ROUNDTABLE

Securities Litigation

EXECUTIVE SUMMARY

This month's discussion focuses on loss causation at the class certification stage in the circuit courts, establishing scienter against senior executives when the alleged fraud concerns the company's core operations, and conduct by solicitors and feeder funds that would make them more than aiders and abettors in the Madoff fraud. Our panels of experts from Northern and Southern California discuss these issues from the defense and plaintiff perspectives. They are Dale E. Barnes and Frank Kaplan of Bingham McCutchen; Jeffrey W. Lawrence of Coughlin Stoia Geller Rudman & Robbins; Richard H. Zelichov of Katten Muchin Rosenman; and Penelope Graboys Blair and Michael D. Torpey of Orrick, Herrington & Sutcliffe. The roundtable was moderated by Kristin Stark, senior director at Hillebrandt, and reported for Barkley Court Reporters by Krishanna DeRita.

MODERATOR: Does the Fifth Circuit's decision in *Flowserve* alter the application of loss causation at the class cert stage in light of *Oscar* and the other Circuit Court decisions (*Alaska Elec. Pension Fund v. Flowserve Corp.*, 2009 WL 1740648 (5th Cir. 2009); (*Oscar Private Equity Inv. v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007))?

BLAIR: *Flowserve* tees up a few interesting issues. One is the issue of burden of proof at class certification and who has the burden to show loss causation and whether there is a rebuttable presumption. There's a difference right now between the Fifth and Second Circuits on whether plaintiffs are entitled to a presumption at class cert, but I don't think that distinction is actually as significant as some might make it. Ultimately *Salomon* in the Second Circuit (*In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474 (2nd Cir. 2008)) and *Flowserve* or *Oscar* in the Fifth Circuit say that, whether it's the plaintiffs' burden or defendants rebutting the presumption, to meet the Rule 23 requirements, plaintiffs and defendants must introduce their evidence to prove or disprove loss causation before summary judgment or trial under the predominance requirements. The second issue raised in *Flowserve* is: what is the standard of proof to show loss causation on the merits as compared to under Rule 23.

ZELICHOV: The merits issue in *Flowserve* was very interesting. On class cert, the panel was bound by *Oscar* and that's what it followed. On the merits, it rejected both plaintiffs' claim that disclosures of the company's true financial condition establishes loss causation and defendants' argument that you need a fact-for-fact disclosure. *Flowserve* said, "Look, you guys are both wrong. We need to determine the appropriate middle ground between those positions that makes legal and economic sense."

KAPLAN: There is a difference between the Second Circuit's approach and the Fifth Circuit's approach. The Second Circuit still imposes a burden on the defendant to rebut the presumption that the Second Circuit thinks exists without regard to loss causation. The Fifth Circuit still imposes the burden on the plaintiff to show something.

LAWRENCE: That's the meaning of a presumption. In the Second Circuit plaintiffs have a presumption as a result of establishing that the market was efficient. The defendants can then offer evidence to rebut that presumption, which is, that the market wasn't efficient.

Flowserve doesn't address reliance and market efficiency; it is a resolution of the substantive issue: loss causation. The court rejects the idea that plaintiffs can rely on any downturn in financial condition but it holds that as long as the plaintiff makes the linkage with regard to the obscured information, there is enough to establish loss causation. Plaintiffs will have to do it at class certification and at trial.

TORPEY: The thing that is interesting about *Flowserve* is that there are really two distinct analytical pieces to them: One is, the Rule 23 analysis piece and the second is the merits analysis. My take on *Flowserve* is that the plaintiffs bar lost on the Rule 23 piece, but it won big on the merits. That is a problem for the defense bar.

From the defense lawyer's point of view, that whole Rule 23 analysis that the Court did in *Flowserve* following *Oscar* is good for the defense bar, but none of the other circuits seem to be paying much attention to it. The whole way the Fifth Circuit connects the Rule 23 analysis and the presumption for the fraud on the market is a Fifth Circuit phenomenon.

LAWRENCE: But there's a lot of reasons for that. You have to prove five elements: falsity, materiality, falsity of scienter, reliance, and loss causation. The Fifth Circuit took the reliance piece and they mixed it with the loss causation piece. If you prove that you bought the stock in an efficient market since all that information is in the price, merely by buying it, you have relied. But that's all it said. It didn't say anything about the loss.

KAPLAN: If the stock didn't move when the correc-

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tive information came out, was the market really efficient?

LAWRENCE: It depends on what you mean by moving and what a correction is. For example, there are situations where the company will disclose good news and bad news on the theory it can offset the news and keep the share price the same. So you may not have a price movement, but you can look at things that will enable experts to figure out whether there was an impact on the stock. They have tests for market efficiency and once you establish an efficient market, you've established reliance.

TORPEY: *Flowserve* is bad for the defendants on the merits. The recent *Oracle* or *Retek* summary judgment motions have created some momentum for defendants on loss causation (*In re Oracle Corp. Sec. Litig.*, 2009 WL 1709050 (N.D. Cal. 2009); *In re Retek, Inc. Sec. Litig.*, 2009 WL 928483 (D. Minn. 2009)). But *Flowserve* is a pro plaintiff decision. It allows plaintiffs a lot of wiggle room to get around the ultimate loss causation problem. Many other cases have a much tougher fact-for-fact analysis.

BLAIR: I don't know that the circuit court foreclosed the ability for the district court on remand to rule in favor of the defendants on class cert or on one of the claims on summary judgment. It may be that *Flowserve* is not as helpful for plaintiffs on loss causation on the merits as it might first appear because the court was focused on what needs to be shown under the Rule 23 predominance requirements.

BARNES: *Flowserve* is certainly not the most pro defense case, but it's also not the most pro plaintiff case. Encouragingly on the defense side, the court is going to insist that plaintiffs allege much more than "the market must have known." Some of the decisions from the courts here allow complaints to survive on an inference that the market must have known. That won't fly under this opinion. We know under *Basic* (*Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)) that any showing that severs the link between the alleged misrepresentation and price is sufficient to rebut the presumption. If the allegedly super-important information was disclosed and the market didn't move, plaintiffs should have the burden to explain how that can be in an efficient market.

ZELICHOV: There definitely needs to be some explanation and it seems that oftentimes it has to come from analyst reports tying the misstatement to the stock drop contemporaneously. In *Flowserve*, the court looked to analyst reports that seemed to suggest that there was a connection between the disclosure and the stock drop. And courts in the Ninth Circuit have done the same including in *Gilead*, and *Corinthian Colleges* and *Oracle* (*In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049 (9th Cir. 2008); *Metzler, Inc. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049 (9th Cir. 2008); *In re Oracle Corp. Sec. Litig.*, WL 1709050 (N.D. Cal. 2009)).

LAWRENCE: Oddly enough, *Oscar* says you are not supposed to rely on analysts. *Basic* wasn't a Rule 23 case. It was a motion to dismiss. So the question was, can you state the element of reliance by pleading an efficient market? If I go in and plead reliance, the market was efficient, and that's my pleading, under *Basic* I should be able to go forward on that element.

BARNES: Under *Ashcroft* (*Ashcroft v. Iqbal*, U.S. 129 S.Ct. 1937 (2009)), the court must disregard the legal conclusions. Without the facts to back it up, an allegation that the market is efficient is no more than a legal conclusion that should be disregarded, particularly if you have a fact that says there was no market movement when this information was disclosed.

LAWRENCE: How is an efficient market a legal conclusion? Whether a market is efficient?

BARNES: If "efficient market" is your only allegation, that is a legal conclusion.

KAPLAN: Even the Second Circuit, which is favorable to the plaintiffs on this whole issue, says the defendant has the opportunity at the certification stage to rebut the efficiency of the market. In the Fifth Circuit, *Oscar* was specifically limited to the situation where the corrective disclosure is made at the same time that there's other bad news coming out and the court felt they needed to sort that out. Do you get any benefit from that finding in the Rule 23 context?

LAWRENCE: *Oscar* says the plaintiff has to prove loss causation by a preponderance of the evidence. So that suggests that there's some weighing at the class cert stage. At the summary judg-

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ment stage, we shouldn't have to prove it at all, in the sense that the defendant has to come in and say there's no genuine issue of material fact. If we've already established it by preponderance, how could we lose it at summary judgment?

TORPEY: I agree. It's a huge analytical problem that none of the courts have addressed, not *Oscar*, not *Flowserve*. None of them address the fact that if you do a merits determination at the Rule 23 motion, you are binding yourself later.

MODERATOR: Where the alleged fraud relates to the company's core operations, is that sufficient by itself to plead scienter against the company's senior executives under *Tellabs* (*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007))?

KAPLAN: The core operations of a company are matters that are so well known that in dealing with the scienter issue, the plaintiffs bar has attempted to say that senior executives of a company must have known about these facts because they were so core to the company's operations. The question that's been litigated is: if you plead that, but you didn't plead any additional factual knowledge by the senior executive, would that be enough to establish scienter? And the law is pretty clear that it's not enough. Maybe the more interesting question is what additional facts would you have to plead and to what extent do you get any benefit if you could convince a court that a core operation is involved? For example, if you had some executive who conceded in a public document that they had a hands-on management style and if the false financial dealt with a contract that was 30 percent of the company's business, what inference would you draw from that if you are analyzing scienter under *Tellabs*?

BLAIR: You need an affirmative statement by the executive that goes to the facts at issue to get there. It's likely to be a fairly rare case where you can make the connection between the executive and the inference necessary to show he or she must have known about the specific facts at issue by relying on the core operations theory. An example is *Tellabs* in the Seventh Circuit where the CEO made a lot of affirmative statements about demand in product and demand in the two flagship products was at issue in the case (*Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702 (7th Cir. Ill. 2008)).

LAWRENCE: If you read *Makor v. Tellabs after* the Supreme Court decision, it seems to suggest that you get a lot of mileage out of the extent to which something is a large part of business and whether executives can be inferred to actually having had knowledge (*Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702 (7th Cir. Ill. 2008)). In that case, the judge basically said this particular product was something like 60 percent of business and he said, "It is ridiculous to believe that these senior executives did not know not know." Not that they should have or must have, but that they actually did know.

ZELICHOV: It can't be enough to point only to a CEO's vague statement about a product—even an important product—and argue that is enough for scienter. It might be different if the CEO makes a very specific statement about a super important product that turns out to be false.

LAWRENCE: Courts seem to view it as a sliding scale. If you have a conference call where the CEO says, "Our product X, which is 75 percent of our business, is going great guns. We are selling more than we expected. It's terrific, things are great," courts have said that could be puffery. If you've got specific witnesses in the complaint who say, "I talked to the CEO two days ago and he said every day we get reports that our product is burning up, exploding, we can't sell them, we are going to kill people," then I think you'd be able to show both knowledge and materiality.

ZELICHOV: That's like Countrywide. The court said that some of the statements would be puffery in the ordinary course, but given what was going on behind the scenes and given the evidence of scienter, she was not going to view them as puffery. This seems strange as puffery should be puffery, but as you said, elements blend together in securities fraud.

LAWRENCE: But if you actually know that things are really miserable, then it's just lying.

BARNES: The standard under *South Ferry* is pretty extreme for plaintiffs alleging nothing more than core operations (*South Ferry LP v. Killinger*, 542 F.3d 776 (9th Cir. Wash. 2008). Cautious plaintiffs counsel will allege something more to demonstrate scienter. On the defense side, executives should make sure to have a basis for what they say.

TORPEY: The core operations allegation clearly

is a pro plaintiff development. The pleading standards for the plaintiffs bar in securities cases are now very high.

Core operations is a mechanism to lessen the burden because it allows the plaintiffs bar to plead less. The truth is all kinds of things are happening in the bowels of every company that senior executives don't know about—even if they are important. They don't find out about it for two weeks, 30 days, 60 days, 90 days later. Securities litigation is always about timing. It is: "You should have said something earlier when you actually said it later." It's always about when did you tell the world and when should you have told the world.

MODERATOR: In regards to the Madoff fraud, what conduct by solicitors and feeder funds is required to make them more than aiders and abettors when sued in a private action by investors?

BARNES: *Stoneridge* is the first problem in that plaintiffs must allege reliance on the defendant's deceptive acts (*Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (U.S. 2008)). Many of the private placement memos these feeder funds issued say things like, "Well, we are not sure we are going to be able to get great information from every one of the funds in which we invest." They have a lot of disclaimers and exculpatory clauses that raise issues about what diligence was due in the first place. And alleging scienter is also a major hurdle. It is not enough for plaintiffs to allege that the feeder funds should have known; they must allege facts to show that the feeder funds did know or were reckless in not knowing. Plaintiffs will have an easier time if a feeder fund has said something like, "Well, we've checked it out and it's okay," and in fact, they didn't or they knew some facts that were inconsistent.

ZELICHOV: I don't think *Stoneridge* will form the primary barrier to these cases at least as to the solicitor and feeder funds themselves. *Stoneridge* as ultimately decided was about reliance and the investors presumably read the private placement memoranda thereby overcoming that problem. The investors will still need to point to a deceptive act, but plaintiffs lawyers are creative in finding misleading statements. The real hurdle is going to be scienter and especially overcoming the plausible competing inference that everybody was fooled including apparently the SEC and others. Navigant also published a study in May indicating that more than half the cases assert claims for breach of fiduciary duty to which *Stoneridge* does not even apply.

KAPLAN: Scienter really is an issue because you do need to make the distinction between what would be sufficient recklessness or intent or just negligence on part of these feeder funds, what did they know and should they have known.

LAWRENCE: What if you are a fund that took in several hundred million dollars in fees from the feeder fund and you didn't do very much due diligence? And it turns out that the only defense is all these risk disclosures that say, "We can't verify. We are not standing by this. We are not guaranteeing it." Don't you think it's going to matter in terms of scienter?

BARNES: It's going to be very fact specific. Maybe they made the phone call and Madoff said, "I'm not telling you what I'm doing." So they are within the risk disclosure. Another fact that may help the feeder fund is if it can show that there was nothing out of the ordinary: "Yes it's a lot of money, but it's not out of line with our other business arrangements."

BLAIR: For the Fairfield Greenwich funds of the world, the analysis is going to turn on the statements that they made or didn't make to their investors. Then there are the cases against funds such as Cohmad, that the SEC has already brought, which will certainly fuel a separate group of cases in the private context. In suits against Cohmad, plaintiffs have a much better shot of showing that the integration between Cohmad and BMIS, [Bernard L. Madoff Investment Securities], the compensation scheme, the access to BMIS's offices, and Madoff's partial ownership demonstrate Cohmad's scienter about BMIS's conduct and Cohmad's own participation. ■

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