Alerts and Updates

SECURITIES FRAUD CLAIMS AGAINST OUTSIDE LAW FIRM COULD NOT BE CERTIFIED AS CLASS ACTION, THIRD CIRCUIT DETERMINES

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On March 29, 2011, the U.S. Court of Appeals for the Third Circuit, in *In re: DVI, Inc. Securities Litigation*,[1] ruled that where investor plaintiffs sought to pursue a class action against a company's outside law firm accountable for behind-the-scenes contributions to an apparently fraudulent public filing, the investors had to show the deceptive conduct was publicly attributed to the law firm in order to invoke the "fraud-on-the-market" presumption of reliance. This market-wide reliance would have supported the certification of a class action against the law firm. Because the investors were unable to show that any public, misleading statements had been specifically attributed to the outside law firm, the Third Circuit decided the claim against the law firm could not be certified as a class action.

The investors contended that they bought or sold company securities in reliance on a material misrepresentation or omission in the company's public filings, and that the company's outside law firm devised a "workaround" scheme for the company to avoid having to disclose material weaknesses in its Form 10-Q. The investors did not allege that the outside law firm directly made any public misstatements; instead, liability was premised on the outside law firm's behind-the-scenes involvement in the alleged scheme to defraud investors.

When the investors asked the trial court to certify the case as a class action, the investors maintained that there was classwide reliance, under the fraud-on-the-market theory. The fraud-on-the-market theory provides that, in an open and developed securities market, the price of a company's stock is determined by the available material information about the company and its business. Under that theory, misleading statements—to the extent they become public—can support a fraud claim by purchasers of stock, even if the purchasers do not directly rely on the misstatements.

The trial court declined to certify the class action with respect to the outside law firm, finding that the fraud-on-the-market presumption of classwide reliance did not apply because none of the outside law firm's alleged conduct had been publicly disclosed. In affirming that decision, the Third Circuit held that "in order for a plaintiff to invoke the fraud-on-the-market presumption of reliance against a secondary actor [such as the behind-the-scenes law firm], the plaintiff must show the deceptive conduct was publicly attributed to that secondary actor." The Third Circuit emphasized that, even assuming the company would have issued a truthful Form 10-Q had the outside law firm not allegedly developed the workaround to avoid disclosure of the material weaknesses, the company itself still filed the 10-Q. The company remained free to do as it chose in preparing *and issuing* its financial statements, regardless of its law firm's alleged investment-related conduct.

On appeal, the Third Circuit rejected the investors' contention that the outside law firm's deceptive conduct had been communicated to the public (*i.e.*, via the allegedly fraudulent Form 10-Q), even if the outside law firm's role had not been specifically disclosed. As the Third Circuit held, "Without attribution, the market will not know, and therefore cannot rely on the deceptive conduct." In reaching its decision, the Third Circuit was guided by similar opinions from the Second and Fifth Circuits.

For Further Information

If you have any questions about this *Alert*, please contact Kelly D. Eckel, Matthew M. Ryan, any member of the Securities Litigation Practice Group, any member of the Broker-Dealer & Securities Regulation Group or the attorney in the firm with whom you are regularly in contact.

Note

1. *In re DVI, Inc. Secs. Litig.*, 2011 U.S. App. LEXIS 6302 (3d Cir. Pa. Mar. 29, 2011).