com

Stephen M. Cutler
+1-212-455-2773
stephen.cutler@stblaw.com

Michael J. Garvey
+1-212-455-7358
mgarvey@stblaw.com

Susannah S. Geltman
+1-212-455-2762
sgeltman@stblaw.com

Paul C. Gluckow
+1-212-455-2653
pgluckow@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Peter E. Kazanoff
+1-212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Linton Mann III
+1-212-455-2654
lmann@stblaw.com

Joseph M. McLaughlin
+1-212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
+1-212-455-2696
lneuner@stblaw.com

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Mark J. Stein
+1-212-455-2310
mstein@stblaw.com

Alan C. Turner
+1-212-455-2472
aturner@stblaw.com

Craig S. Waldman
+1-212-455-2881
cwaldman@stblaw.com

George S. Wang
+1-212-455-2228
gwang@stblaw.com

Jonathan K. Youngwood
+1-212-455-3539
jyoungwood@stblaw.com

David Elbaum
Senior Counsel
+1-212-455-2861
david.elbaum@stblaw.com

Janet A. Gochman
Senior Counsel
+1-212-455-2815
jgochman@stblaw.com

Los Angeles

Michael D. Kibler
+1-310-407-7515
mkibler@stblaw.com

Chet A. Kronenberg
+1-310-407-7557
ckronenberg@stblaw.com

Palo Alto

Stephen P. Blake
+1-650-251-5153
sblake@stblaw.com

Alexis S. Coll-Very
+1-650-251-5201
acoll-very@stblaw.com

James G. Kreissman
+1-650-251-5080
jkreissman@stblaw.com

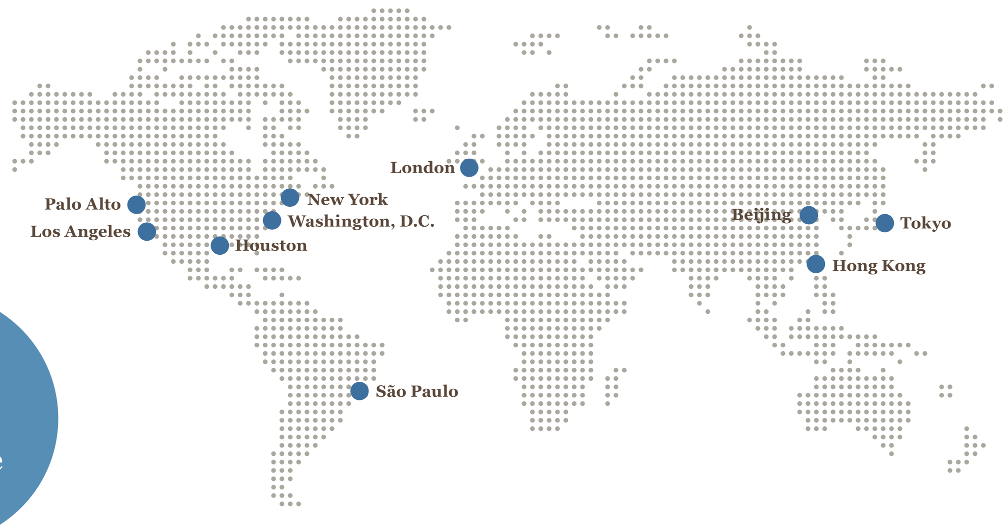
Simona G. Strauss
Senior Counsel
+1-650-251-5203
sstrauss@stblaw.com

Washington, D.C.

Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

Cheryl J. Scarboro
+1-202-636-5529
cscarboro@stblaw.com

Peter C. Thomas
+1-202-636-5535
pthomas@stblaw.com



Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000