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This month's Alert discusses the Supreme Court's grant of *certiorari* in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds*, No. 11-1085, to address the question of whether plaintiffs must prove materiality to qualify for the fraud-on-the-market presumption of reliance at the class certification stage. We also discuss a First Circuit decision affirming the dismissal of a securities fraud action against Textron; a Second Circuit ruling addressing the standard for pleading a failure to disclose "known uncertainties" under Item 303 of Regulation S-K; and an Eighth Circuit decision reversing the dismissal of a securities fraud action against KV Pharmaceutical Company. Finally, we review a Delaware Chancery Court opinion holding that collateral estoppel does not mandate the dismissal of a derivative suit brought by Allergan shareholders.

We wish you and yours a wonderful July 4th holiday.

The Supreme Court Will Address Whether Plaintiffs Must Establish Materiality to Obtain Class Certification Under the Fraud-on-the-Market Theory

On June 12, 2012, the Supreme Court granted *certiorari* to review the Ninth Circuit's decision in *Connecticut Retirement Plans and Trust Funds v. Amgen Inc.*, 660 F.3d 1170 (9th Cir. 2011) (Silverman, J.) (*Amgen*). *Amgen, Inc. v. Conn. Ret. Plans and Trust Funds*, No. 11-1085. The Court will address "[w]hether, in a misrepresentation case under SEC Rule 10b-5, the district court must require proof of materiality before certifying a plaintiff class based on the fraud-on-the-market theory" set forth in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). Petition for a Writ of *Certiorari*, at i. The Court will also consider "[w]hether … the district court must allow the defendant to present evidence rebutting the applicability of the fraud-on-the-market theory before certifying a plaintiff class based on that theory." *Id.*

Almost exactly one year ago, the Supreme Court addressed the question of whether plaintiffs must establish loss causation in order to qualify for the fraud-on-the-market presumption at the class certification stage. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2183 (2011) (Roberts, C.J.) (*Erica P. John Fund*). The Court unanimously held that securities fraud plaintiffs "need not" "prove loss causation in order to obtain class certification." *Id.* Notably, the Court declined to address "any other question about *Basic*, its [fraud-on-the-market] presumption, or how and when [the fraud-on-the-market presumption] may be rebutted." *Id.* at 2187.

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Background

In 2009, the Central District of California granted the plaintiff's motion for class certification in a Rule 10b-5 action alleging that Amgen and several of its officers had made misstatements and omissions with respect to the safety of two Amgen pharmaceuticals. The court ruled that the plaintiff had "successfully invoked the fraud-on-the-market presumption by showing that Amgen's stock traded in an efficient market (which Amgen conceded) and that the alleged misstatements were public (which Amgen did not contest)." *Amgen*, 660 F.3d at 1174. "The district court further held that at the class certification stage, [the plaintiff] did not need to *prove*—but rather could merely *allege*—that Amgen's supposed falsehoods were material …." *Id*. The district court "declined to afford Amgen an opportunity to rebut the presumption of reliance at the class certification stage" on the grounds that "rebuttal of the presumption was a trial issue." *Id*. Amgen appealed.

The Ninth Circuit Holds that Plaintiffs Do Not Have to Prove Materiality at the Class Certification Stage

The Ninth Circuit affirmed the district court's decision, holding that "plaintiffs need not *prove* materiality to avail themselves of the fraud-on-the-market presumption of reliance at the class certification stage." *Amgen*, 660 F.3d at 1177. The court found that "[p]roof of materiality, like all other elements of a 10b–5 claim, is a merits issue that abides the trial or motion for summary judgment." *Id*. at 1172.

The Ninth Circuit explained that "plaintiffs cannot both fail to prove materiality yet still have a viable claim for which they would need to prove reliance individually." *Id*. at 1175. "If the misrepresentations turn out to be material, then the fraud-on-the-market presumption makes the reliance issue common to the class, and class treatment is appropriate." *Id*. "But

if the misrepresentations turn out to be immaterial, then *every* plaintiff's claim fails on the merits" because "materiality is an element of the *merits* of their securities fraud claim …." *Id*. "Either way," the Ninth Circuit found that "the plaintiffs' claims stand or fall together—the critical question in the Rule 23 inquiry" under the Supreme Court's decision in *Wal-Mart Stores, Inc. v. Dukes*, 131 S.Ct. 2541 (2011) (*Dukes*).[1] *Id*. at 1175.

The Ninth Circuit further determined that "the district court correctly refused to consider Amgen's truth-on-the-market defense at the class certification stage" because "the truth-on-the-market defense is a method of refuting an alleged misrepresentation's *materiality*." *Id*. at 1177.

Amgen petitioned the Supreme Court for *certiorari* to review the Ninth Circuit's decision.

Amgen Argues that the Ninth Circuit's Ruling Widens a Circuit Split on Whether Proof of Materiality Is Required for Class Certification

In its petition for *certiorari*, Amgen contended that "[t]he Ninth Circuit's decision deepens an

1. The *Dukes* Court stated that "[w]hat matters to class certification … is not the raising of common 'questions'—even in droves—but rather the capacity of a classwide proceeding to generate common *answers* apt to drive the resolution of the litigation." 131 S. Ct. at 2551 (quoting Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. Rev. 97, 132 (2009)).

irreconcilable, mature circuit split on important questions of class certification law in securities litigation." Petition for a Writ of *Certiorari* at 8.

"The Second and Fifth Circuits hold that a plaintiff must prove materiality for class certification and … defendants may present evidence to rebut the applicability of the fraud-on-the-market theory at the class certification stage."[2] *Id*. at 9 (citing *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 481 (2d Cir. 2008); *Oscar Private Equity v. Allegiance Telecom, Inc.*, 487 F.3d 261, 265 (5th Cir. 2007), *abrogated on other grounds by Erica P. John Fund*, 131 S. Ct. 2179). "The Third Circuit has adopted an intermediate approach[,]" holding that "plaintiffs need not demonstrate materiality as part of an initial showing before class certification" but permitting defendants to "rebut the applicability of the fraud-on-the-market theory by disproving the materiality of the alleged misrepresentation." *Id*. at 11 (citing *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 631 (3d Cir. 2011)). Finally, "the Seventh Circuit holds that district courts are barred from evaluating materiality at the class certification stage." *Id*. (citing *Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010)).

"Given the immense settlement pressure generated by class certification orders in securities fraud litigation," Amgen argued that "defendants in the Seventh and Ninth Circuits will frequently be forced, by practical realities, to settle cases for enormous sums regardless of whether they have a meritorious materiality defense that would rebut application of the fraud-on-the-market theory." Petition for a Writ of *Certiorari* at 15. "A rule that postpones consideration of materiality until summary judgment or trial effectively means that, in most cases, there will be no examination of materiality—at any stage of litigation." *Id*.

2. Amgen noted that "[t]he First and Fourth Circuits have also stated that a plaintiff must prove materiality at the class certification stage, albeit in dicta." *Id*. at 11, n. 2 (citing *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 7 n. 11 (1st Cir. 2005); *Gariety v. Grant Thornton LLP*, 368 F.3d 356, 364 (4th Cir. 2004)).

Amgen Contends that Plaintiffs Must Establish Materiality to Qualify for the Fraud-on-the-Market Presumption at the Class Certification Stage

Amgen argued that materiality "is just as important" as "the efficient-market and public statement predicates to the fraud-on-the-market theory." *Id*. at 19–20. In *Basic*, the Court stated that "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public *material* misrepresentations … may be presumed for purposes of a Rule 10b-5 action." 485 U.S. at 247 (emphasis added). "The premise of *Basic* is that a purchaser or seller of a security can be presumed to have *indirectly* relied on a material misstatement through that person's *direct* reliance on the integrity of the market price for the security, which price in turn reflects all material information." Petition for a Writ of *Certiorari* at 20. "Absent materiality," Amgen contended that "the fundamental premise of *Basic* is not established, because an essential link between the misstatement and the plaintiff is entirely missing." *Id*.

Amgen claimed that "[t]here is more than one reason why an alleged misrepresentation would not be reflected in the market price…." *Id*. at 21 (quotation omitted). "It may be that the market for the security is not efficient," but "it may also be that the misstatement itself is not material, in which case the statement cannot be presumed to have affected the security's price." *Id*.

"*Basic* and its logic thus require that all predicates to the fraud-on-the-market theory—including the materiality predicate—be examined before class certification to determine whether the named plaintiff has any way to prove the reliance element of a Rule 10b-5 claim on a class-wide basis." *Id.*

Amgen Argues that Defendants Must Be Entitled to Rebut the Fraud-on-the-Market Presumption Prior to Class Certification

In *Basic*, the Supreme Court held that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff" is "sufficient to rebut the presumption of reliance." 485 U.S. at 248. Amgen contended that "the fundamental logic of *Basic* requires that defendants be permitted to rebut the application of the fraud-on-the-market theory to the facts of their cases—whether that rebuttal is based on the immateriality of the statements at issue, the inefficiency of the market, or some other pertinent fact." Petition for a Writ of *Certiorari* at 23. "Given the immense settlement pressure created by class certification in securities fraud cases," Amgen argued that the defendants' right of rebuttal "would be effectively meaningless if it could not be exercised until after class certification." *Id.*

The Respondent Argues that the Ninth Circuit Correctly Applied *Dukes* and *Erica P. John Fund*

In opposition to Amgen's petition for *certiorari*, the respondent contended that "no mature, irreconcilable conflict exists" because the Ninth Circuit's ruling was "the first decision to consider the questions presented in light of *Dukes* and *Erica P. John Fund* …" Brief for Respondent in Opposition at 10, 15.

The respondent argued that "[t]he logic and holding of" the Ninth Circuit's decision "are entirely consistent with *Dukes*." *Id.* at 14. "Because the market in Amgen securities is efficient, the class-action mechanism has 'the capacity … to generate' a common answer on whether Amgen's misrepresentations were material." *Id.* (quoting *Dukes*, 131 S. Ct. at 2551).

The respondent also claimed that the Ninth Circuit's ruling "is consistent with *Erica P. John Fund*, which held that proof of loss causation is not required at the class-certification stage." *Id.* at 15. "In its decision, this Court enumerated the 'undisputed' required proofs for invoking the 'rebuttable presumption of reliance' at the class-certification stage."[3] *Id.* (quoting *Erica P. John Fund*, 131 S. Ct. at 2185). "Nowhere did this Court mention materiality." *Id.*

Former SEC Commissioners Submit an Amicus Brief in Support of Amgen's Petition

A group of former SEC Commissioners, together with a number of law and finance professors, submitted an amicus brief in support of Amgen's petition for *certiorari*. The amici argued that "[t]he crux of the fraud-on-the-market theory is that, in an efficient market, all public material information will be reflected in the price of a security." Brief of Former SEC Commissioners and Officials and Law and Finance Professors as *Amici Curiae* in Support of

3. "It is undisputed that securities fraud plaintiffs must prove certain things in order to invoke *Basic*'s rebuttable presumption of reliance. It is common ground, for example, that plaintiffs must demonstrate that the alleged misrepresentations were publicly known (else how would the market take them into account?), that the stock traded in an efficient market, and that the relevant transaction took place 'between the time the misrepresentations were made and the time the truth was revealed.'" *Erica P. John Fund*, 131 S.Ct. at 2185. (quoting *Basic*, 485 U.S. at 248).

Petitioners at 3. "An investor who purchases a security relying on the integrity of its market price relies on any *material* misrepresentations that have been made to the market." *Id.* "If, however, the value of a security reacts to *immaterial* information, then by definition the market in that security is not efficient and *Basic*'s presumption of class-wide reliance does not apply." *Id.* "Materiality is thus a critical component of the very theory that makes class certification of Section 10(b) claims possible." *Id.* "The Ninth Circuit failed to follow these important principles when it held that a Section 10(b) plaintiff need not demonstrate materiality in order to obtain class certification." *Id.*

The amici further asserted that "[t]he Ninth Circuit's misunderstanding of *Basic* has significant implications." *Id.* "Securities class actions are almost always settled once a class is certified, because the risks to a defendant of going to trial are so substantial." *Id.* "In consequence, the materiality of an alleged misstatement will in practice never be tested, beyond the pleading requirements, unless it is tested as part of the Rule 23 inquiry." *Id.* at 3–4.

Finally, the amici argued that the "three-way conflict" among the circuits "affects the vast majority of federal securities fraud actions" and "invites forum shopping[.]" *Id.* at 4.

* * *

The Court will review the *Amgen* case in October Term 2012. A date for oral argument has not been set.

The First Circuit Affirms Dismissal of a Securities Fraud Action Against Textron on Scienter Grounds

On June 7, 2012, the First Circuit affirmed the dismissal of a securities fraud suit against Textron, Inc. and a number of its officers. *Automotive Indus. Pension Trust Fund v. Textron, Inc.*, 2012 WL 2038098 (1st Cir. June 7, 2012) (Boudin, J.). While the district court had originally dismissed the complaint on materiality grounds, the First Circuit found that the question of materiality was "a close call" and relied "instead on the failure of the complaint to plead facts justifying a reasonable inference of scienter." *Id.* at *3.

Background

The case concerned reported sales at Cessna Aircraft Company, a wholly owned Textron subsidiary that accounted for approximately forty percent of Textron's 2008 revenues. In 2007 and 2008, "Textron [allegedly] made public statements assuring its investors of the strength and depth of the backlog of orders at Cessna, which Textron represented would help carry it through difficult economic times." *Id.* at *1. In January 2008, Textron's then-President, CEO, and Chairman of the Board Lewis B. Campbell stated that "Cessna was seeing 'unusually low cancellations.'" *Id.* On July 17, 2008, Campbell and another Textron executive stated that "Cessna had only seen two cancellations in the first two quarters of 2008." *Id.* And on November 4, 2008, "when Textron revised downward Cessna's jet aircraft production schedule[,]" Campbell stated that Cessna's "record aerospace and defense backlog and pending customer orders of nearly $30 billion [would] provide a cushion and ballast to weather [economic] uncertainties[.]" *Id.*

"[T]hree months later, on January 29, 2009, Textron reported substantial cuts to Cessna's production levels

due to a disappointing fourth quarter 2008: few orders, 23 cancellations, and 'an unprecedented number of deferrals' of delivery dates by customers." *Id.* "Textron stock closed at $9.09 that day, down 31 percent from the previous day[.]" *Id.* Soon afterwards, Campbell stepped down as Textron's President but remained on as its CEO and Chairman.

Plaintiffs subsequently brought suit alleging that "Textron had misstated the strength of Cessna's backlog." *Id.* at *2. The plaintiffs did "not challenge the technical accuracy of most of Textron's statements, for example, the precise dollar figures of backlog." *Id.* Rather, the plaintiffs contended that "the Cessna backlog was artificially inflated, that Textron deliberately omitted material information revealing this fact, and that Textron's officers could not have believed in the truth of their unrelentingly positive avowals of the backlog's strength." *Id.* The plaintiffs relied on statements by twenty-three confidential witnesses to allege numerous "weaknesses in the backlog[,]" such as Cessna's implementation of "lowered underwriting standards" and "generous loan repayment terms[.]" *Id.*

On August 24, 2011, the Rhode Island District Court granted Textron's motion to dismiss on the grounds that the plaintiffs' allegations were "insufficient to show that *material* information was omitted." *Id.* "The court ruled that the allegations of relaxed underwriting standards were too vague; that plaintiffs [had] failed to explain clearly how the standards [had] changed, how many loans were affected, or whether the allegedly risky loans translated into cancellations or losses; and that generous financing did not show that a customer could not afford an aircraft." *Id.* (citation omitted).

The First Circuit Finds the Question of Materiality Is a "Close Call"

On appeal, the First Circuit emphasized that "when a company makes affirmative statements, it must include whatever disclosures and qualifications are needed to avoid misleading a reasonable investor." *Id.* at *3. The court explained that "[a] substantial weakening of a company's traditional requirements for listing orders as backlogged, if slackened standards were not disclosed, could make such backlog figures materially misleading." *Id.* "If this occurred here, Textron's general warnings about the possibility of canceled orders—of which there were a number—would not rescue it from liability." *Id.* "Such warnings might insulate Textron from liability for 'forward-looking statements' like revenue projections, but not for intentionally misleading characterizations of the present or historical state of the backlog." *Id.* (citation omitted).

The First Circuit found that "[t]he confidential witnesses … provide at least some indication that underwriting standards were loosened, while Textron comforted investors with assurances of its 'traditional strong conservative underwriting process.'" *Id.* at *4. However, the court determined that it "need not decide the materiality issue because the complaint fails adequately to allege scienter." *Id.*

The First Circuit Holds the Complaint Falls far Short of Pleading Scienter

The First Circuit found that "[n]othing in the complaint suggests that any of the named officers believed, or was recklessly unaware, that the backlog's significance had been undermined by weakened underwriting standards, sales to intermediates, or any of the other flaws on which the plaintiffs rely." *Id.* "[W]hile the relatively detailed factual proffers in the complaint go some distance toward making a case for materiality," the court noted that the allegations were "considerably weaker in offering any direct evidence of guilty knowledge or fraudulent intent." *Id.* at *5.

For example, the First Circuit found that Campbell's July 2008 statement regarding low cancellation rates was "not in conflict" with "the confidential witness'[s] description of cancellations increasing 'suddenly' in

'late summer[.]'" *Id.* Moreover, allegations of "warnings by subordinates or expressions of concern by executives [were] notably absent" from the complaint. *Id.* The court also explained that "the questionable materiality of the practices [at issue] … deprive[d] any inference of scienter of forward momentum …." *Id.* at *4.

The First Circuit held that the "complaint's scienter allegations were weaker than its materiality allegations and did not even arguably fall into a gray area encouraging further proceedings." *Id.* at *6. The court therefore affirmed the dismissal of the complaint.

The Second Circuit Addresses the Standard for Pleading a Failure to Disclose "Known Uncertainties" Under Item 303 of Regulation S-K

On May 25, 2012, the Second Circuit vacated a district court order denying leave to amend a complaint alleging that Ikanos Communications Inc. and "various of its officers, directors, and underwriters" had violated Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 by failing to disclose "known defects in the [c]ompany's semiconductor chips" in the offering materials for Ikanos's March 2006 secondary offering (the "Secondary Offering"). *Panther Partners Inc. v. Ikanos Commc'ns, Inc.*, 2012 WL 1889622, at *1 (2d Cir. May 25, 2012) (*Panther Partners V*) (Parker, J.). The Second Circuit held that "the proposed complaint stated a claim because it plausibly alleged that the defects constituted a known trend or uncertainty that the [c]ompany reasonably expected would have a material unfavorable impact on revenues" under Item 303 of SEC Regulation S-K.[4] *Id.*

Background

The initial complaint alleged that "Ikanos learned in January 2006 that its VDSL Version Four chips were failing" and that the company was "forced to ship replacement products to Sumitomo Electric and NEC at [its own] expense[.]" *Id.* at *2. The complaint further alleged that "at some point, Ikanos determined that the chips had a failure rate of 25–30%." *Id.* On March 11, 2008, the Southern District of New York dismissed the complaint on the grounds that "[n]o plausibly pleaded fact[s] suggest[ed] that Ikanos knew or should have known of the scope or magnitude of the defect problem at the time of the Secondary Offering." *Panther Partners, Inc. v. Ikanos Commc'ns, Inc.*, 538 F. Supp. 2d 662, 673 (S.D.N.Y. 2008) (Crotty, J.).

The plaintiff moved for reconsideration and provided the district court with a proposed amended complaint, which "added allegations that the defect issue was becoming 'more pronounced' in the weeks leading up to the Secondary Offering, when Ikanos was receiving 'an increasing number of calls' from Sumitomo Electric and NEC; that the defect problems were 'a substantial problem' for the [c]ompany to

4. According to the court, Regulation S-K "requires registrants to '[d]escribe any known trends or uncertainties … that the registrant reasonably expects will have a material … unfavorable impact on … revenues or income from continuing operations.'" *Id.* at *5 (quoting 17 C.F.R. § 229.303(a)).

resolve; and that the Board of Directors was discussing the issue at the time it arose." *Panther Partners V*, 2012 WL 1889622 at *3. The district court denied the plaintiff's motion for reconsideration and for leave to replead, reasoning that the plaintiff was required to allege "what was going on when—and how much the defect experienced actually differed from the norm." *Panther Partners, Inc. v. Ikanos Commc'ns, Inc.*, 2008 WL 2414047, at *3 (S.D.N.Y. June 12, 2008) (Crotty, J.) (quotation omitted).

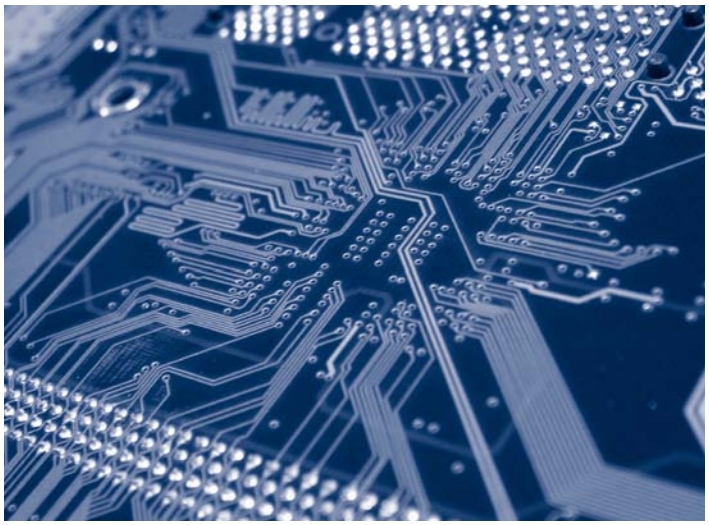
The Second Circuit affirmed the district court's dismissal of the plaintiff's complaint, and found that the proposed amended complaint "failed to allege plausibly that [Ikanos] knew of abnormally high and potentially problematic defect rates before Ikanos published the registration statement." *Panther Partners, Inc. v. Ikanos Commc'ns, Inc.* 347 F. App'x 617, 622 (2d Cir. 2009). Nevertheless, the Second Circuit vacated the district court's order denying the plaintiff's motion for reconsideration and for leave to replead because "it seems to us possible that [the] plaintiff could allege additional facts that Ikanos knew the defect rate was above average before filing the registration statement." *Id.*

On remand, the plaintiff moved for leave to file a proposed second amended complaint ("2PSAC") "adding the allegations that Sumitomo Electric and NEC were Ikanos's two largest customers and that they accounted for 72% of Ikanos's revenue in 2005." *Panther Partners V*, 2012 WL 1889622 at *4. The plaintiff "further alleged that, weeks before the Secondary Offering—when Ikanos was receiving an increasing volume of complaints from these customers—Ikanos knew it would be unable to determine which of the chip sets it sold them contained defective chips." *Id.* In November 2010, the district court again denied the plaintiff's motion for leave to amend on the grounds that the new allegations "have no logical connection to the issue of when Ikanos knew that the defect rate was above average." *Id.* (quotation omitted).

The Second Circuit Finds the 2PSAC Adequately Alleges that Ikanos Failed to Disclose "Known Uncertainties" Under Item 303 of Regulation S-K

On appeal, the Second Circuit held that the district court had "construed the proposed complaint and our remand order too narrowly" by "focusing on whether the plaintiff alleged that Ikanos knew the defect rate was 'above average.'" *Id.* at *7. The Court found that when "viewed in the context of Item 303's disclosure obligations, the defect rate, in a vacuum, is not what is at issue." *Id.* at *5. "Rather, it is the manner in which uncertainty surrounding that defect rate, generated by an increasing flow of highly negative information from key customers, might reasonably be expected to have a material impact on future revenues." *Id.*

The Second Circuit explained that "Item 303's disclosure obligations, like materiality under the federal securities laws' anti-fraud provisions, do not turn on restrictive mechanical or quantitative inquiries." *Id.* at *7. Citing the SEC's interpretive release, the court pointed out that Item 303 "imposes a disclosure duty 'where a trend, demand, commitment, event or uncertainty is both [1] presently known to management and [2] reasonably likely to have material effects on the registrant's financial condition or results of operations.'" *Id.* (quoting *Management's Discussion and*



Analysis of Financial Condition and Results of Operations, Securities Act Release No. 6835, Exchange Act Release No. 26,831, Investment Company Act Release No. 16,961, 43 SEC Docket 1330 (May 18, 1989)).

The Second Circuit found "instructive" its prior opinion in *Litwin v. Blackstone Group L.P.*, 634 F.3d 706 (2d Cir. 2011). In *Litwin*, the plaintiffs brought Section 11 and 12(a)(2) claims against Blackstone "for [allegedly] omitting from a registration statement and prospectus information regarding negative trends in the real estate market." *Panther Partners V*, 2012 WL 1889622 at *6; *Litwin*, 634 F.3d at 708.

As in *Litwin*, the Second Circuit in *Ikanos* found that the 2PSAC "plausibly alleges that the defect issue, and its potential impact on Ikanos's business, constituted a known trend or uncertainty that Ikanos reasonably expected would have a material unfavorable impact on revenues or income from continuing operations." *Id*. The 2PSAC added the "critical allegations" that Sumitomo Electric and NEC "accounted for 72% of Ikanos's revenues in 2005" and that "Ikanos knew at the time it was receiving an increasing number of calls from these customers that it would be unable to determine which chip sets contained defective chips." *Id*. "The reasonable and plausible inferences from these allegations are not simply that Ikanos quite possibly would have to replace and write off a large volume of its chip sets, but also that it had jeopardized its relationship with clients who at that time accounted for the vast majority of its revenues." *Id*. at *7. The Second Circuit found that "[i]t goes without saying that such 'known uncertainties' could materially impact revenues." *Id*.

"In light of" the 2PSAC's new allegations, the Second Circuit determined that "the Registration Statement's generic cautionary language that '[h]ighly complex products such as those [Ikanos] offer[s] frequently contain defects and bugs' was incomplete and … did not fulfill Ikanos's duty [under Item 303] to inform the investing public of the particular, factually-based uncertainties of which it was aware in the weeks leading up to the Secondary Offering." *Id*. The court therefore vacated the judgment of the district court and remanded with instructions to grant the plaintiff leave to file the 2PSAC.

The Eighth Circuit Reverses Dismissal of a Securities Fraud Action Against KV Pharmaceutical Company

On June 4, 2012, the Eighth Circuit reversed in part a district court decision dismissing a securities fraud action against KV Pharmaceutical Company and several of its officers. *Pub. Pension Fund Grp. v. KV Pharm. Co.*, 2012 WL 1970226 (8th Cir. June 4, 2012) (Bye, J.). The Eighth Circuit held that the plaintiffs had adequately alleged that KV's receipt of Form 483s from the Food & Drug Administration ("FDA") documenting "significant objectionable conditions" at KV's manufacturing facilities rendered KV's statements regarding compliance with FDA regulations and current Good Manufacturing Practices ("cGMP") misleading. *Id*. at *7.

The Eighth Circuit agreed with the district court that KV did not undertake a duty to disclose

manufacturing issues with one of its generic products simply by attributing past financial results to that product. The court also affirmed the district court's ruling that scheme liability claims must be based on conduct beyond misrepresentations or omissions under Rule 10(b)–5(b). Finally, the Eighth Circuit found that the district court had abused its discretion in denying the plaintiffs' motion for leave to amend their complaint.

Background

The plaintiffs alleged that KV had "made ten specific statements about its compliance with FDA regulations or cGMP which were false or misleading." *Id*. at *6. The plaintiffs based their claims on "the results of [a] series of inspections performed by the FDA … which were reported to KV on Form 483s."[5] *Id*. at *7. The plaintiffs also alleged that KV's statements "attributing its [past] financial success to the manufacture and sale of generic Metoprolol" were "false and misleading because KV knew and failed to disclose that its manufacturing process for generic Metoprolol violated FDA regulations, including cGMP." *Id*. at *5. Lastly, the plaintiffs asserted scheme liability claims against certain individual KV officers.

In February 2010, the Eastern District of Missouri granted KV's motion to dismiss the complaint in its entirety. "The district court determined [that] the statements KV [had] made … about compliance with FDA manufacturing regulations were not false or misleading because the [Form 483s] only listed 'observations' rather than 'violations' and were not the FDA's final agency determination on whether KV was compliant with regulations." *Id*. "The district court further determined [that] … KV did not have a duty to disclose its manufacturing issues with generic Metoprolol." *Id*. Finally, the court dismissed the plaintiffs' scheme liability claims, and denied the plaintiffs' post-judgment motion to amend the complaint.

The Complaint States a Claim that KV's Statements Regarding FDA Compliance Were False or Misleading When Made

On appeal, the Eighth Circuit held that "the issuance of Form 483s may render a defendant's statement about its compliance with FDA regulations or cGMP false, or at least misleading, in some circumstances." *Id*. at *9. The court explained that "[t]he issuance of a Form 483 represents a risk that the FDA may take corrective action against a company, and thus a company is obligated to assess the seriousness of the risk and disclose such information to potential investors if it also represents it is in compliance with FDA regulations and cGMP." *Id*. at *8.

Here, the Eighth Circuit found that "the investors' complaint pleads numerous, severe, and pervasive objectionable conditions which were outlined in the Form 483s." *Id*. at *9. The complaint also "indicates [that] KV's operations were ultimately shut down as a result of its failure to comply with the FDA's requirements, and the stock market reacted to news of the shutdown with a significant drop in the price of KV's stock." *Id*. "Under the circumstances present in this case," the Eighth Circuit "conclude[d] [that] there [was] a substantial likelihood [that] KV's disclosure of its receipt of Form 483s, during the same time period it was representing [that] it was in material compliance with FDA regulations and cGMP, would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *Id*. at *7. The Eighth Circuit reversed

5. "Form 483s are issued pursuant to FDA regulations to notify a company's 'top management in writing of significant objectionable conditions, relating to products and/or processes, or other violations … which were observed during the inspection' of a facility." *Id*. at *2 (emphasis omitted) (quoting FDA Investigations Operations Manual, Ch. 5, § 5.2.3 (2009)

the district court's dismissal of these claims, holding that "the investors' complaint adequately set forth the reasons why KV's statements about its compliance with FDA regulations and cGMP were false, or at least misleading, at the time they were made." *Id.* at *9.

KV Had No Duty to Disclose Manufacturing Issues Involving Generic Metoprolol

The plaintiffs contended that "KV had a duty to disclose the manufacturing problems associated with generic Metoprolol because KV chose to publicly highlight the product's financial success." *Id.* at *9. Agreeing with the district court's determination, the Eighth Circuit held that "KV did not undertake a duty to speak about its manufacturing problems with generic Metoprolol solely by reporting historical financial results." *Id.* at *10. The Eighth Circuit explained that "[t]he financial statements did not discuss compliance with FDA regulations, or tie KV's financial performance directly to manufacturing processes." *Id.* "As a result, KV's statements did not trigger a duty to disclose its compliance with FDA regulations, or to discuss its manufacturing problems with generic Metoprolol." *Id.*

The plaintiffs argued that the Supreme Court's decision in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) "stands for the broad proposition that a statement ascribing past financial success to a particular product is misleading unless the problems associated with the product are also disclosed." *Id.* at *11. The Eighth Circuit "disagree[d]." *Id.* "[I]n *Matrixx* there was a direct connection between the information the company failed to disclose—the adverse reports of a link between the use of Zicam and anosmia [the loss of sense of smell]—and the public statements the company made indicating the reports that Zicam causes anosmia were completely unfounded and misleading." *Id.* "In addition, the company made statements projecting future growth attributable to the product in issue." *Id.*

Here, however, "KV's statements were accurate reports of its past financial success, and there was no direct connection between those statements and the alleged manufacturing problems associated with generic Metoprolol." *Id.* Moreover, there was no allegation that "KV misled investors with projections regarding future performance, as KV only undertook to speak about its past financial success." *Id.* The Eighth Circuit "therefore conclude[d] [that] the district court did not err when it determined [that] the investors' complaint did not sufficiently plead that KV [had] made false or misleading statements about earnings tied to the manufacture of generic Metoprolol." *Id.*

Plaintiffs Cannot Base Scheme Liability Claims Solely on Misrepresentations or Omissions

With respect to the plaintiffs' scheme liability claims against two of KV's officers, the Eighth Circuit found that "[t]he only scheme liability allegations in the investors' complaint which arguably are *not* merely conclusory are those which incorporate the allegations regarding the misrepresentations or omissions about

FDA/cGMP compliance, and earnings tied to generic Metoprolol." *Id.* at *13. The district court had dismissed the plaintiffs' scheme liability claims on the grounds that "misrepresentation claims under Rule 10b–5(b) cannot simply be recast as scheme liability claims under Rules 10b–5(a) and (c) unless a plaintiff alleges [that] a defendant 'participated in a scheme that encompassed conduct beyond misrepresentation.'" *Id.* (quoting *Pub. Pension Fund Grp. v. KV Pharm. Co.*, 705 F. Supp. 2d 1088, 1104 (E.D. Mo. 2010)).

The Eighth Circuit noted that "[w]e have not directly addressed this issue in our circuit …." *Id.* at *13. However, "[b]oth the Second and Ninth Circuits have held [that] '[a] defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b–5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions.'" *Id.* (quoting *WPP Lux. Gamma Three Sarl v. Sport Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011) and citing *Lentell v. Merrill Lynch & Co.*, 366 F.3d 161, 177 (2d Cir. 2005)).

In *KV*, the Eighth Circuit "join[ed] the Second and Ninth Circuits in recognizing [that] a scheme liability claim must be based on conduct beyond misrepresentations or omissions actionable under Rule 10b–5(b)." *Id.* Because the complaint does "not allege with specificity (or otherwise) what conduct [the KV officer defendants] engaged in beyond having knowledge of the misrepresentations and omissions regarding FDA/cGMP compliance and earnings tied to generic Metoprolol," the Eighth Circuit held that the district court had "correctly dismissed the scheme liability claims against the two individual KV officers." *Id.*

The District Court Erred in Denying the Plaintiffs' Motion for Leave to Amend

After the district court dismissed the plaintiffs' complaint, the plaintiffs moved to amend their complaint to allege that "KV engaged in a criminal cover-up of its manufacturing problems starting in May 2008." *Id.* In February 2010, ETHEX, one of KV's subsidiaries, pled guilty to two felony counts of fraud allegedly "as a result of failing to report [to the FDA] the discovery of tablets that did not meet product specifications." *Id.* (citation omitted). The proposed amended complaint also alleged an additional false statement in connection with the purported cover-up. The district court denied the plaintiffs' motion to amend on the grounds that, *inter alia*, "ETHEX's guilty plea merely added evidentiary support to the original allegations which the district court had determined were insufficient to state a cause of action." *Id.* at *14. Moreover, the court found that "the cover-up conduct took place after May 2008, and therefore covered only a small portion of the relevant class period." *Id.*

On appeal, the Eighth Circuit held that the district court had "abused its discretion in denying the motion to amend the complaint." *Id.* at *15. The Eighth Circuit explained that "[t]he new allegations support[ ] the investors' contention that KV [had] made false and misleading statements during the [c]lass [p]eriod," and the court was "unaware of any legal basis for discounting this relevant information simply because it covers only a portion of the relevant [c]lass [p]eriod." *Id.* "In addition," the Eighth Circuit found that "[t]he

criminal behavior alleged in the [proposed amended complaint] was relevant to determining whether [the] new statement [alleged] was actionable in its own right, irrespective of whether the original allegations were insufficient." *Id.*

The Delaware Chancery Court Holds that Collateral Estoppel Does Not Mandate the Dismissal of a Derivative Suit Brought by Allergan Shareholders

On June 11, 2012, the Delaware Chancery Court found that the Central District of California's Rule 23.1 dismissal of a derivative suit brought by shareholders of Allergan, Inc. did not mandate the dismissal on collateral estoppel grounds of a similar derivative action brought in Delaware by a different group of Allergan shareholders. *Louisiana Municipal Police Employees' Retirement System v. Pyott*, 2012 WL 2087205 (Del. Ch. June 11, 2012) (Laster, V.C.). The court held that the California plaintiffs were not in privity with the Delaware plaintiffs because "a derivative plaintiff whose litigation efforts are opposed by the corporation does not have authority to sue in the name of the corporation" until "a Rule 23.1 motion has been *denied*."[6] *Id.* at *8.

The Delaware Chancery Court further determined that collateral estoppel was "inapplicable" because the California plaintiffs, "by filing hastily and failing to conduct a meaningful investigation …. did not provide adequate representation[.]" *Id.* at *37.

Finally, the court held that demand was "excused as futile" because the Delaware plaintiffs' complaint "alleges particularized facts that present a substantial threat of liability under the heightened Rule 23.1 pleading standard[.]" *Id.* at *8, 37.

Background

"Allergan manufactures Botox, a drug widely known for its muscle-relaxing properties." *Id.* at *2. "A small market existed for the limited Botox uses approved by the FDA before 2010." *Id.* "Treating physicians, however, were not limited to FDA-approved applications" of Botox because physicians "may prescribe an approved pharmaceutical product for any use, including uses not approved by the FDA." *Id.* "It is *illegal*, however, for a manufacturer to *market* a drug for off-label use." *Id.*

"From at least 1997, the [Allergan] Board [allegedly] discussed and approved a series of annual strategic plans that sought to expand off-label Botox sales." *Id.* at *4. "Off-label sales skyrocketed." *Id.* "By 2007, annual Botox sales for therapeutic uses totaled nearly $600 million, with 70–80% generated by off-label use." *Id.* at *5.

6. "Rule 23.1 requires that a derivative plaintiff 'allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.'" *La. Mun. Police Emps. Ret. Sys.*, at *29 (quoting Ct. Ch. R. 23.1).

On September 1, 2010, Allegan entered into a settlement with the DOJ following a "three-year joint investigation of Allergan's off-label marketing practices by the Federal Bureau of Investigation, the FDA's Office of Criminal Investigation, and the Department of Health and Human Services, Office of the Inspector General." *Id*. at *6. "Under the terms of the settlement, Allergan agreed to plead guilty to criminal misdemeanor misbranding[.]" *Id*. "The $600 million penalty [Allergan paid] equaled 96% of the company's reported net income in 2009 and exceeded both its 2007 and 2008 net income." *Id*.

On September 3, 2010, the Louisiana Municipal Police Employees' Retirement System ("LAMPERS") filed a derivative suit in Delaware relying "solely on the Allergan press release and other publicly available information." *Id*. at *6. "Within weeks, three comparably scant complaints had been filed in the California Federal Court." *Id*. at *28. The California cases were subsequently consolidated (the "California Action").

On November 3, 2010, U.C.F.W. Local 1776 & Participating Employers Pension Fund ("UCFW") sent Allergan a Section 220 demand for books and records. On July 8, 2011, LAMPERS and UCFW (together, "the Delaware plaintiffs") filed a complaint in the instant derivative suit ("the Delaware Action"). The Delaware plaintiffs relied on Allergan's internal books and records, obtained through UCFW's Section 220 demand, to support their allegations.

The defendants moved to dismiss both the Delaware Action and the California Action. On April 12, 2011, the Central District of California dismissed the California Action without prejudice. The California plaintiffs then "asked Allergan for the Section 220 production" and "subsequently filed an amended complaint that incorporated the documents [that] Allergan provided[.]" *Id*. at *7. The defendants again moved to dismiss. On January 17, 2012, the Central District of California dismissed the California Action with prejudice under Rule 23.1 for failure to plead demand futility (the "California Judgment").

Following the court's ruling, the defendants supplemented their motions to dismiss the Delaware Action to allege that "the California Judgment mandates dismissal with prejudice under the doctrine of collateral estoppel." *Id*. at *1.

Collateral Estoppel Does Not Mandate Dismissal of the Delaware Action

The defendants relied on the Central District of California's earlier decision in *LeBoyer v. Greenspan*, 2007 WL 4287646 (C.D. Cal. June 13, 2007) in support of their assertion of collateral estoppel. In *LeBoyer*, the court "applied collateral estoppel to hold that a California state court's dismissal with prejudice of one stockholder plaintiff's derivative action pursuant to Rule 23.1 barred a different stockholder plaintiff from suing derivatively." *Id*. at *17. The *LeBoyer* court "determin[ed] that successive stockholders were in privity for purposes of giving collateral estoppel effect to a Rule 23.1 dismissal" based on "the legal truism that a derivative plaintiff sues in the name of the corporation." *Id*. at 11.

In *Allergan*, the Delaware Chancery Court found that the question of "[w]hether successive stockholders are sufficiently in privity with the corporation and

each other is a matter of substantive Delaware law governed by the internal affairs doctrine." *Id.* at *9. Under Delaware law, "a stockholder whose litigation efforts are opposed by the corporation does not have authority to sue on behalf of the corporation until there has been a finding of demand excusal or wrongful refusal." *Id.* at 11. The *Allergan* court therefore held that "an earlier Rule 23.1 dismissal does not have preclusive effect on a subsequent derivative action brought by a different plaintiff because, as the earlier Rule 23.1 decision itself established, the prior plaintiff lacked authority to sue on behalf of the corporation and therefore was not in privity with the corporation or other stockholders." *Id.* at 17.

The court explained that a derivative action "has two phases—one is the equivalent of a suit to compel the corporation to sue, and the other is the suit by the corporation, asserted by the stockholders in its behalf, against those liable to it." *Id.* at *12. "The former belongs to the complaining stockholders; the latter to the corporation." *Id.* Under "controlling Delaware precedents," a stockholder "does not have the authority to assert the corporation's claims and is not suing in the name of the corporation" unless and "until the derivative action passes the Rule 23.1 stage[.]" *Id.* at *13. Prior to the point that "a Rule 23.1 motion is denied or the board decides not to oppose the derivative action," a stockholder is only "asking the [c]ourt for authority to sue in the name of the corporation." *Id.* "Indeed, where a court *grants* a Rule 23.1 motion, the fact that the suing stockholder lacks authority to sue in the name of the corporation and assert corporate claims should be clear." *Id.* "That is precisely what granting a Rule 23.1 motion means." *Id.*

Although the court found that "an earlier Rule 23.1 dismissal does not have preclusive effect on a subsequent derivative action brought by a different plaintiff[,]" the *Allergan* court noted that "the earlier decision remains persuasive authority and could operate as *stare decisis*." *Id* at *17. "When any other derivative plaintiff faces a Rule 23.1 motion involving the same transaction, the plaintiff must distinguish the new complaint or explain how the prior court erred such that the outcome of the motion would be different." *Id.*

The California Plaintiffs Did Not Adequately Represent Allergan

"As an independent basis for declining to give collateral estoppel effect to the California Judgment," the Delaware Chancery Court held that "the California plaintiffs did not adequately represent Allergan." *Id.* The court noted that "[t]he decisions that give preclusive effect to a Rule 23.1 dismissal universally recognize that another stockholder still can sue if the first plaintiff provided inadequate representation." *Id.*

Here, the Delaware Chancery Court found that "[b]y leaping to litigate without first conducting a meaningful investigation, the California plaintiffs' firms failed to fulfill the fiduciary duties they voluntarily assumed as derivative action plaintiffs." *Id.* at *28. "Rather than seeking to benefit Allergan, they sought to benefit themselves by rushing to gain control of a case that could be harvested for legal fees." *Id.* "In doing so, the fast-filing plaintiffs failed to provide adequate representation." *Id.*

The Delaware Chancery Court has previously "suggested [that] Delaware law presume that a fast-filing stockholder with a nominal stake, who sues derivatively after the public announcement of a corporate trauma … but without first conducting a meaningful investigation, has not provided adequate representation." *Id*. at *18 (citing *King v. VeriFone Hldgs., Inc*., 994 A.2d 354, 364 n.34 (Del. Ch. 2010)). In *Allergan*, the Delaware Chancery Court explained that it had "adopt[ed] and appl[ied] the fast-filer presumption in this case." *Id*. The *Allergan* court emphasized that "fast-filing imposes real costs on corporations and their stockholders." *Id*. at *19. "When plaintiffs sue derivatively to recover damages from directors and senior officers for harm suffered by the corporation, the hastily filed complaints have little chance of surviving a Rule 23.1 motion, yet the defendant fiduciaries must respond, and the corporation must underwrite the costs of defense …." *Id*. "Put simply, fast-filing generates dismissals." *Id*. at *24.

Rule 23.1 Does Not Require Dismissal of the Delaware Action

"Having determined that collateral estoppel does not require judgment for the defendants," the Delaware Chancery Court then "consider[ed] independently whether Rule 23.1 requires dismissal" based on the plaintiffs' failure to adequately allege demand futility. *Id*. at *29. The court held that "the [c]omplaint's particularized allegations raise a reasonable doubt that a majority of the Board could properly consider a demand." *Id*. at *8. "Read as a whole, the particularized allegations support a reasonable inference that the Board consciously approved a business plan predicated on violating the federal statutory prohibition against off-label marketing." *Id*. "The [c]omplaint therefore pleads a non-exculpated breach of the duty of loyalty, exposes the defendants to a substantial threat of liability, and renders demand futile." *Id*.

"In reaching this conclusion," the Delaware Chancery Court "part[ed] company with the [Central District of California] and [found] unpersuasive the analysis in the California Judgment." *Id*. at *35. The Central District of California "held that the California complaint fell short because '[t]here is still no evidence of a *decision* by board members to promote the use of off-label marketing[.]'" *Id*. (citation omitted). The Delaware Chancery Court explained that "a plaintiff does not have to point to actual confessions of illegality by defendant directors to survive a Rule 23.1 motion[.]" *Id*. "When, as here, the pled facts can support a reasonable inference that directors *in fact* approved a business plan that contemplated off-label marketing, the plaintiffs receive the benefit of the inference at the pleadings stage." *Id*.

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