SIMPSON THACHER

SECURITIES LAW ALERT

MAY 2011

This month's Alert discusses the oral arguments before the Supreme Court in the *Halliburton* case, which concerns the question of whether plaintiffs must establish loss causation at the class certification stage of a securities fraud action. This Alert also addresses: the Second Circuit's decision holding that rating agencies do not qualify as "underwriters" for purposes of Section 11 liability; the Seventh Circuit's decision holding that Motorola's 401(k) Plan was not entitled to share in the proceeds of a securities fraud settlement because the plan qualified as an "affiliate" of Motorola within the meaning of an exclusion to the class definition; and two rulings from the Ninth Circuit, one reinstating securities fraud claims against Ernst & Young in the Broadcom stock options backdating action, and another holding that the whistleblower provisions of the Sarbanes-Oxley Act do not protect disclosures to the media. Finally, this Alert discusses the Southern District of Florida's ruling setting aside the jury verdict in the BankAtlantic subprime action on the grounds that the plaintiffs had failed to establish loss causation.

Save the Date for Our Upcoming CLE Program

On Thursday, June 23rd at 4 pm, the Firm will host a panel discussion on recent decisions, emerging trends and breaking developments in securities and corporate litigation, including: the Supreme Court's recent ruling in *Matrixx*; the Court's consideration of the *Halliburton*, *Wal-Mart* and *Janus Capital* cases; developments in mortgage-backed securities and auction rate securities cases; and recent developments in Delaware law with respect to merger litigation, among other topics. Cocktails to follow.

The Supreme Court Hears Arguments on the Relevance of Loss Causation at the Class Certification Stage

On April 25, 2011, the Supreme Court heard oral arguments in the case of *Erica P. John Fund, Inc. v. Halliburton Co.*, No. 09–1403. At issue is the Fifth Circuit's requirement that plaintiffs seeking class certification must "establish loss causation in order to trigger the fraud-on-the-market presumption" of reliance. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 335 (5th Cir. 2010) ("*Halliburton II*"). The fraud-on-the-market presumption rests on the premise that in an efficient market, any materially misleading statement or omission is factored into the company's stock price, thus satisfying the burden of plaintiffs to establish reliance on an individual basis.

Both the Third and the Seventh Circuits have explicitly rejected the Fifth Circuit's approach. *See In re*

This edition of the Securities Law Alert was edited by Peter E. Kazanoff (pkazanoff@stblaw.com/212-455-3525) and Jonathan K. Youngwood (jyoungwood@stblaw.com/212-455-3539).

DVI, Inc. Sec. Litig., 2011 WL 1125926, at *7 (3d Cir. Mar. 29, 2011) (declining to "require plaintiffs to demonstrate loss causation at class certification" and explaining that plaintiffs need not "establish loss causation as a prerequisite to invoking the presumption of reliance in the first instance"); *Schleicher v. Wendt*, 618 F.3d 679, 687 (7th Cir. 2010) (holding that "[i]t gets the cart before the horse to insist that [a loss causation determination] be made before any class can be certified"). The Second Circuit has also held that "plaintiffs do not bear the burden of showing an impact on price" at the class certification stage, but defendants in the Second Circuit may rebut the fraud-on-the-market presumption (and defeat class certification) by "submitting evidence to show that the misrepresentations did not affect market price." *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 483, 485 (2d Cir. 2008).

The Court's ruling in *Halliburton* will likely resolve this circuit split, and provide guidance on the contours of the plaintiffs' burden with respect to loss causation at the class certification stage.

Background

On November 4, 2008, the Northern District of Texas denied class certification in a securities fraud action alleging that Halliburton Company "downplayed the company's asbestos liabilities, falsified earnings statements, and overstated the benefits of a merger with Dresser [Industries], in an effort to inflate Halliburton's stock price." *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 2008 WL 4791492, at *1 (N.D. Tex. Nov. 4, 2008) ("*Halliburton I*").

The *Halliburton I* court emphasized that "the Fifth Circuit has placed an extremely high burden on plaintiffs seeking class certification in a securities fraud case." *Id.* at *20. To "trigger the fraud-on-the-market presumption of class reliance," plaintiffs must establish loss causation "at the class certification stage by a preponderance of all admissible evidence.'" *Id.* at *2 (*quoting Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 265, 269 (5th Cir. 2007)). Plaintiffs can satisfy this requirement by either "(1) demonstrating an increase in the stock price after the release of false positive news; or (2) demonstrating a decrease in price following a corrective disclosure." *Id.* "[W]hen relying on a *decline* in the company's stock price to prove that the price had been inflated by false positive information," plaintiffs must meet the additional burden of "'show[ing] that the false statement causing the increase was related to the statement causing the decrease.'" *Id.* (*quoting Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 665 (5th Cir. 2004)).

The plaintiffs "point[ed] to eight specific [allegedly corrective] disclosures, accompanied by a drop in Halliburton's stock price," as evidence of loss causation. *Id.* at *1. The *Halliburton I* court determined that the plaintiffs failed to meet their burden because they did not "link the alleged corrective disclosures with prior actionable misrepresentations." *Id.* at *4. The court explained that "[u]nless actionable statements, which were later corrected, are identified, [p]laintiffs cannot establish loss causation." *Id.* at *5.

On appeal, the Fifth Circuit affirmed the district court's decision, finding that the plaintiffs "largely failed to identify disclosures that had a *corrective* effect linked to a specific misrepresentation, as opposed to simply a *negative* effect." *Halliburton II*, at 338.

The Justices Question What Can (and Cannot) Be Disputed at the Class Certification Stage

At the outset of oral arguments before the Supreme Court, several of the Justices questioned why plaintiffs must establish market efficiency, but not loss causation, to win class certification. "Why could [market efficiency] be disputed at the certification stage, but not the question of price impact?" asked Justice Kagan. Tr. at 4:6–8. Counsel for the plaintiffs-petitioners answered that "the issue of [an] efficient market goes to the presumption of reliance, and if the court holds at the certification stage that there is no efficient market, then the basis for presuming class-wide reliance is impacted … That cannot happen with respect to loss causation because … loss causation is a common issue." Tr. at 4:9–17.

Counsel for the plaintiffs-petitioners took the position that at the class certification stage, defendants can only rebut the presumption of reliance with "proof generally disproving the efficiency of the market." Tr. at 6:2–3. Relying on footnote 29 of the Supreme Court's decision in *Basic v. Levinson*, 485 U.S. 224 (1998), in which the Court wrote that challenges to the presumption of reliance "is a matter for trial," counsel for the plaintiffs-petitioners argued that any other challenge to the presumption of reliance is "reserved for trial." Tr. at 6:6. Justice Alito responded that this argument was "pretty thin" insofar as it was based solely on "dictum in a footnote in an opinion issued at a time when conditional class certification was permitted." Tr. at 6:10–13.

On behalf of the United States, the Solicitor General's office argued that "[t]he Fifth Circuit erred in requiring proof of loss causation at class certification" because, among other reasons, this approach involves "conducting a merits inquiry that's not tethered to the Rule 23 requirements." Tr. at 15:3–9. "[T]he Fifth Circuit took it upon itself to tighten the Rule 23 requirements," the Solicitor General's office contended. Tr. at 24:13–17. "It was not satisfied with the rules as they exist, and it took the class certification stage and turned it into a merits inquiry stage." *Id.*

Notably, counsel for the respondent-defendant stated unequivocally that "[w]e are not defending all of the [Fifth Circuit's] language." Tr. at 26:11–12. Counsel for the respondent-defendant argued that "the basic test in the Fifth Circuit … is not loss causation; it's price impact." Tr. at 26:12–15. Plaintiffs seeking class certification can "show price inflation upon a misrepresentation," or "a price decline following a corrective disclosure." Tr. at 27:10–11. Although the "showing is similar to loss causation," counsel for the respondent-defendant maintained that the price impact test is "an easier, less rigorous showing of loss causation." Tr. at 27:18–20.

When pressed by Justice Kagan to clarify whether it is the plaintiffs who have the burden of demonstrating price impact or whether the defendants may rebut price impact, counsel for the respondent-defendant stated:

> *Basic* puts the initial burden on the defendant to show the absence of price impact … Once that threshold showing is made, the burden remains on the plaintiff … to show by a preponderance of the evidence that the market price was in fact distorted.

Tr. at 28:11–17. Counsel for the respondent-defendant conceded that "the Fifth Circuit put the initial burden of production on the plaintiff and that's contrary to *Basic*." Tr. at 29:7–8.

Justice Sotomayor asked what price impact had to do with market efficiency. "[W]hat I see is a difference between saying it's an inefficient market or that the statements had no price impact for some other merits-related reason. But why does that tie to an inefficient market at all?" Tr. at 33:22–34:1. Counsel for the respondent-defendant maintained that "if the stock price was not distorted by the misrepresentation, you can't say the entire class relied upon the misrepresentation to the stock price … It is the DNA proof … of the absence of price impact." Tr. at 35:3–10.

Justice Ginsburg suggested that to adopt this theory would be to require plaintiffs to prove their entire case at the class certification stage: "[Y]our argument seems to say … to get a class certified you have to virtually prove your case on the merits … What else is left on the merits? You win on the merits if you win certification." Tr. at 35:25–36:8. Counsel for the respondent-defendant answered: "[T]hat is not our position. Our position is in order to get the class-wide presumption of reliance, it's the plaintiff's burden to plead … a public misrepresentation that was material [and] made in an efficient market." Tr. at 36:10–14.

On the issue of burdens of proof, Justice Kagan asked "what kind of evidence do you think you have to come forward with in order to flip the burden [on evidence of price impact] back to the plaintiff?" Tr. at 39:3–5. When counsel for the respondent-defendant mentioned expert testimony, Justice Kagan inquired whether defendants simply had to "put an expert on the stand … say[ing] there was no price impact, and then the plaintiffs have to make the case that there, in fact, was a … price impact at the certification stage." Tr. at 39:12–15. Counsel for the respondent-defendant answered in the affirmative. Justice Kagan stated: "Well, that does suggest that the *Basic* presumption isn't worth much in your world. That you put an expert on the stand, and the *Basic* presumption falls away." Tr. at 40:1–4.

Chief Justice Roberts asked counsel for the respondent-defendant to address the objection that plaintiffs do not have discovery at the class certification stage, and therefore should not be required to present proof of loss causation. Counsel for the respondent-defendant answered that the discovery issue is "a complete red herring" because Rule 23 permits "discovery into the merits at the class certification stage to the extent that they are relevant to the class certification issue." Tr. at 41:21–25.

In rebuttal, counsel for the petitioner-plaintiffs emphasized that "when you have pleadings, summary judgment, and trial tests for merits questions, then you don't need another merits test … at the class certification stage." Tr. at 48:24–49:2.

We will report on the Supreme Court's decision in the *Halliburton* case when it is issued in the coming months.

The Second Circuit Holds that Rating Agencies Are Not "Underwriters" Subject to Section 11 Liability

On May 11, 2011, the Second Circuit affirmed the dismissal of three actions "seeking to hold [the rating agency defendants] liable as underwriters or control persons … in violation of §§ 11 and 15 of the Securities Act of 1933 (the "'33 Act")." *In re Lehman Bros. Mortgage-Backed Sec. Litig.*, 2011 WL 1778726 at *1 (2d Cir. May 11, 2011) (Raggi, J.).

The Second Circuit found "without merit" the plaintiffs' argument that the rating agencies were 'underwriters" for Section 11 purposes "because they helped structure securities transactions to achieve desired ratings." *Id*. The court held that "the mere structuring or creation of securities does not constitute participation in statutory underwriting." *Id*. at *13. As to the plaintiffs' Section 15 claims, the Second Circuit determined that the rating agencies' "provision of advice and guidance regarding transaction structures was insufficient to permit an inference that they had the power to direct the management or policies of alleged primary violators of § 11." *Id*. at *16.

Background

According to the complaints, the rating agency defendants allegedly "exceeded their traditional roles" as "passive evaluators of credit risk" with respect to the mortgage-backed securities at issue. *Id*. at *2. The rating agency defendants allegedly "actively aid[ed] in the structuring and securitization process" by "engag[ing] in an 'iterative process' with the banks, [and] providing 'feedback' on which combinations of loans and credit enhancements would generate particular ratings." *Id*. at *2–*3. "In the course of this dialogue, issuers [allegedly] adjusted the certificates' structures until they achieved desired ratings." *Id*. at *3. The plaintiffs contended that "the [r]ating [a]gencies thus helped determine the composition of loan pools, the certificates' structures, and the amount and kind of credit enhancement for particular tranches." *Id*.

Last year, the Southern District of New York dismissed the actions on the grounds that the rating agencies "could not be liable under § 11 because they did not fall within the statutory definition of 'underwriter.'" *Id*. at *4. While the rating agencies may have "participated in creating the securities," the district court found that the rating agencies played no role in "purchasing [these securities] for resale." *Id*. The Southern District of New York also dismissed the Section 15 control person claims, finding that "the [r]ating [a]gencies' power to influence or persuade the primary violators did not constitute the requisite 'practical ability to *direct* the actions of people who issue or sell securities.'" *Id*.

The Plain Language of the '33 Act Establishes that Rating Agencies Are Not "Underwriters" Within the Meaning of Section 11

The Second Circuit held that the plaintiffs' Section 11 claims were "properly dismissed" because the rating agencies' "alleged structuring or creation of securities was insufficient to demonstrate their involvement in" activities "in connection with a distribution" of the securities at issue. *Id*. at *17.

At the outset of its analysis, the Second Circuit looked to the language of the '33 Act, which defines the term "underwriter" as follows:

> [A]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.

15 U.S.C. § 77b(a)(11). *Id*. at *5. The court found that under "[t]he plain language of the statute," the term "underwriter" encompasses only "persons who participate in the purchase, offer, or sale of securities for distribution." *Id*. "[T]he statute does not reach further to identify as underwriters persons who provide services that facilitate a securities offering, but who do not themselves participate in the statutorily specified distribution-related activities." *Id*.

Although the plaintiffs "acknowledged that § 77b(a)(11) references activities relating to the distribution of securities," they argued that Second Circuit "precedent has construed the term 'underwriter' broadly to 'include any person who is 'engaged in steps necessary to the distribution of security issues.'" *Id*. at *7 (*quoting SEC v. Kern*, 425 F. 3d 143, 152 (2d Cir. 2005)). The Second Circuit rejected this argument as a misreading of the *Kern* decision:

> [T]his precedent cannot be read to expand the definition of underwriter to those who participate only in non-distributional activities that may facilitate securities' offering[s] by others. Rather, *Kern* is fairly construed to instruct that [only] persons playing roles *essential in the actual distribution of securities* qualify as underwriters.

Id. (emphasis added).

The Second Circuit found similarly unavailing the plaintiffs' reliance on dictum in a footnote in *Pinter v. Dahl*, 486 U.S. 622 (1988) stating that Section 11 imposes liability on "many who are participants in the activities leading up to the sale" of securities. *Id*. at *8. While the *Pinter* court indicated that Section 11 "imposes participant liability," the Second Circuit emphasized that the *Pinter* court's statement "d[id] not answer the question: participation in what?" *Id*. at *9. The Second Circuit stated that "[a] plain reading of the text points us to one answer: *participation in the distribution of securities*, either through the purchase of securities from an issuer with a view towards distribution, the sale or offer of such securities by an issuer, or the underwriter of such undertakings." *Id*. (emphasis added).

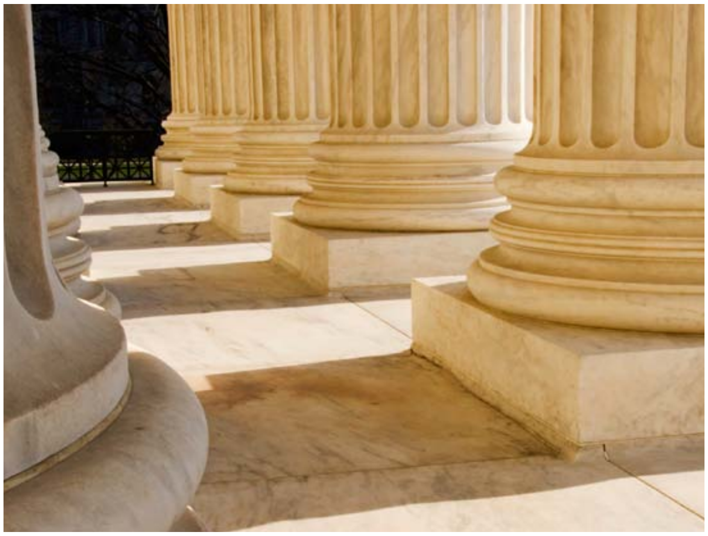
Finally, the Second Circuit found that "an examination of § 11's legislative history and purpose reinforces [the] holding that … [r]ating [a]gencies do not qualify as 'underwriters.'" *Id*. "Congress did not intend for strict underwriter liability to extend to persons merely *interested in* a distribution by virtue of their provision of non-distribution services to an offeror." *Id*. at *10. Rather, "Congress intended the participation clause of the underwriter definition to reach those who participate in purchasing securities with a view towards distribution, or in offering or selling securities for an issuer in connection with a distribution, but not further." *Id*. at *11.

Applying this interpretation of the term "underwriter" to the facts at hand, the Second Circuit "conclude[d] that plaintiffs failed to allege facts sufficient to state a plausible § 11 claim against the [r]ating [a]gency defendants." *Id*. "[E]xpanding § 11 to cover the conduct of the [r]ating [a]gencies would contradict that section's specific enumeration of liable parties, which does not include a number of persons necessary to the creation of securities, such as banks that originated the underlying loans [and] traders who structured the transactions." *Id*. at *13.

The Plaintiffs Failed to Establish that the Rating Agencies Had "Control" Over the Primary Section 11 Violators Within the Meaning of Section 15

The Second Circuit also found that the plaintiffs' Section 15 "control person" claims against the rating agencies were "properly dismissed." *Id*. at *17. "Because it [was] [allegedly] undisputed that [the] plaintiffs adequately pleaded primary § 11 violations by the certificates' issuers or depositors, the only question on appeal [was] whether the facts alleged permit an inference that the [r]ating [a]gencies controlled the primary violators." *Id*. at *14.

The Second Circuit defined the term "control" as "the power to direct or cause the direction of the management and policies of [the primary



violators].” *Id*. Applying this definition, the Second Circuit found that the allegations here “[a]t most … suggest that the [r]ating [a]gencies provided advice and ‘strategic direction’ … on how to structure transactions to achieve particular ratings.” *Id*. at *15. “Such purported involvement in transaction-level decisions falls far short of showing a power to direct the primary violators’ management and policies.” *Id*. The Second Circuit explained that “allegations of advice, feedback, and guidance fail to raise a reasonable inference that the [r]ating [a]gencies had the power to *direct*, rather than merely inform, the banks’ ultimate structuring decisions.” *Id*. “[P]roviding advice that the banks chose to follow does not suggest control.” *Id*.

The Seventh Circuit Rules That Motorola’s 401(k) Plan Is Ineligible to Share in the Settlement Proceeds of a Securities Fraud Action Against the Company

On May 4, 2011, the Seventh Circuit held that Motorola, Inc.’s 401(k) Profit-Sharing Plan (the “Plan”) was not entitled to a share of the settlement proceeds in a securities fraud action brought against Motorola and its then-principal officers because the Plan was an “affiliate” of Motorola within the meaning of an exclusion to the class definition. *See In re Motorola Sec. Litig.*, 2011 WL 1662838 (7th Cir. May 4, 2011) (“*Motorola II*”) (Sykes, J.).

Background

In 2003, purchasers of Motorola common stock brought a securities fraud class action alleging that the company “artificially inflated the prices of its securities … by making materially false and misleading statements regarding a deal with Telsim, a Turkish wireless provider.” *Id*. at *2. After the case settled, the Plan submitted a claim for a share of the settlement proceeds.

The district court denied the Plan’s claim on two grounds. First, the court “noted that the class definition was limited to persons who purchased publicly traded Motorola common stock.” *Id*. at *1. Since Plan participants purchased Motorola Stock Fund units rather than Motorola common stock, the district court found that the Plan was “not a member of the class.” *Id*. Second, the court “relied on the exclusion in the class definition for any ‘affiliate’ of Motorola” to find that the Plan “was specifically excluded from the class.” *Id*.

The Seventh Circuit Affirms, But On “Somewhat Different” Grounds

Although the Seventh Circuit affirmed the district court’s decision, the appellate court relied on “somewhat different reasoning.” *Id*. The *Motorola II* court “disagree[d] that the Plan is excluded from the class because the participants did not themselves purchase Motorola common stock.” *Id*. Although the Plan’s participants did not purchase Motorola common stock, it was “undisputed” that the Trustee of the Profit-Sharing Committee of the Plan “periodically purchased Motorola common stock on the open market to ensure that the Motorola Common Stock Fund held a sufficient quantity of Motorola stock to account for the participants’ unit transactions in the Fund.” *Id*. at *1, *5. The Seventh Circuit emphasized that “the claim was filed by the Plan,” not the Plan’s participants. *Id*. at *1.

The Seventh Circuit “agree[d], however, that the Plan is an affiliate of Motorola and on this basis is excluded from the class.” *Id*. In “arriv[ing] at this conclusion,” the *Motorola II* court relied on a “slightly different analysis” than the district court. *Id*. The

district court had relied on "an ordinary-meaning definition of 'affiliate,' using the Sixth Edition of *Black's Law Dictionary*, which defines 'affiliate' as 'a condition of being united; being in close connection, allied, associated, or attached as a member or branch.'" *Id*. at *5. Applying this definition, the district court found that there was a sufficiently "close connection" between Motorola and the Plan to render the Plan an affiliate of Motorola. *Id*. The district court found it significant that "the Plan's administrators were either Motorola directors or appointed by Motorola directors, and for a period of time, both Motorola and the Plan were represented by the same attorneys." *Id*.

The Seventh Circuit applied the "more specialized meaning [of the term "affiliate"] under federal securities law," instead of the ordinary definition of the term. *Id*. "This is a securities-fraud action," the *Motorola II* court wrote, "and as such, federal securities law should inform the meaning of the term 'affiliate' as it appears in the class definition." *Id*. According to the Ninth Edition of *Black's Law Dictionary*, the term "affiliate" is defined specifically within the securities law context as "[o]ne who controls, is controlled by, or is under common control with an issuer of a security." *Id*. at *7. The Seventh Circuit observed that "this more appropriate contextual definition," taken together with Securities & Exchange Commission rules referencing the term "affiliate," establishes that "'control' by or in common with the issuer of a security is the key inquiry in assessing whether an entity is an affiliate." *Id*.

Here, the Seventh Circuit found that "the Profit-Sharing Committee, as Plan Administrator, had managerial control over the policies and operation of the Plan" in view of "the Plan's structure and the requirements of ERISA." *Id*. The *Motorola II* court further determined that "Motorola controlled the [Profit-Sharing] Committee through appointment and removal of its members." *Id*. at *8. Thus, the Seventh Circuit held that "Motorola had structural organizational control over the Plan" to a "degree … sufficient to make the Plan an affiliate of Motorola." *Id*.

The Seventh Circuit rejected the Plan's argument that "the [Plan] participants, and not the Profit-Sharing Committee, controlled the Plan" because they "controlled decisions to buy or sell units in the Motorola Stock Fund and retained voting control over the Motorola common stock allocated to their accounts." *Id*. While "Plan participants could direct their own investment decisions," the *Motorola II* court explained that "their choices were severely circumscribed by Plan administrators" and "[t]itle to the stock was held by the Trustee of the Fund, not the participants." *Id*.

Notably, the Seventh Circuit stated that "the question of control for purposes of being considered an 'affiliate' does not require that the [Profit-Sharing Committee] had the kind or degree of control necessary to be deemed an ERISA fiduciary." *Id*. This issue was relevant because "there [had been] some threshold questions about whether the [Motorola] defendants were ERISA fiduciaries" in related ERISA class actions filed by the Plan's participants. *Id*. at *4. On appeal in these ERISA actions, the Seventh Circuit had "assumed for the sake of argument that [the Motorola defendants] were [ERISA fiduciaries]," but had nonetheless "conclude[d] that the record was insufficient to raise a material issue for trial regarding whether ERISA duties had been breached." *Id*.

The Ninth Circuit Reverses the Dismissal of Securities Fraud Claims Against Ernst & Young in the Broadcom Class Action

On April 14, 2011, the Ninth Circuit reinstated securities fraud claims against Ernst & Young ("EY") in connection with a class action stemming from an allegedly "fraudulent $2.2 billion stock options backdating scheme" involving Broadcom Corporation. *New Mexico State Investment Council v. Ernst & Young LLP*, 2011 WL 1419642, at *1 (9th Cir. Apr. 14, 2011) (Zouhary, J.). The plaintiffs alleged that "EY, as Broadcom's auditor, knew of, or recklessly disregarded, Broadcom's fraudulent backdating actions yet issued unqualified audit opinions attesting to the validity of Broadcom's financial statements." *Id.*

In finding that the plaintiffs had adequately alleged scienter as to EY, the Ninth Circuit explained that it is "[t]ypically … difficult" to meet the scienter requirement with respect to outside auditors because "outsider auditors have more limited information than, for example, the company executives who oversee the audit." *Id.* at *6. The Ninth Circuit also noted that "courts are not ideally positioned to second guess" an outside auditor's "'complex and subjective professional judgments.'" *Id.* Notwithstanding these hurdles, the Ninth Circuit held that "the allegations [against EY] … present at least as strong an inference of scienter as any competing innocent inference." *Id.* at *11.

Background

In January 2007, Broadcom restated its financial results for the fiscal years 1998 through 2005, and acknowledged that it "had improperly accounted for $2 billion in income, largely due to improper option backdating." *Id.* at *2. The plaintiffs claimed that EY was "complicit" in Broadcom's alleged "stock option backdating scheme." *Id.* at *1.

The plaintiffs' allegations against EY centered on its issuance of an unqualified opinion in 2005 (the "2005 Opinion") covering the years 2003 through 2005. The 2005 Opinion noted that the financial statements "'present fairly, in all material respects, the consolidated financial position of Broadcom'" for the years covered, and indicated that "EY had performed the audit in accordance with generally accepted accounting standards ('GAAS')." *Id.* at *2. According to the complaint, "EY was, or should have been, aware of significant accounting problems within audit years covered by its 2005 Opinion." *Id.* at *4.

The plaintiffs alleged scienter based, *inter alia*, on three instances that would allegedly "compel a reasonable auditor to further investigate and disclose Broadcom's backdating of options: (1) a large grant of options on May 26, 2000 for which EY was given no documentation; (2) options granted in 2001 during a period when Broadcom's compensation committee did not have a quorum due to the death of one of its members; and (3) EY's direct involvement in 2003 with corrective reforms to Broadcom's prior options practices." *Id.* The Ninth Circuit found that these allegations "were each sufficient to support an inference of scienter by EY." *Id.* at *3. "When viewed in totality," the court held that "there is no doubt the allegations … present at least as strong an inference of scienter as any competing innocent inference." *Id.* at *11.

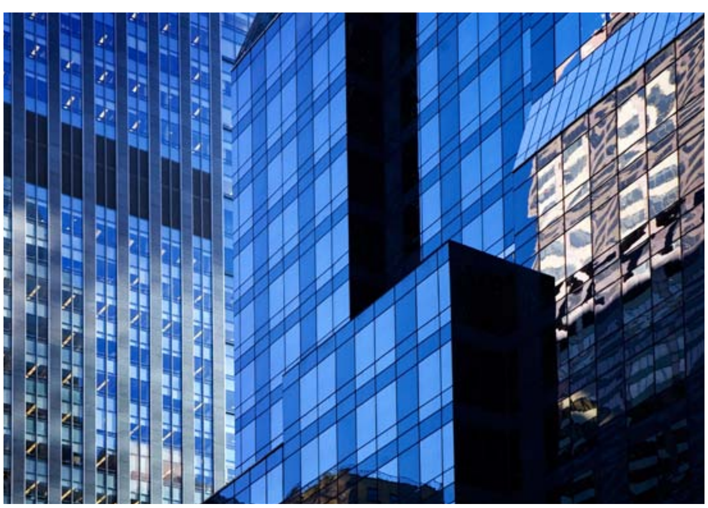
The Ninth Circuit Holds That the Plaintiffs' Allegations Were Sufficient to Raise an Inference of Scienter

At the outset of its scienter analysis, the Ninth Circuit rejected the district court's suggestion that "scienter allegations against accountants or auditors carry 'a little bit of a heavier burden.'" *Id.* at *3. The court explained that it has "previously advised against developing 'separate[ ] rules of thumb for each type of scienter allegation.'" *Id.*

"In examining allegations of scienter" against outside auditors, the Ninth Circuit noted that "courts have looked at a range of factors for potential 'red flags,' including the interaction of auditors with company executives and the breadth and scope of the auditor's deviation from GAAP or GAAS." *Id*. at *6. "The 'red flag' doctrine guides the GAAP and GAAS inquiries: the more facts alleged that should cause a reasonable auditor to investigate before making a representation, the more cogent and compelling a scienter inference becomes." *Id*. A "misapplication of accounting principles" is not sufficient to establish scienter. *Id*. Rather, "[t]he plaintiff must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made such that no reasonable accountant would have made the same decisions if confronted with the same facts." *Id*.

EY's Awareness of the May 2000 Backdated Option Grant

Applying these standards to the May 2000 backdated option grant, which vested over a four-year period, the Ninth Circuit found that "the grant was, at a minimum, suspicious in not only its timing but its relative size." *Id*. at *7. The grant was "the largest … in the company's young history and the potential $700 million impact on Broadcom's earnings was material." *Id*. The Ninth Circuit found that EY's "failure to investigate such a large grant was not minor or technical in nature, and it is hard to imagine how a reasonable auditor, confronted with the same set of circumstances, would fail to obtain some documentation to verify" that the grants were issued appropriately. *Id*. In the court's view, "EY knew, or should have known, [that] the May 2000 options were not legitimate." *Id*.



The Ninth Circuit rejected EY's claim that "its failure to further investigate amounts to, at most, negligence." *Id*. at *8. Explaining that EY "owes its ultimate allegiance to the company's creditors and stockholders, as well as to the investing public," the Ninth Circuit held that "an auditor, in fulfilling duties of public trust, should take a long hard look at a transaction of $700 million, roughly a quarter of Broadcom's reported revenue in 2006 of $2.5 billion." *Id*.

As to EY's argument that the "[p]laintiffs cannot show a concrete connection between the auditors who performed the audit in 2000 and those who issued the 2005 Opinion," the Ninth Circuit ruled that "EY cannot insulate itself from accountability for multiple years of approved financial statements with a 'right hand, left hand' defense." *Id*. The court held that EY could have limited its 2005 Opinion to "the years for which it is confident in the audit." *Id*. Having failed to do so, EY "cannot now disclaim those prior opinions simply because the same individuals were not involved." *Id*.

EY's Approval of Option Grants Issued When Broadcom's Compensation Committee Was Not Legally Constituted

With respect to allegations that EY failed to "audit option grants allegedly awarded on dates when Broadcom's compensation committee … was not legally constituted due to the death of one of the committee members," the Ninth Circuit found that the complaint "pleads sufficient facts to support a strong inference of scienter." *Id*. at *9. The court held that although the complaint "indicates that Broadcom executives may have attempted to deceive EY, there is an equal inference that EY overlooked significant events without further questioning or investigation." *Id*. "The failure of EY to follow up on the grant approvals, and to sign off on these options months later after reviewing false documentation, sufficiently pleads an audit so deficient that the audit amounted to no audit at all." *Id*.

The court also considered it relevant that the questionable option grants ultimately required a compensation expense of $569 million. *Id*. "While … magnitude alone is not sufficient to support a finding of scienter, large GAAP and GAAS violations can play a role in finding scienter." *Id*.

EY's Involvement in Broadcom's 2003 Corrective Reforms

As to the plaintiffs' claims that "EY had direct knowledge of the irregularities in Broadcom's option granting process due to EY's participation in 'corrective' reforms undertaken in 2003 to ensure future options grants were treated properly," the Ninth Circuit found that "the allegations strongly suggest that EY knew of … improper stock option grants but made no communication and took no action" with respect to these grants until "Broadcom announced its restatement several *years* later." *Id*. at *10. The Ninth Circuit held that "[t]his scenario survives a motion to dismiss." *Id*.

The Ninth Circuit Holds that the Whistleblower Provisions of the Sarbanes-Oxley Act Do Not Protect Disclosures to the Media

On April 5, 2011, the Ninth Circuit held that "[l]eaks to the media are not protected" under the "express terms" of the whistleblower provisions of the Sarbanes-Oxley Act set forth at 18 U.S.C. § 1514A(a)(1). *Tides v. The Boeing Co.*, 2011 WL 1651245, at *1 (9th Cir. May 3, 2011) (Silverman, J.). The appellate court found that these whistleblower protections are explicitly limited to "employees of publicly-traded companies who disclose certain types of information only to the three categories of recipients specifically enumerated in the Act—federal regulatory and law enforcement agencies, Congress, and employee supervisors." *Id*.

Background

In January 2007, plaintiffs Matthew Neumann and Nicholas Tides began serving as auditors in The Boeing Company's IT Sarbanes-Oxley ("SOX") Audit Group. The plaintiffs contended that "management [allegedly] pressured IT SOX auditors to rate Boeing's internal controls as 'effective' and [allegedly] fostered a generally hostile work environment." *Id*. Starting in February 2007, the plaintiffs allegedly "began separately expressing concerns about … deficiencies in Boeing's perceived auditing practices that they viewed as potential violations of SOX." *Id*.

In late April 2007, a reporter from the *Seattle Post-Intelligencer* reached out to the plaintiffs in connection with an article on Boeing's SOX compliance. In late May 2007, plaintiff Neumann "agreed to speak with [reporters from the *Post-Intelligencer*] about Boeing's compliance with SOX." *Id*. at *2. During the interview, Neumann "described the pressure he felt to render positive audit results." *Id*. In July 2007, plaintiff Tides also reached out to the *Post-Intelligencer* following "what he viewed as a negative and unsubstantiated performance evaluation." *Id*. He turned over a series of emails "document[ing] the concerns he had previously raised with management and human resources regarding perceived problems with the IT SOX Audit group's auditing practices." *Id*.

On July 17, 2007, the *Post-Intelligencer* ran an article "detail[ing] … a threatening company culture perceived by employees involved in SOX compliance, a record of poor internal audits indicating that many of the company's computer system controls were failing, and an internal allegation that audit results were being manipulated." *Id*. Following an investigation at Boeing, the plaintiffs "admitted to speaking with the [reporter from the *Post-Intelligencer*] about Boeing's auditing practices and to providing her with company documents." *Id*. Boeing subsequently terminated their employment.

In December 2007, the plaintiffs filed SOX whistleblower complaints with the Occupational Safety and Health Administration, and subsequently filed complaints in district court. In February 2010, the district court granted Boeing's motion for summary judgment in the consolidated cases.

The Ninth Circuit Finds that Disclosures to the Media Are Not Protected Under the Plain Language of § 1514A(a)(1)

The key issue on appeal was "whether the plaintiffs' disclosures to the *Post-Intelligencer* were protected under § 1514A(a)(1)," the whistleblower provisions of the Sarbanes-Oxley Act. *Id*. at *4. In the plaintiffs' view, these disclosures "were protected … because reports to the media may eventually 'cause information to be provided' to members of Congress or federal law enforcement or regulatory agencies." *Id*. The Ninth Circuit "decline[d] to adopt such a boundless interpretation of the statute." *Id*.

"If Congress [had] wanted to protect reports to the media under § 1514A(a)(1), it could have listed the media as one of the entities to which protected reports may be made." *Id*. Or Congress could have chosen to "protect[ ] 'any disclosure' of specified information." *Id*. But the Ninth Circuit explained that Congress "took neither course, opting instead to limit protected activity to employees who raise certain concerns of

fraud or securities violations with those authorized or required to act on the information." *Id*.

The Ninth Circuit found that the plaintiffs' proposed construction would effectively eviscerate any limits on the statute's reach: "If … the disclosure of information to the media is protected on the ground that it may ultimately fall into the hands of a member of Congress or a federal regulator, then virtually *any* disclosure to *any* person or entity would qualify as protected whistleblower activity." *Id*. at *5. The Ninth Circuit found no basis for "afford[ing] such an expansive meaning to the statutory language." *Id*.

Affirming the grant of summary judgment in favor of Boeing, the Ninth Circuit held unequivocally that "§ 1514A(a)(1) does not protect employees of publicly-held companies from retaliation when they disclose information regarding designated types of fraud or securities violations to members of the media." *Id*. at *6.

The Southern District of Florida Sets Aside the BankAtlantic Subprime Verdict For Failure to Establish Loss Causation

On April 25, 2011, the Southern District of Florida granted the defendants' motion for judgment as a matter of law and set aside the jury's verdict in the subprime securities fraud suit brought by investors in BankAtlantic Bancorp, Inc. ("Bancorp"), the publicly-traded parent company of BankAtlantic. *See In re BankAtlantic Bancorp, Inc. Sec. Litig.*, 2011 WL 1585605 (S.D. Fla. Apr. 25, 2011) (Ungaro, J.).

The plaintiffs alleged that the defendants "misrepresented and concealed the true quality and consequent value of certain assets in BankAtlantic's loan portfolio." *Id*. at *1. The case went to trial, and on November 18, 2010, the jury "returned a verdict mainly in [the] [d]efendant's favor." *Id*. at *6. However, the jury did find the defendants liable for "$2.41-per-share damages caused by Statement 10," an April 26, 2007 statement regarding the risks in Bancorp's land loan portfolio made by Alan Levan, former Chairman of the Board and CEO of Bancorp and former Chairman of the Board and President and CEO of BankAtlantic. *Id*. at *7.

Following the verdict, the defendants moved for judgment as a matter of law on the grounds that the plaintiffs "failed to put forth sufficient evidence at trial to support any of the elements of a Rule 10b–5 claim as to Statement 10 (or any other statement)," among other arguments. *Id*. at *8. The court focused its analysis on "whether the evidence supported a finding that Statement 10 was an actionable misrepresentation or omission and, if so, whether the evidence supported a finding of loss causation or damages as to Statement 10." *Id*. Because the court concluded that the "evidence of loss causation or damages was insufficient as to Statement 10," it did not address the defendants' remaining arguments. *Id*.

Background

The court found that by early 2007, the defendants had begun to "take notice of negative performance trends within the land loan portfolio." *Id*. at *10. "As the deadline for filing 2007 first-quarter financial results approached," BankAtlantic began to differentiate between "what came to be called the 'builder land bank' or 'BLB' loans and the remainder of the loan portfolio." *Id*. at *11. BLB loans were made to developers who relied on revenue from option contracts with homebuilders to "meet their loan obligations to Bank Atlantic on a timely basis." *Id*. Non-BLB land loans were also made to developers, but did not involve option contracts with homebuilders. The court determined that "[t]he problems [the] [d]efendants observed in the land loan portfolio were not limited to either the BLB or non-BLB land loans—they were spread throughout the portfolio." *Id*.

On April 26, 2007, Bancorp announced its first quarter 2007 financial results in an 8-K press release, explaining that "[t]he current environment for residential land acquisition and development loans is a concern" and cautioning investors that "we may experience further deterioration in the portfolio over the next several quarters." *Id*. While the press release did not differentiate between BLB and non-BLB loans, "Alan Levan emphasized the risks of the BLB land loans to the exclusion of the remaining land loans" during the first-quarter earnings conference call held that same day. *Id*. "This was the first time Alan Levan or Bancorp publicly distinguished the BLB portfolio from the remainder of the land loan portfolio." *Id*. at *12.

When an investment analyst inquired about the composition of Bancorp's loan portfolio, Alan Levan explained that "lots of our portfolio is a construction portfolio that we're not in any way concerned about." *Id*. at *13. This statement is identified as Statement 10.

On October 25, 2007, Bancorp announced its third quarter 2007 financial results, disclosing that Bancorp had "suffered a loss from continuing operations of $29.6 million" and that BankAtlantic had "suffered a net loss for the quarter of $27.1 million." *Id.* at *14. The press release attributed BankAtlantic's loss to "increased loan loss provisions and impairments of real estate owned and held for sale," and identified "net interest margin compression and costs associated with operating new stores" as "[o]ther factors contributing to the decline." *Id.* In addition, the press release announced that "BankAtlantic's loan loss provision for the quarter was $48.9 million." *Id.* Although Bancorp did not "break down the [loan loss] provision across the various segments of its loan portfolio," the company "detailed the deterioration across the entire land loan portfolio" for "the first time." *Id.* Bancorp's stock price dropped by $2.93 on the day the third-quarter losses were announced. *Id.* On October 26, 2007, the company filed the press release as an 8-K.

The Court Finds that the Plaintiffs Presented Sufficient Evidence for a Jury to Find that Statement 10 Was Actionable

"Given the context" of Statement 10, the court held that "a jury could have found that when Alan Levan professed a lack of concern as to 'lots of our portfolio,' he was essentially stating that he was only concerned with the BLB land loans and *not* with the entire land loan portfolio." *Id.* at *13. The court ruled that "the evidence supports a finding that Statement 10 is actionable" with respect to the non-BLB land loans. *Id.*

Prior to the April 26, 2007 conference call, Alan Levan had "internally expressed undifferentiated concern regarding the *entire* land loan portfolio." *Id.* (emphasis added). The court determined that "[b]ased on th[e] evidence a jury could have found that Alan Levan falsely professed a lack of concern about the remainder of the land loan portfolio" and that Statement 10 was "an actionable concealment of the risk of substantial losses to the non-BLB land loans." *Id.* at *13–*14.

The Court Holds that the Plaintiffs Failed to Establish Loss Causation With Respect to Statement 10

The court concluded that the evidence did not support the plaintiffs' contention that "the revelation of this risk was the *sole cause* of the $2.93 decline in Bancorp's stock price on October 26, 2007." *Id.* (emphasis added). "To establish that the price decline resulted from the revelation," the plaintiffs relied "exclusively" on the trial testimony of an expert who, according to the defendants, "failed to disaggregate the loss related to BLB loans, the loss related to the increase in general reserves, and the loss attributable to market forces." *Id.* at *18. The court explained that "where a fraud is revealed contemporaneously with the announcement of other negative, but non-fraud related information, plaintiffs bear the burden of disaggregating the effect of the unrelated negative information on the stock price." *Id.* at *19.

"In this case, there is no question that Bancorp announced a bundle of negative information on October 25 and 26, 2007, some of it fraud-related and some of it not fraud-related." *Id.* Yet the plaintiffs' expert did not attempt to disaggregate the negative information that did not concern land loans, "claim[ing] this information had no effect on the stock price." *Id.* She also did not attempt to disaggregate the negative information regarding the land loans, which "was itself a bundle of information," because of her assumption that "it was all fraud related, *i.e.*, that the fraud related to the entire land loan portfolio, including the BLB loans." *Id.* In view of these deficiencies, the court held that "a jury could not have relied on [the plaintiffs' expert's] opinion—at least not with respect to Statement 10." *Id.* at *20.

NEW YORK

Bruce D. Angiolillo
212-455-3735
bangiolillo@stblaw.com

Michael J. Chepiga
212-455-2598
mchepiga@stblaw.com

Mark G. Cunha
212-455-3475
mcunha@stblaw.com

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

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

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

David W. Ichel
212-455-2563
dichel@stblaw.com

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

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

Linda H. Martin
212-455-7722
lmartin@stblaw.com

Mary Elizabeth McGarry
212-455-2574
mmcgarry@stblaw.com

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

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

Barry R. Ostrager
212-455-2655
bostrager@stblaw.com

Thomas C. Rice
212-455-3040
trice@stblaw.com

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

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

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

David J. Woll
212-455-3136
dwoll@stblaw.com

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

LOS ANGELES

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

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

PALO ALTO

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

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

WASHINGTON, D.C.

Peter H. Bresnan
202-636-5569
pbresnan@stblaw.com

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

"'particular strength in securities ...'"

—EUROMONEY BENCHMARK LITIGATION 2011

UNITED STATES

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

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

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

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

ASIA

Beijing
3919 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
Gaikokuho Jimu Bengoshi Jimusho
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

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