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# The Top 10 Obstacles to Litigating Securities Fraud Claims: Part I

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**Introduction**

Congress passed the Securities Act of 1933, 15 U.S.C. §§ 77a *et seq*. (Securities Act), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq*. (Exchange Act, collectively, the Acts) following the 1929 stock market crash that triggered the Great Depression. Prior to the passage of the Securities Act, President Franklin Roosevelt stated, "This proposal adds to the ancient rule of caveat emptor the further doctrine, 'let the seller also beware.' It puts the burden of telling the whole truth on the seller." The Acts were intended to be clear statutes with clear violations.

However, over the past 80 years, both Congress and the courts have significantly weakened the Acts. Paying all due respect to the retiring David Letterman, this article is the first in a two part series that counts down the Top 10 obstacles to successfully litigating securities fraud claims under the Acts.

**#10. No Tolling of the Statute of Repose**

In *Police & Fire Ret. Sys. v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013), the Second Circuit recently held that while *American Pipe* tolling (*see Am. Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 551 (1974) (holding that filing of class-action lawsuit suspends running of filing deadline for all class members)) applies to the one-year statute of limitation under Section 13 of the Securities Act, 15 U.S.C. § 77k, it does not apply to the three-year statute of repose. The Second Circuit issued a broad holding, which could, in theory, be easily be extended to eliminate tolling of the five-year statute of repose applicable to actions under Section 10(b) of the Exchange Act, 15 U.S.C. § 78, and Rule 10b-5, 17 C.F.R. § 240.10b-5, claims as well.

The Second Circuit's holding in *IndyMac* appears to conflict with the Tenth Circuit's holding in*Joseph v. Wiles*, 223 F.3d 1155, 1168 (10th Cir. 2000). Perhaps for this reason, on March 10, 2014, the Supreme Court granted certiorari in *Public Employees' Retirement System of Mississippi v. IndyMac MBS, Inc.*, No. 13-640. However, on September 29, 2014, the Court revoked certiorari as having been improvidently granted. The issue that would have been decided by the Court was whether the filing of a putative class action serves to toll under*American Pipe* the three-year statute of repose in § 13 of the Securities Act with respect to the claims of putative class members. Thus, at this time, the question remains unanswered (other than in the Second Circuit).

Some potential results of the Second Circuit holding may include institutional investors waiting to file individual actions until after the class action has progressed through discovery. On the other hand, it could also encourage early filings by institutional investors and push institutional investors to opt out of class actions earlier than before.

**#9. The Elimination of Transnational Jurisdiction**
Both Section 22 of the Securities Act, 15 U.S.C. § 77v, and Section 27 of the Exchange Act,15 U.S.C. § 78aa, vest jurisdiction in the United States District Courts for violations of the Acts. The Acts are silent as to their extraterritorial application, which left courts to address whether transnational securities frauds are covered under the Acts.

In matters involving fraud, the circuit courts had developed "conduct" and "effects" tests that permitted U.S. jurisdiction when the defendant's conduct (or failure to act) occurred within the United States, or, if the conduct occurred abroad, when that conduct caused a substantial effect within the United States. These tests provided investors a domestic forum in cases where a company's stock traded on a foreign exchange, provided the fraudulent conduct alleged had the requisite nexus to the United States.

In 2010, however, the Supreme Court rejected the "conduct" and "effects" tests. The Court developed a bright-line jurisdictional rule, holding that section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), only applied to "domestic transactions" regardless of where the fraudulent conduct occurred or if the conduct caused effects in the United States. *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2883–84 (2010).

The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 929P(b) & 929Y, 124 Stat. 1376 (2010) (Dodd-Frank Act), amended Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act to partially restore the "conduct" and "effect" jurisdictional tests, but only for enforcement proceedings brought by the Securities Exchange Commission (SEC) or Department of Justice (DOJ), and not for actions brought by private investors.

As a result, investors in companies that conduct substantial business in the United States have no domestic remedy for violations of the Acts if a company's stock trades only on a foreign exchange.

**#8. The Narrowing of What Constitutes Materiality**
Although courts usually only dismiss claims made pursuant to Section 11 of the Securities Act and Section 10(b) of the Exchange Act on materiality grounds if misstatements were minor enough that "reasonable minds could not differ on the question of their importance" (*see, e.g.*,*ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 197 (2d Cir. 2009)), a number of doctrines and principles still stand in a plaintiff's way with respect to pleading and establishing materiality. Each is addressed in turn as follows:

**"Bespeaks caution" doctrine.** Under the "bespeaks caution" doctrine, sufficient

cautionary language in a disclosure document can render an alleged omission or misrepresentation immaterial as a matter of law. *See* *Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 357 (2d Cir. 2002).

**Forward-looking statements.** SEC Rule 175, 17 C.F.R. § 230.175, creates a safe harbor for forward-looking statements in registration statements, and other specific documents, making misrepresentations in these types of statements not actionable unless the plaintiff can show that the defendant made the statement with actual knowledge of its falsity. *See* 15 U.S.C. § 77z-2(c). Examples of forward-looking statements include

- a statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
- a statement of management's plans and objectives for future operations; and
- a statement of future economic performance.

**Opinions**. For Section 10(b) claims, statements of opinion are only actionable if the statement/opinion was not honestly held by the speaker at the time the statement was made. *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1095–96 (1991).

Concerning Section 11 claims, on March 3, 2014, the Supreme Court granted certiorari in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, No. 13-435. The issue to be decided will be whether, for purposes of a claim under Section 11 of the Securities Act, a plaintiff may plead that a statement of opinion was "untrue" merely by alleging that the opinion itself was objectively wrong, as the Sixth Circuit has concluded, or whether the plaintiff must also allege that the statement was subjectively false—requiring allegations that the speaker's actual opinion was different from the one expressed—as the Second, Third, and Ninth Circuits have held.

In *Indiana State District Council v. Omnicare, Inc.*, 719 F.3d 498, 505 (6th Cir. 2013), the Sixth Circuit noted that Section 11 is a strict liability statute and held that "once a false statement has been made, a defendant's knowledge is not relevant to a strict liability claim." Thus, the Sixth Circuit concluded, "if the defendant discloses information that includes a material misstatement, that is sufficient and a complaint may survive a motion to dismiss without pleading knowledge of falsity." In contrast, in *Fait v. Regions Financial Corp.*, 655 F.3d 105, 110–13 (2d Cir. 2011), the plaintiffs claimed that certain statements concerning goodwill and loan loss reserves in the defendant's registration statement gave rise to liability under Sections 11 and 12 of the Securities Act. The Second Circuit held that a defendant's statements were opinions because they were based on subjective estimates by the company's management. The Ninth and Third Circuits reached similar holdings in *Rubke v. Capitol Bancorp, Ltd.*, 551 F.3d 1156, 1162 (9th Cir. 2009) (holding that statements of opinion "can give rise to a claim under section 11 only if the complaint alleges with particularity that the statements were both objectively

and subjectively false or misleading") and *In re Merck & Co., Inc. Sec. Derivative & ERISA Litig.*, 543 F.3d 150, 166 (3d Cir. 2008) ("[I]n the context of a claim alleging falsely-held opinions or beliefs, investors must have sufficient information to suspect that the defendants engaged in culpable activity, i.e., that they did not hold those opinions or beliefs in earnest.").

**Puffery.** Most courts conclude that "vague and general statements of optimism constitute no more than 'puffery' and are understood by reasonable investors as such." *See, e.g., In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 538-39 (3d Cir. 1999)(citing cases).

**Factual characterizations.** As long as material facts are disclosed, a failure to characterize facts in a negative manner is not actionable. *See, e.g., Ley v. Visteon Corp.*, 543 F.3d 801, 808 (6th Cir. 2008).

**Firm-specific information.** The Acts "only require" issuers to disclose firm-specific information, and there is no duty to disclose industrywide or nationwide economic information. *See Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 515 (7th Cir. 1989) ("Issuers need not 'disclose' Murphy's Law or the Peter Principle, even though these have substantial effects on business.").

**#7. The SEC's Failure to Adequately Patrol Public Markets**

There is no comprehensive enforcement by the SEC of public company disclosures. Rather, plaintiffs' lawyers end up policing the public company markets. This raises a number of obstacles to recovery. First, parallel government actions will typically lead to higher settlement amounts in private actions. Also, because an SEC complaint gives the allegations in a private action more credibility, facts uncovered in an SEC investigation can assist plaintiffs in developing a robust complaint that can overcome a motion to dismiss. Lastly, because plaintiff's firms generally work on a contingent fee basis, only the most substantial plaintiffs' firms are able to pursue certain cases where an SEC complaint is not involved.

**#6. Heightened Pleading under Rules 8 and 9 of the Federal Rules of Civil Procedure**

Rule 8 applies to claims under Section 11 that are not based on fraud. After the Supreme Court's rulings in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), however, Rule 8 no longer only requires "a short and plain statement of the claim showing that the pleader is entitled to relief" that "gives the defendant fair notice of what the . . . claim is and the grounds upon which it rests." *Conley v. Gibson*, 355 U.S. 41, 47 (1957). Now, the plaintiff's allegations, stripped of legal conclusions, must state a claim that is not merely possible, but "plausible on its face."

Historically, Section 11 was, in essence, a strict liability statute. *See In re Fleetboston Fin. Corp. Secs. Litig.*, 253 F.R.D. 315, 343 n.29 (D.N.J. 2008) (stating that Section 11 "imposes virtually strict liability on offerors and sellers directly involved in a fraudulent registered transaction"). In order to state a claim, a plaintiff only had to show that the defendant made an untrue statement or omission in a registration statement and that there was a "substantial likelihood that a reasonable

investor would consider it important." *See* *Greenapple v. Detroit Edison Co.*, 468 F. Supp. 702, 708 (S.D.N.Y. 1979), aff'd 618 F.2d 198 (2d Cir. 1980). This was especially true as to claims against issuers, as others had a "due diligence" defense to Section 11 claims. Recently, however, courts have dismissed Section 11 claims at the pleading stage, on the basis that the plaintiff's allegations are "conclusory" or "implausible."*See, e.g.*, *Berger v. Apple Reit Ten, Inc.*, No. 13-1395-cv, 2014 U.S. App. LEXIS 7583, 5 (2d Cir. Apr. 23, 2014) (affirming dismissal of Section 11 claims where plaintiffs did not plead enough facts to support conclusory allegations because "the plaintiffs ask us to make too great an inferential leap"); *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762, 774 & n.13 (1st Cir. 2011) (citing cases).

Under Rule 9(b), complaints alleging fraud must be pled with particularity. *See* *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007) ("Rule 9(b) applies to 'all averments of fraud or mistake'; it requires that 'the circumstances constituting fraud . . . be stated with particularity' but provides that '[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally.'"). Most courts have held that claims brought under the Securities Act that "sound in fraud," regardless of how a plaintiff labels the claim, must satisfy Rule 9(b)'s heightened-pleading requirement. *See, e.g.*, *ACA Fin.* Guar. *Corp. v. Advest, Inc.*, 512 F.3d 46, 68 (1st Cir. 2008) ("Where section 12(a)(2) claims are grounded in fraud, Rule 9(b) applies."); *Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004) (Rule 9(b) applies to claims brought under Sections 11 and 12(a)(2) of Securities Act when claims are grounded in fraud and not in negligence); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 288 (3d Cir. 1992) (same).

**To Be Continued**

In Part II, which will appears in the next issue of *Securities Litigation Journal*, we will discuss the Top 5 obstacles, including important subjects such as heightened-pleading requirements, the elimination of group pleading, recklessness, discovery stays, and class certification. We believe our description of these remaining obstacles will aid practitioners in both preparing complaints and defending against them.

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