

WACHTELL, LIPTON, ROSEN & KATZ

LIABILITIES UNDER THE FEDERAL SECURITIES LAWS

SECTIONS 11, 12, 15 AND 17
OF THE SECURITIES ACT OF 1933
AND
SECTIONS 10, 18 AND 20
OF THE SECURITIES EXCHANGE
ACT OF 1934

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I

Introduction

This outline deals with certain of the liability provisions of the federal securities laws: §§ 11, 12, 15 and 17 of the Securities Act of 1933 (the Securities Act), and §§ 10, 18 and 20 of the Securities Exchange Act of 1934 (the Exchange Act). It does not address other potential sources of liability and sanction, such as federal mail and wire fraud statutes, state fraud statutes and common law remedies, RICO and the United States Securities and Exchange Commission's (SEC) disciplinary powers.

On December 22, 1995, the Private Securities Litigation Reform Act of 1995 (the Reform Act or PSLRA) became law after the Senate overrode President Clinton's veto. Pub. L. No. 104-67, 109 Stat. 737. Where relevant, this outline discusses changes and additions that the PSLRA made to the liability provisions of the Securities Act and the Exchange Act.

The Securities Litigation Uniform Standards Act of 1998 (SLUSA) amended portions of the Securities Act and the Exchange Act to preempt certain class actions that allege fraud under state law. Specifically, SLUSA precludes a private party from bringing a "covered class action" in federal or state court based on state law alleging a "misrepresentation or omission of a material fact" or the use of "any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." 15 U.S.C.A. § 78bb(f)(1) (West Supp. 2003); *see also* § 77p(b). "Generally, a 'covered class action' involves common questions of law or fact brought on behalf of more than 50 persons or an action brought on behalf of one or more unnamed parties." *Prager v. Knight/Trimark Group, Inc.*, 124 F. Supp. 2d 229, 231 (D.N.J. 2000) (citing 15 U.S.C. § 78bb(f)(5)(B)); *see also* 15 U.S.C.A. § 77p(f)(2)(A). SLUSA effectively makes federal court the exclusive venue for nearly all securities fraud class actions.

On December 21, 2000, Congress enacted the Commodities Futures Modernization Act (the CFMA), which revamped the Commodity Exchange Act and amended the securities, banking and bankruptcy laws to update the federal regulatory structure and to clarify the legal status of derivative products. Pub. L. No. 106-554, 114 Stat. 2763 (2000). The CFMA made two noteworthy changes to the securities laws. First, it lifted the ban on single stock futures and included "security future[s]" and "security futures product[s]" in the definition of "security" under the Exchange Act. *See* 15 U.S.C.A. § 78c(a)(10), (55), (56) (West 1997 & Supp. 2003). Because of this inclusion, security futures and

security futures products are now subject to the reporting and recordkeeping, as well as the antifraud and antimanipulation, provisions of the Exchange Act. Second, the CFMA excluded swap agreements, either security-based or non-security-based, from the definition of “security” under both the Securities Act and the Exchange Act, thus excluding swap agreements from the SEC’s reporting and recordkeeping requirements. *See id.* §§ 77b-1(a), (b), 78c-1(a), (b). The SEC does retain limited antifraud and antimanipulation authority over security-based swap agreements, including under § 17(a) of the Securities Act, § 9(a) of the Exchange Act and § 10(b) of the Exchange Act. *See id.* §§ 77q(a), (d), 78i(a)(2)-(5), (i), 78j(b); *see also Caiola v. Citibank, N.A.*, 295 F.3d 312, 327 (2d Cir. 2002); *SEC v. Rorech*, 673 F. Supp. 2d 217, 225 (S.D.N.Y. 2009). While this outline will reflect fundamental changes made by the CFMA, the specifics of this complex law are beyond the scope of the outline.

In the wake of serious accounting abuses at several large public companies, Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), one of the most significant revisions to United States securities laws since the New Deal. Pub. L. No. 107-204, 116 Stat. 745 (2002). Sarbanes-Oxley covers a variety of areas and seeks, among other things, to enhance public disclosure, improve the quality and transparency of financial reporting and auditing, and strengthen penalties for securities law violations. Sarbanes-Oxley provides that any violation of its provisions is considered a violation of the Exchange Act, thus availing the SEC of its full range of powers, remedies and penalties under the Exchange Act. For example, Section 304 of Sarbanes-Oxley requires a CEO or CFO to pay back certain compensation when the company’s misconduct requires it to restate its financial statements due to its material noncompliance with any financial requirement under the securities laws. *See SEC v. Jenkins*, 718 F. Supp. 2d 1070 (D. Ariz. 2010) (Section 304 does not require personal responsibility by CEO or CFO for the misconduct that was cause of the issuer’s restatement). Sarbanes-Oxley also expands Exchange Act remedies by providing that, in civil enforcement actions brought by the SEC, courts may grant any equitable relief that is appropriate for protection of investors, which suggests broader court oversight of (and monetary remedies against) violators of Sarbanes-Oxley than was the case before. Except with respect to recovery of profits from prohibited sales during a blackout period and suits by “whistleblowers,” Sarbanes-Oxley does not expressly create new private rights of action for violations of its provisions. However, Sarbanes-Oxley affects existing private rights of action under the Exchange Act by (1) lengthening the general statute of limitations applicable to private securities fraud actions to the earlier of two years after discovery of the facts constituting the violation or five years after the violation (*see* discussions of individual statutes of limitations, *infra*) and (2) expanding

reporting and disclosure requirements, which could potentially expand the range of actions that can be alleged to give rise to private suits under Sections 10(b) and 18 of the Exchange Act and SEC Rule 10b-5.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, enacted in response to the financial aid crisis of 2008-2009. While this law primarily addresses financial regulations and corporate governance issues, it does contain provisions affecting securities law liability, such as increasing exposure to liability under the federal securities laws of credit ratings agencies and establishing new incentives and protections for whistleblowers. With respect to the specific provisions of the federal securities laws covered by this outline, Dodd-Frank amended § 20(e) of the Exchange Act to augment the SEC's authority to pursue civil enforcement actions alleging aiding and abetting of Exchange Act violations by expanding the requisite state of mind to encompass "reckless," in addition to "knowing," acts, and adding § 15(b) to the Securities Act to empower the SEC to pursue actions premised on knowingly or recklessly aiding or abetting violations of that act (and adding similar provisions to the Investment Company Act of 1940 and the Investment Advisors Act of 1940). Dodd-Frank §§ 929M, 929O.

A. Scope of the Securities Act and of the Exchange Act

The different scopes of the Securities Act and the Exchange Act are more marked in the registration and filing provisions of the Acts than in the liability provisions. Thus, while § 11 of the Securities Act pertains to public offerings and the registration statements used therein, § 17 of the Securities Act can apply to any purchase of securities, whether part of a public offering or not, as can § 10 of the Exchange Act. However, the liability provisions of the Securities Act reflect the Act's general philosophy of protecting only purchasers, while the liability provisions of the Exchange Act protect both purchasers and sellers.

The liability provisions of the Securities Act and the Exchange Act overlap, and liability under one provision or one act does not preclude liability under another. *See, e.g., Randall v. Loftsgaarden*, 478 U.S. 647, 661 (1986); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383-87 (1983). Most actions under the securities laws are brought under more than one section. In particular, virtually all securities actions involve a claim under § 10(b), the general antifraud provision of the Exchange Act, and Rule 10b-5 thereunder, by far the most important liability provisions in the securities laws. Additionally, many plaintiffs attach control person liability claims (§ 15 or § 20) to the underlying Securities Act or Exchange Act claims.

B. Extraterritorial Application of the Federal Securities Laws

In 2010, the Supreme Court overruled longstanding lower court jurisprudence and held that § 10(b) of the Exchange Act does not apply to securities transactions that take place outside the United States. *Morrison v. Nat'l Austl. Bank, Ltd.*, 130 S. Ct. 2869 (2010).

Before *Morrison*, the Second Circuit had long held that “because the Exchange Act is silent as to the extraterritorial application of § 10(b), it was left to the court to ‘discern’ whether Congress would have wanted the statute to apply.” *Morrison*, 130 S. Ct. at 2878 (quoting *Morrison v. Nat'l Austl. Bank, Ltd.*, 547 F.3d 167, 170 (2d Cir. 2008)). The Second Circuit previously concluded that “neither the usual presumption against extraterritorial application nor the specific language of [the Exchange Act] show Congressional intent to preclude” extraterritorial application of the Act. *Schoenbaum v. Firstbrook*, 405 F.2d 200, 205 (2d Cir. 1968), *rev'd on reh'g on other grounds*, 405 F.2d 215 (1968) (en banc). Following this reasoning, the courts of appeals for over four decades applied judicially-created “conduct” and “effects” tests to determine whether sufficient domestic conduct or effects existed in a given case so as to warrant the application of the federal securities laws abroad. *See, e.g., SEC v. Kasser*, 548 F.2d 109, 116 (3d Cir. 1977); *Continental Grain Pty., Ltd. v. Pacific Oilseeds, Inc.*, 492 F.2d 409, 421-22 (8th Cir. 1979); *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 424-25 (9th Cir. 1983); *Kauthar SDN BHD v. Steinberg*, 149 F.3d 659, 667 (7th Cir. 1998); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 32 (D.C. Cir. 1987); *Robinson v. T.C.I. U.S. West Commc'ns, Inc.*, 117 F.3d 900, 906-07 (5th Cir. 1997).

In *Morrison*, Australian plaintiffs sued an Australian bank under § 10(b) of the Exchange Act for losses they allegedly suffered on purchases of the bank's stock on Australian exchanges; they argued that the “conduct” test had been met because the alleged misstatements originated from a Florida subsidiary of the Australian bank. *Id.* at 2869-76. The Supreme Court held that Section 10(b) did not apply to the Australian plaintiffs' claims, and, in doing so, categorically rejected the conduct and effects tests.

The Court reached applied the presumption against extraterritoriality, “a ‘longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.’” *Morrison*, 130 S. Ct. at 2877 (quoting *EEOC v. Arabian American Oil Co.*, 499 U.S. 244, 248 (1991)). The Court found “no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially, and ... therefore conclude[d] that it does not” *Morrison*, 130 S. Ct. at 2883. Harshly

noting the “difficulty of applying,” and the “unpredictable and inconsistent” results produced by, the “vague formulations” that had developed under the conduct and effects tests, Justice Scalia’s opinion for the Court observed that the “results of [the] judicial-speculation-made-law” by the lower courts—“divining what Congress would have wanted if it had thought of the situation—demonstrate[d] the wisdom of the presumption against extraterritoriality.” *Id.* at 2881.

In lieu of the conduct and effects tests, the Court adopted a new “transactional test,” *id.* at 2886, that it believed was, unlike the conduct and effects tests, grounded in the text of Section 10(b) and consistent with the presumption against extraterritoriality. “Section 10(b),” the Court held, “reaches the use of a deceptive device only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.” *Id.* at 2888. In reaching this holding, the Court looked to the “focus” of the statute’s text, and concluded that “the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases or sales of securities in the United States.” *Id.* at 2884. The decision has been interpreted to apply to the Securities Act as well. *See, e.g., In re Vivendi Universal, S.A., Sec. Litig.*, 842 F. Supp. 2d 522, 529 (S.D.N.Y. 2012).

Since *Morrison*, plaintiffs have advanced two arguments in support of allowing at least some foreign-transaction claims to proceed under Section 10(b). Neither argument, however, has been accepted by any court.

First, some plaintiffs have contended that a purchase or sale of a security on a foreign exchange takes place “in the United States” under *Morrison* if the purchase or sale order is made from the United States. District courts have consistently rejected this argument as “amount[ing] to nothing more than reinstatement of the conduct test” that was rejected by the Supreme Court. *Cornwell v. Credit Suisse Group*, 729 F. Supp. 2d 620, 624 (S.D.N.Y. 2010); *accord, e.g., In re UBS Sec. Litig.*, No. 07 Civ. 11225 (RJS), 2011 WL 4059356, at *7-*8 (S.D.N.Y. Sept. 13, 2011); *In re Vivendi Univ., S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 532-33 (S.D.N.Y. 2011); *In re Royal Bank of Scotland Group PLC Sec. Litig.*, 765 F. Supp. 2d 327, 336-37 (S.D.N.Y. 2011); *Plumbers’ Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166, 177-78 (S.D.N.Y. 2010); *In re Société Générale Sec. Litig.*, No. 08 Civ. 2495 (RMB), 2010 WL 3910286, at *5-*6 (S.D.N.Y. Sept. 29, 2010); *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469, 472 (S.D.N.Y. 2010).

Second, some plaintiffs have made an even more expansive argument that is based upon *Morrison*’s reference to transactions in securities that are “listed” on

U.S. exchanges. These plaintiffs argued that whenever the home-country security of a foreign issuer was “listed” domestically (as must often be done, for example, in order to issue and list American Depositary Receipts), trades in that security anywhere in the world would be subject to Section 10(b). According to this argument, if a foreign company sponsored even a small issue of ADRs, or if it dual-listed its home-country shares on an American exchange, global class actions covering all foreign transactions in those shares would be fair game. This theory has been roundly and consistently rejected by district judges as “being simply contrary to the spirit of *Morrison*,” *In re Royal Bank of Scotland*, 765 F. Supp. 2d at 336, and as “a selective and overly-technical reading of *Morrison* that ignores the larger point of the decision, which, “read in total context,” compels “the opposite result,” *In re Alstom*, 741 F. Supp. 2d at 472; accord *In re BP plc Sec. Litig.*, 843 F. Supp. 2d 712, 794-95 (S.D. Tex. 2012); *In re UBS*, 2011 WL 4059356, at *5-*7; *In re Infineon Tech. Sec. Litig.*, No. C 04-04156 JW, 2011 WL 7121006, at *3 (N.D. Cal. Mar. 17, 2011); *In re Vivendi*, 765 F. Supp. 2d at 527-31.

In applying *Morrison*’s transactional analysis, the focus is on “where” the purchase or sale actually occurs. Transactions on an exchange presumably take place where the exchange is located, but that leaves open how to determine where “the purchase or sale of any other security,” *Morrison*, 130 S. Ct. at 2888, transpires. That question arose in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012), where the Second Circuit considered “under what circumstances the purchase or sale of a security that is not listed on a domestic exchange should be considered ‘domestic’ within the meaning of *Morrison*.” *Id.* at 66-67. The court came up with a two-pronged test to answer this question. First, because “the point at which the parties become irrevocably bound is used to determine the timing of a purchase and sale,” the court held “that the point of irrevocable liability can be used to determine the locus of a securities purchase or sale.” *Id.* at 68. Second, because “a ‘sale’ is ordinarily defined as ‘[t]he transfer of property or title for a price,’” the court concluded that “a sale of securities can be understood to take place at the location in which title is transferred.” *Id.* at 68 (citation omitted); accord *Quail Cruises Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, 645 F.3d 1307, 1310-11 (11th Cir. 2011) (allegation that “transfer of title to . . . shares in the United States” establishes that transaction lies within Section 10(b)’s “territorial reach” on motion to dismiss). “Accordingly, to sufficiently allege a domestic securities transaction in securities not listed on a domestic exchange, . . . a plaintiff must allege facts suggesting that [1] irrevocable liability was incurred or [2] title was transferred within the United States.” *Absolute Activist*, 677 F.3d at 68. Among the factors that could be used to indicate where the transaction took place, the court added, would be facts

concerning the formation of the contract, the placement of purchase orders, or the exchange of money. *Id.* at 70.

Despite *Morrison*'s conclusion that Section 10(b) of the Exchange Act cannot be applied extraterritorially, that restriction has been interpreted not to bar the extraterritorial application of equitable relief provided by Section 21 of that Act, including by repatriating and freezing offshore assets. *See SEC v. Illarramendi*, No. 3:11cv78(JBA), 2011 WL 2457734 (D. Conn. June 16, 2011).

The Dodd-Frank Act apparently intended to partly overrule *Morrison* by restoring a version of the conduct and effects tests in cases brought by the United States and the SEC. *See* 156 CONG. REC. H5236 (June 30, 2010) (statement of Rep. Paul Kanjorski) (purpose of section 929P(b) "is to make clear" that in actions or proceedings brought by SEC or Department of Justice, federal securities laws "may have extraterritorial application . . . irrespective of whether the securities are traded on a domestic exchange or the transactions occur in the United States"). But whether it successfully did so is an open question. Section 929P(b) of the Dodd-Frank Act provides the federal courts with "jurisdiction" to hear cases brought by the United States or the SEC that involve extraterritorial elements, but *Morrison* addressed the substantive reach of section 10(b), not the federal courts' jurisdiction. *See Morrison*, 130 S. Ct. at 2877 (acknowledging that district court had jurisdiction). As a result, because Section 929P(b) does not amend any substantive provision of the securities laws, courts may be "forced to find that Section 929P was 'stillborn' in that it conferred jurisdiction that could not be used for anything substantive . . . until a further statute were enacted." Richard W. Painter, *The Dodd-Frank Extraterritorial Jurisdiction Provision: Was It Effective, Needed or Sufficient?*, 1 HARV. BUS. L. REV. 195, 208 (2011); *see also* Genevieve Beyea, *Morrison v. National Australia Bank and the Extraterritorial Application of the Securities Laws*, 72 OHIO ST. L. J. 537, 570-71 (2011) ("the language of the Act as drafted does not actually" "preserve the conduct and effects tests," and "may not have any effect on the application of Section 10(b), depending on the willingness of the courts to overlook the plain language of the statute").

C. Disclosure Philosophy

The liability provisions under discussion adopt the general disclosure philosophy of the federal securities laws: with the exception of a few provisions governing the mechanics of securities trading, all impose only requirements of fair disclosure, not requirements of substantive fairness. *See, e.g., SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (stating that the purpose common to the securities laws was to "substitute a philosophy of full disclosure

for the philosophy of caveat emptor”); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977); *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 435 (7th Cir. 1987).

D. Duty to Disclose

Disclosure is only required, however, where the law imposes a duty to disclose. “Silence, absent a duty to disclose, is not misleading” under the federal securities laws. *Basic, Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988). *See also Badger v. Southern Farms Bureau Life Ins. Co.*, 612 F.3d 1334 (11th Cir. 2010) (no duty to disclose running from one party in an arm’s length securities transaction to the shareholders of the counterparty to the transaction); *Vladimir v. Bioenvision, Inc.*, 374 F. App’x 141, 143 (2d Cir. 2010) (“For an omission to be actionable, the securities laws must impose a duty to disclose the omitted information”); *U.S. v. Schiff*, 602 F.3d 152, 162 (3d Cir. 2010) (“Absent a duty to disclose, silence is not fraudulent.”); *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331 (7th Cir. 1995) (“Mere silence about even material information is not fraudulent absent a duty to speak.”). However, a party that makes a public statement may not omit relevant information if the information is necessary to make the public statement, in light of the circumstances under which it was made, not misleading. *See* 17 C.F.R. § 240.10b-5(b). In other words, once a party makes a disclosure, even if it is one that it had no duty to make, it assumes a duty to disclose all information necessary to make its statement not misleading, including information that it would not otherwise have been required to disclose had it not made the initial disclosure. *Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d Cir. 2002) (when a party speaks, it has a “duty to be both accurate and complete”); *Ellenburg v. J.A. Solar Holdings Co.*, No. 08 Civ. 10475, 2010 U.S. Dist. LEXIS 49220 (S.D.N.Y. May 17, 2010) (once the CFO disclosed the substance of a financial transaction, a duty to fully disclose all the risks arose, even though there was no duty to disclose the transaction in the first place); *In re Bristol Myers Squibb Co. Sec. Litig.*, 586 F. Supp. 2d 148, 160 (S.D.N.Y. 2008) (“even an entirely truthful statement may provide a basis for liability if material omissions related to the content of the statement make it . . . materially misleading”); *see also Basic*, 485 U.S. at 231-32. *But see Minneapolis Firefighters’ Relief Ass’n v. MEMC Electronic Materials, Inc.*, 641 F.2d 1023 (8th Cir. 2011) (no duty to disclose merely because of prior pattern of disclosure). To trigger this prohibition on the omission of relevant information, the statement must pertain to the same subject matter as the alleged omission, and the missing disclosure must render the statement misleading because it alters the meaning of the statement; *Richman v. Goldman Sachs Grp., Inc.*, --- F. Supp. 2d ---, 2012 WL 2362539, at *5-*7 (S.D.N.Y. June 21, 2012) (finding no duty to disclose receipt of Wells notice either to make prior disclosures regarding ongoing governmental investigations not misleading or to

comply with Regulation S-K, Item 103 because, at best, notice reflected desire of SEC enforcement staff to move forward and did not necessarily indicate that charges would be filed). *See McDonald v. Kinder-Morgan, Inc.*, 287 F.3d 992, 998 (10th Cir. 2002) (duty to disclose only arises where statement made is material and “omitted fact is material to the statement in that it alters the meaning of the statement”). That is, the statement “must affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists.” *Indiana Elec. Workers v. Shaw Group*, 537 F.3d 527, 541 (5th Cir. 2008); *see also Winer Family Trust v. Queen*, 503 F.3d 319, 330 (3d Cir. 2007) (no duty to disclose information related to a public statement arose when the statement itself was “true” and nondisclosure of additional information did not render the statement “misleading or untrue”); *In re GAP Sec. Litig.*, 1991 WL 17091, at *2 (9th Cir. Feb. 8, 1991) (no duty to disclose where company did not make “an affirmative statement on the same subject which would be misleading absent disclosure of the information”). Companies, however, need not disclose any and all information that could conceivably affect stock prices, in particular regarding contingent future events. *See, e.g., In re Bos. Scientific Corp. Sec. Litig.*, --- F.3d ---, 2012 WL 2849660, at *4-*6 (1st Cir. July 12, 2012) (no duty to disclose potential firings while internal investigation was ongoing; no duty to disclose statements after firings because numbers were not material and consequences were unforeseeable).

Nor is there any bright-line rule for the portion of a company’s business that must be affected so as to render an issue that affects it material: “If a particular product or productline, or division or segment of a company’s business, has independent significance for investors, then even a matter material to less than all of the company’s business may be material for purposes of the securities laws.” *Hutchison v. Deutsche Bank Sec. Inc.*, 647 F.3d 479, 488 (2d Cir. 2011). *See also Panther Partners Inc. v. Ikanos Commc’ns, Inc.*, 681 F.3d 114, 121-22 (2d Cir. 2012) (holding that defect affecting sales to clients representing 72% of revenues constituted known uncertainty that could materially impact revenues, and therefore that allegations regarding failure to disclose defect issue stated a claim under Securities Act Sections 11 and 12); *Silverman v. Motorola, Inc.*, 798 F. Supp. 2d 954, 966-67 (N.D. Ill. 2011) (finding genuine dispute of material fact regarding materiality of 3G phone disclosures where, *inter alia*, 3G phones constituted 2.2% of overall mobile sales, but company referred to 3G phones as “flagship products” for “some of our lead operators in the world”).

E. Materiality

Of course, not every fact about every transaction can be disclosed. Accordingly, all of the liability provisions under discussion limit liability to *material*

nondisclosure or misrepresentation. The leading case on materiality is *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), which defined a material fact as one to which there is a substantial likelihood that a reasonable investor would attach importance in making a decision because the fact would significantly alter the “total mix” of available information. 426 U.S. at 449. This definition, promulgated in the context of a case under § 14 of the Exchange Act, is now universally applied under all of the liability provisions under discussion here. *See, e.g., Basic*, 485 U.S. at 231-32 (expressly adopting the *TSC Industries* standard of materiality in the § 10(b) and Rule 10b-5 context). *See also Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) (rejecting bright-line test of materiality based on statistical significance of undisclosed information, and, citing *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), finding that complaint’s allegations taken collectively sufficed to raise a reasonable expectation that discovery would reveal evidence satisfying the materiality requirement).

Although the “materiality” of a misstated or omitted fact is determined on a case-by-case basis, courts have developed some general principles. Relying on the “total mix” concept, for example, some courts have held that false statements or omissions are not materially misleading as long as the market possessed the correct information. *See, e.g., Lowinger v. Pzena Inv. Mgmt.*, 341 F. App’x 717 (2d Cir. 2009) (affirming dismissal of plaintiff’s complaint where its contentions were based on a selective reading of statements in a prospectus, ignoring other disclosures and cautionary language); *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 368 (5th Cir. 2004) (finding that information filed with the SEC and known to the market could not have artificially inflated the stock price); *Ieradi v. Mylan Labs., Inc.*, 230 F.3d 594, 599-600 (3d Cir. 2000) (failure to disclose exclusive raw material supply contracts not material when company disclosed in its 10-Q that it was the subject of FTC investigation for anti-competitive activity); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1217-19 (1st Cir. 1996) (holding that a corporation was not liable for the optimistic statements of its officer because the market realized the immateriality of those statements), *abrogated by statute on other grounds*, 15 U.S.C. § 78u(4)(b)(2); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 515 (7th Cir. 1989) (holding that a utility company did not need to disclose the risk of future regulation or construction delay because such “hazards of its business [were] . . . apparent to all serious observers and most casual ones”); *see also Asher v. Baxter Int’l Inc.*, 377 F.3d 727, 735 (7th Cir. 2004) (discussing a “truth-on-the-market” defense and stating that it is unavailable at the pleading stage); *Seaboard World Airlines, Inc. v. Tiger Int’l, Inc.*, 600 F.2d 355, 361-62 (2d Cir. 1979) (tender offeror’s statement that target’s asking price of \$20 per share in the event of a merger was “unrealistic” was not materially misleading where the target’s stock

traded on the market at \$4 per share prior to the tender offer). In the context of an SEC enforcement action, “the materiality test requires the court to consider *all* the information available to the hypothetical reasonable investor, which necessarily includes private communications” and oral misrepresentations made by brokers, though there is no “numerical threshold for materiality.” *SEC v. Morgan Keegan & Co., Inc.*, 678 F.3d 1233, 1248-49 (11th Cir. 2012).

Additionally, courts have held that actionable statements must be sufficiently “concrete” and “specific,” as opposed to “single, vague statement[s] that are essentially mere puffery.” *In re N. Telecom Ltd. Sec. Litig.*, 116 F. Supp. 2d 446, 466 (S.D.N.Y. 2000) (alteration in the original and internal quotation marks omitted); *see also City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 671 (6th Cir. 2005) (court distinguished between hard information and soft information, and said about the latter that “vague statements [such as the optimistic statements at issue in the case at hand] not subject to verification by proof are generally deemed non-actionable puffery”); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 869-70 (5th Cir. 2003) (statements that company’s “fundamentals are strong,” that it is “making steady progress” and that its “pipeline of private transactions . . . remains strong,” are immaterial puffery not actionable under the securities laws). However, half-truths — “literally true statements that create a materially misleading impression” — may support securities fraud claims; for instance, the Second Circuit reversed a dismissal where the disclosure that an investment adviser had attempted to reduce or eliminate market timing did not also disclose that the adviser had expressly agreed to allow one major investor do so. *SEC v. Gabelli*, 653 F.3d 49, 57 (2d Cir. 2011).

The integrity and competence of management can be material facts subject to disclosure under some circumstances. *But see Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 657 (4th Cir. 2004) (in finding that the CEO’s lie regarding his college degree was immaterial as a matter of law, the court stated, “The only requirement is that no reasonable jury could find it substantially likely that a reasonable investor would find the fact at issue material in the ‘total mix’ of information”). The materiality of a given fact that bears on management’s character is normally determined by the general materiality standard already noted above. Courts have, however, made more precise rulings with regard to the materiality of some situations that frequently occur. For example, a failure to disclose arguable lapses in business judgment by the directors will not normally render a disclosure document materially misleading. *See Gaines v. Haughton*, 645 F.2d 761, 779 (9th Cir. 1981) (holding that “director misconduct of the type traditionally regulated by state corporate law need not be disclosed in proxy solicitations”), *overruled on other grounds by Stahl v. Gibraltar Fin. Corp.*, 967

F.2d 335, 338 (9th Cir. 1992); *In re Franchard Corp.*, 42 SEC 163, 175-78 (1964) (holding non-material a failure to disclose the directors' lax oversight of the corporation); *cf. Santa Fe Indus., Inc.*, 430 U.S. at 476 (noting that fiduciary misconduct alone, without deception, misrepresentation, or nondisclosure, is not necessarily actionable under the securities laws). By contrast, self-dealing or illegal payments by a director is usually a material fact that must be disclosed. *See Gaines*, 645 F.2d at 776-78; *Maldonado v. Flynn*, 597 F.2d 789, 796 (2d Cir. 1979) (identifying self-dealing as material information to be disclosed under Rule 14a-9); *United States v. Fields*, 592 F.2d 638, 649 (2d Cir. 1978) (deeming material the payment of illegal kickbacks to directors). Violations of the securities laws by directors or officers are also usually material, except that some violations occurring more than five years prior to the date of the disclosure may be so distant as to be immaterial. *See Disclosure of Management Background: Uniform Reporting Requirements*, Securities Act Release No. 5758, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,783 (Nov. 2, 1976); *see also SEC v. Goldfield Deep Mines Co.*, 758 F.2d 459, 466-7 (9th Cir. 1985) (affirming that violations within five years of filing date must be disclosed). *But see Bertoglio v. Texas Int'l Co.*, 488 F. Supp. 630, 661 (D. Del. 1980) (holding material the fact that a board nominee had been found guilty of securities law violations fifteen years earlier where the nominee was currently the subject of new charges of securities violations).

Although questions of materiality are usually for the jury to decide because they require "delicate assessments of the inferences a 'reasonable [investor]' would draw from a given set of facts and the significance of those inferences to him," *TSC Indus.*, 426 U.S. at 450, "if the alleged misstatements or omissions 'are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality, the court may rule them immaterial as a matter of law.'" *Recupito v. Prudential Sec., Inc.*, 112 F. Supp. 2d 449, 454 (D. Md. 2000) (quoting *Klein v. Gen. Nutrition Cos.*, 186 F.3d 338, 342 (3d Cir. 1999)). In *Chambers v. AMDOCS Ltd.*, the Eighth Circuit clarified which categories of statements may be deemed immaterial as a matter of law. 390 F.3d 542, 548 (8th Cir. 2004). The court held, "Alleged misrepresentations can be immaterial as a matter of law if they: 1) are of such common knowledge that a reasonable investor can be presumed to understand them; 2) present or conceal such insignificant data that, in the total mix of information, it simply would not matter; 3) are so vague and of such obvious hyperbole that no reasonable investor would rely upon them; or 4) are accompanied by sufficient cautionary statements." *Cf. Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162-63 (2d Cir. 2000) (reversing district court for relying on single numerical or percentage benchmark in determining immateriality as a matter of law).

Similarly, most courts recognize the “bespeaks caution” doctrine, by which the materiality of a misstatement or omission can be negated by appropriate cautionary language in a disclosure document. *See, e.g., Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 360 (2d Cir. 2002) (affirming dismissal of complaint where offering memoranda “not only bespeak caution, they shout it from the rooftops” with respect to the risk that securities will not be registered); *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1120 (10th Cir. 1997); *Gasner v. Board of Supervisors*, 103 F.3d 351, 358 (4th Cir. 1996); *Saltzberg v. TM Sterling/Austin Assocs.*, 45 F.3d 399, 400 (11th Cir. 1995); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1413-15 (9th Cir. 1994); *Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371-73 (3d Cir. 1993); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991); *I. Meyer Pincus & Assoc. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991), *superseded by statute on other grounds by* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737; *Polin v. Conductron Corp.*, 552 F.2d 797, 806 n.28 (8th Cir. 1977); *see also Eckstein v. Balcors Film Investors*, 8 F.3d 1121, 1131-32 (7th Cir. 1993) (holding that supplemental sales literature is not materially misleading when there is complete disclosure in the prospectus), *aff’d*, 58 F.3d 1162 (7th Cir. 1995). To cleanse a later or concurrent misstatement, the cautionary language must be specific; that is, it must caution against precisely the sort of risk for which the alleged misstatement or omission failed to account. *See, e.g., Grossman*, 120 F.3d at 1121 (finding optimistic predictions immaterial when accompanied by “highly specific [and] very factual” cautionary statements that directly address those predictions); *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 707-08 (3d Cir. 1996); *Shaw*, 82 F.3d at 1213-14; *Fecht v. Price Co.*, 70 F.3d 1078, 1082 (9th Cir. 1995); *Trump Casino*, 7 F.3d at 371-72.

The Reform Act established a statutory safe harbor for certain forward-looking statements in Section 27A of the Securities Act and in Section 21E of the Exchange Act. This provision captures the essence of the “bespeaks caution” doctrine but provides brighter lines than does the judicially created doctrine. *See, e.g., Employers Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1132 (9th Cir. 2004) (stating that the Reform Act contains a statutory version of the judicial doctrine); *In re Stratosphere Corp. Sec. Litig.*, 610 F.3d 1103, 1 F. Supp. 2d 1096, 1117-19 (D. Nev. 1998) (finding the Reform Act applies, but assessing defense of cautionary language under bespeaks caution doctrine). The Reform Act safe harbor states that a person is not liable for a forward-looking statement if the statement is (1) immaterial or accompanied by cautionary statements; or (2) if the plaintiff fails to prove that the statement was

made with actual knowledge that the statement was false or misleading. 15 U.S.C.A. § 78u-5(c)(1)(A)(i)-(ii), (B)(i); *see also Southland Sec. Corp.*, 365 F.3d at 371-72; *In re Secure Computing Sec. Litig.*, 120 F. Supp. 810, 818 (N.D. Cal. 2000). *See generally Asher*, 377 F.3d at 729 (criticizing the imprecise and undefined language establishing the safe harbor).

The Reform Act has no state of mind requirement; if cautionary language is adequate, the inquiry ends there. *W. Wash. Laborers-Employers Pension Trust v. Panera Bread Co.*, No. 4:08CV00120, 2009 U.S. Dist. LEXIS 103460, at *6 (E.D. Mo. Nov. 6, 2009) (citing *In re Stone & Webster, Inc., Sec. Litig.*, 414 F.3d 187, 212-13 (1st Cir. 2005)). Even if a forward-looking statement is deliberately false, cautionary statements will protect the author from any liability, pursuant to the plain meaning of the safe harbor provisions. *In re Cutera Sec. Litig.*, 610 F.3d 1103 (9th Cir. 2010) (rejecting as inconsistent with the plain language of the statute a conjunctive reading “under which a sufficiently strong inference of actual knowledge would overcome a claim of safe harbor protection even for statements identified as forward-looking and accompanied by meaningful cautionary language”) (citing *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 371-72 (5th Cir. 2004) (holding that one safe harbor provision “focus[es] on the defendant’s cautionary statements” while another, separate provision focuses “on the defendant’s state of mind”)); *Miller v. Champion Enters., Inc.*, 346 F.3d 660, 672 (6th Cir. 2003) (for forward-looking statements that are accompanied by meaningful cautionary language, the safe harbor provision for identified forward-looking statements makes the state of mind irrelevant.”); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 554 (6th Cir. 2001) (holding the disjunctive reading mandated by the statutory text), *overruled in part on other grounds as stated in Konkol v. Diebold, Inc.*, 590 F.3d 390, 396 (6th Cir. 2009); *Harris v. Ivax Corp.*, 182 F.3d 799, 803 (11th Cir. 1999) (holding that where all allegedly false statements were identified as forward-looking statements and accompanied by cautionary language, “the defendant’s state of mind is irrelevant”). *See also Hoffman v. Authentec, Inc.*, No. 6:08-CV-1741-ORL-28DAB, 2009 U.S. Dist. LEXIS 87809, at *58 (M.D. Fla. Sept. 24, 2009) (officers’ statements about a new product, when accompanied by cautionary statements, fell within the safe harbor provisions notwithstanding plaintiffs’ allegations that the statements were false and omitted information about problems encountered during product development); *Desai v. Gen. Growth Props.*, 654 F. Supp. 2d 836, 844 (N.D. Ill. 2009) (“[U]nder the literal language of the safe harbor statute the author of any forward-looking statement — even though a deliberate falsehood — is insulated from liability so long as that statement is accompanied by some meaningful cautionary statement.”). *But see Asher v. Baxter*, 2005 U.S. Dist. LEXIS 2131 at *17-19 (N.D. Ill. Feb. 3, 2005) (collecting

cases and finding that where public statements were made with actual knowledge of their falsity, the second prong of the PSLRA safe harbor provision will not apply).

The “bespeaks caution” doctrine seems to have survived the Reform Act, as it is seen simply as a judicial gloss on the meaning of “materiality.” The Second Circuit, for example, applied the doctrine in a § 10(b) and Rule 10b-5 action without any reference to the Reform Act, demonstrating the doctrine’s survival. *See Halperin*, 295 F.3d at 357 (“[W]hen cautionary language is present, we analyze the allegedly fraudulent materials in their entirety to determine whether a reasonable investor would have been misled.”); *see also* H.R. Conf. Rep. No. 104-369, at 46 (1995) (“The [PSLRA] Conference Committee does not intend for the safe harbor provisions to replace the judicial bespeaks caution doctrine or to foreclose further development of that doctrine by the courts.”) (internal quotations omitted). Several courts have simultaneously considered defenses based on the safe harbor provided by the Reform Act, *see infra*, and the bespeaks caution doctrine. *See, e.g., Secure Computing*, 120 F. Supp. 2d at 818; *Roer v. Oxbridge Inc.*, 198 F. Supp. 2d 212, 228 (E.D.N.Y. 2001) (“These [safe harbor] provisions of the PSLRA were modeled after, but not meant to displace, the judicial bespeaks caution doctrine.”); *In re Valujet, Inc., Sec. Litig.*, 984 F. Supp. 1472, 1479 (N.D. Ga. 1997).

Forward-looking statements for purposes of the Reform Act’s safe harbor include those that “contain[] a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items,” those that are “statement[s] of the plans or objectives of management for future operations,” and those that are “statement[s] of future economic performance.” 15 U.S.C.A. § 78u-5(i)(1)(A), (B), (C). Courts applying the “bespeaks caution” doctrine define forward-looking statements in a similar fashion. *See, e.g., Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 948 (9th Cir. 2005) (expressly adopting the First and Seventh Circuits’ position that “extension of the bespeaks caution doctrine to statements of historical fact is inappropriate”); *EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 874 (3d Cir. 2000) (“By its terms, the bespeaks caution doctrine, like the safe harbor provision in the Reform Act, is directed only to forward-looking statements.”) (internal quotations omitted); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1213 (1st Cir. 1996), *abrogated by statute on other grounds*, 15 U.S.C. § 78u(4)(b)(2); *Worlds of Wonder*, 35 F.3d at 1414 (noting that the doctrine applies to future projections, estimates, and forecasts). However, courts sometimes deny “forward-looking” status to statements by construing predictions of future success as misrepresentations regarding current business conditions. *See, e.g., No. 84 Employer-Teamster Joint Council Pension Trust*

Fund v. Am. West Holding Corp., 320 F.3d 920, 936-37 (9th Cir. 2003) (finding statement that no increased maintenance costs were expected as a result of a settlement agreement with the FAA not to be forward looking, and denying protection under the PSLRA safe harbor); *In re Nortel Networks Corp. Sec. Litig.*, 238 F. Supp. 2d 613 (S.D.N.Y. 2003) (finding that various forward-looking statements were based upon fraudulent historical and current facts, and thus ineligible for safe harbor protection); *In re Viropharma, Inc. Sec. Litig.*, 2003 WL 1824914, *7 (E.D. Pa. 2003) (holding that press release claiming patients using drug experienced improvement and that “our plan is to continue the path towards regulatory approval” were not forward looking, because “the truth or falsity of both of these statements was determinable at the time they were made”); *In re TheMart.com Sec. Litig.*, 114 F. Supp. 2d 955, 961-63 (C.D. Cal. 2000) (holding that projections that an online auction site would soon be operational were not protected by “bespeaks caution” doctrine or the Reform Act safe harbor provision because circumstances indicated that defendant had no reasonable basis for statements when made); *In re Cell Pathways, Inc. Sec. Litig.*, No. 99-752, 2000 U.S. Dist. LEXIS 8584, at *39-40 (E.D. Pa. 2000) (stating that defendant pharmaceutical company’s statements anticipating successful completion of FDA trials were not forward-looking when plaintiffs alleged failure to disclose fundamental flaw in Phase III trial process); *Secure Computing*, 120 F. Supp. 2d at 818 (holding that statements predicting realization of analyst estimates for earnings were not forward-looking when plaintiffs characterized statements as going to current business condition).

To immunize a forward-looking statement, “the cautionary language must be precise and must directly relate to the defendants’ forward-looking statement.” *In re Splash Tech. Holdings, Inc. Sec. Litig.*, No. C 99-00109 SBA, 2000 U.S. Dist. LEXIS 15369, at *32 (N.D. Cal. Sept. 29, 2000) (citing *Provenz v. Miller*, 102 F.3d 1478, 1493 (9th Cir. 1996)). “General statements that fail to disclose specific underlying material information fail to trigger the protection [of the safe harbor]. Likewise, boilerplate warnings merely reminding an investor that the investment holds risks are not sufficient.” *Id.* at *32-33 (citation omitted). *Accord Slayton v. Am. Express Co.*, 604 F.3d 758, 768 (2d Cir. 2010); *Asher v. Baxter*, 377 F.3d at 732. Acceptable cautionary language includes warnings that are specific and linked to the challenged projections. *Compare Ehlert v. Singer*, 245 F.3d 1313, 1320 (11th Cir. 2001) (concluding that defendants were immunized from liability under the safe harbor because “[i]n this case, the warnings actually given were not only of a similar significance to the risks actually realized, but were also closely related to the specific warning which Plaintiffs assert should have been given”), *with In re Reliance Sec. Litig.*, 135 F. Supp. 2d 480, 504 (D. Del. 2001) (finding that bespeaks caution doctrine did

not apply because cautionary language was not “directed to forward looking statements and . . . relate[d] directly to those statements on which investors claim to have relied”); *In re HI/FN, Inc., Sec. Litig.*, No. C 99-4531 SI, 2000 U.S. Dist. LEXIS 11631, at *15 (N.D. Cal. Aug. 9, 2000) (cautionary language in unrelated SEC filings was not sufficient for dismissal of claim on bespeaks caution grounds because “[m]isleading oral statements are not protected by cautionary language ‘spread out among various documents’”) (internal citations omitted). *See also In re Daktronics, Inc. Sec. Litig.*, No. CIV-08-4176, 2010 U.S. Dist. LEXIS 56778 (D.S.D. June 9, 2010) (with respect to how sales of digital billboards might be impeded by government regulation, disclosure that “financial performance may vary significantly from quarter to quarter” is not specific enough to offer safe harbor protection, but statement that there are regulatory constraints “on the rate of application for digital billboards . . . and it is important that investors understand that this constraint exists” is sufficient). Furthermore, in order to garner the protection of the safe harbor, a forward-looking statement must be specifically identified as such. *In re Splash Tech. Holdings*, 2000 U.S. Dist. LEXIS 15369, at *20-21; *but see In re Infonet Servs. Corp. Sec. Litig.*, 310 F. Supp. 2d 1080, 1092-93 (C.D. Cal. 2003) (holding cautionary language contained in a prospectus sufficient to warn investors about forward-looking statements made during roadshow presentations).

Courts have placed further restrictions on the PSLRA’s safe harbor. For example, one court has held that the availability of the safe harbor cannot be decided on a motion to dismiss when the relevant forward-looking statements were spoken, rather than written. *See In re Silicon Graphics*, No. C 96-0393 FMS, 1996 U.S. Dist. LEXIS 16989, at *39-40 (N.D. Cal. Sept. 25, 1996), *aff’d*, 183 F.3d 970 (9th Cir. 1999), *abrogation on other grounds recognized, South Ferry LP v. Killinger*, 542 F.3d 776 (9th Cir. 2008). In *Silicon Graphics*, the court reasoned that oral statements cannot be considered on a motion to dismiss because “such extrinsic evidence . . . is not referenced in plaintiff’s complaint nor subject to judicial notice as a public record. Further, as a factual claim by an interested party, this evidence may be subject to material dispute.” *Id.* Additionally, courts will deny safe harbor protection if the statement sought to be protected by the safe harbor was made with actual knowledge of its falsity. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d at 937, n.15 (safe harbor held not to apply because of strong inference of defendants’ actual knowledge of falsity).

F. Federal and State Law

Section 16 of the Securities Act and § 28(a) of the Exchange Act explicitly preserve remedies existing prior to passage of the securities acts. Thus, the

federal securities laws do not preclude state law actions, such as actions for common law fraud, arising out of securities transactions. Such actions can be, and often are, joined with actions brought under the liability provisions of the securities laws.

Actions under the Securities Act can be brought in either federal or state courts, under § 22(a) of the Act. Section 27 of the Exchange Act requires actions under that Act to be brought only in the federal courts. At least one statutory basis for venue has to have occurred in the federal district where the Exchange Act lawsuit has been brought. *See SEC v. Johnson*, 650 F.3d 710, 714-15 (D.C. Cir. 2011) (holding that the “co-conspirator theory of venue” is not consistent with Section 78aa of the Exchange Act).

After the passage of the Reform Act, an increasing number of plaintiffs filed actions in state rather than federal courts in attempts to avoid the Reform Act’s strictures. In the year after the Reform Act’s passage, the number of securities fraud cases filed in state courts nearly doubled. *See* Edward Brodsky, *Discovery Abuses: A Shifting Target?*, N.Y.L.J., Apr. 9, 1997, at 3. Congress responded to this trend by passing SLUSA, which added Section 16(b) to the Securities Act and Section 28(f) to the Exchange Act. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 101(a)(1), (b)(1), 112 Stat. 3227, 3227-30 (1998). These provisions make federal court the exclusive venue for nearly all securities fraud class actions. *See* Introduction, *supra* Part I.

Before the Supreme Court ruled on the question in 2006, the Courts of Appeal disagreed about whether the “in connection with” language in SLUSA was coterminous with the meaning of the nearly identical language of § 10(b). In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006), the Court ruled that SLUSA operated to preempt not only state law seller and purchaser claims, but also “holder” claims that alleged injury based on the prolonged retention of stock due to fraud. Though Rule 10b-5 only establishes a private cause of action under federal law for purchaser-seller claims, and that rule uses the same “in connection with” language as SLUSA, the Court ruled that the exclusion of holder claims from Rule 10b-5 was a judicially crafted limitation on private litigation, rather than an interpretation of its language. The Court rejected the Second Circuit’s adoption of the *Blue Chip Stamps* standard (*see* Section III.A.2, *infra*) to determine standing for holder claims under SLUSA. *See also Kircher v. Putnam Funds Trust*, 547 U.S. 633, 640-41 (2006) (deciding that a remand by federal district court to state court on ground that it was improperly removed is not appealable to federal appeals court, and noting that defendants can ask state court to determine applicability of SLUSA and the Court’s decision in *Dabit*). The Tenth Circuit similarly held that claims under state law were

precluded even when the state cause of action did not require allegations of scienter or reliance, as would be required for a § 10(b) claim, and such allegations were not made. *Anderson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 521 F.3d 1278, 1285 (10th Cir. 2008). *See also Romano v. Kozacos*, 609 F.3d 512 (2d Cir. 2010) (alleged misrepresentations and omissions of material fact satisfied SLUSA’s “in connection with” requirement because plaintiffs were led to invest in securities with the expectation of future gains that were not realized, notwithstanding 18-month lapse between the advice and the investment). Perhaps the most practical formulation of the “in connection with” test comes from the Northern District of California: “if it looks like a securities fraud claim, sounds like a securities fraud claim and acts like a securities fraud claim, it is a securities fraud claim, no matter how you dress it up.” *Feitelberg v. Merrill Lynch & Co.*, 234 F. Supp. 2d 1043, 1051 (N.D. Cal. 2002), *aff’d per curiam*, 353 F.3d 765 (9th Cir. 2003).

The term “covered securities” in SLUSA includes those listed or authorized for listing on the New York Stock Exchange, the American Stock Exchange, or the NASDAQ Stock Market, 15 U.S.C.A. § 77r(b); *Prager v. Knight/Trimark Group, Inc.*, 124 F. Supp. 2d 229, 231 (D.N.J. 2000). This definition extends to options, *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1130 (9th Cir. 2002) (“This analysis . . . leads us to conclude that the granting of an option constitutes a ‘purchase or sale’ under SLUSA”), *abrogation on other grounds recognized*, *Proctor v. Vishay Intertechnology, Inc.*, 584 F.3d 1208 (9th Cir. 2009), variable life insurance policies, *Herndon v. Equitable Variable Life Ins. Co.*, 325 F.3d 1252, 1253 (11th Cir. 2003) (“We hold that . . . a variable life insurance policy is a ‘covered security’ under SLUSA.”), and tax-deferred variable annuities, *Patenaude v. Equitable Life Assurance Soc’y of the United States*, 290 F.3d 1020, 1024 (9th Cir. 2002) (holding that “the deferred tax variable annuity purchased . . . qualifies as a ‘covered security’ within the meaning of SLUSA”), *abrogation on other grounds recognized*, *Proctor*, 584 F.3d at 1208.

Covered class actions brought in state court are removable to federal court and the state law claims are subject to dismissal based on the preemption provisions in § 16(b) of the Securities Act and § 28(f)(1) of the Exchange Act. *See* 15 U.S.C.A. §§ 77p(c), 78bb(f)(2). The party seeking removal must establish that the action is “(1) a ‘covered class action,’ (2) that is based on state law, (3) alleging a misrepresentation or omission of a material fact or use of any manipulative or deceptive device or contrivance, (4) ‘in connection with’ [or ‘involving,’ for removal purposes], (5) the purchase or sale of a covered security.” *Prager*, 124 F. Supp. 2d at 231-32 (collecting cases). The Eleventh Circuit has held that prospective class actions could be removed to federal court even if the state court had not determined whether the action should go forward as a class action. *See*

Behlen v. Merrill Lynch, 311 F.3d 1087, 1092-93 (11th Cir. 2002) (“The SLUSA does not require that an action be ‘maintained as a class action’ before it can be removed.”). Once a case has been removed to federal court, courts are divided on whether plaintiffs may file an amended complaint to exclude the federally preempted claim and obtain a remand to state court. The Ninth Circuit allows such amendment because of “the inequity of dismissing otherwise valid and viable state law claims on the ground that plaintiff pled — perhaps inadvertently — a cause of action that may be construed as federal in nature,” *U.S. Mortg., Inc. v. Saxton*, 494 F.3d 833, 843 (9th Cir. 2007), *abrogation on other grounds recognized*, *Proctor*, 584 F.3d at 1208, while the Eleventh Circuit has barred such amendment, *see Behlen*, 311 F.3d at 1095-96 (upholding District Court’s dismissal of class-wide claims with prejudice and individual claims without prejudice). The Seventh Circuit has rejected such repleading to exclude preempted claims because to do so would be “a case not just of the plaintiff’s abandoning his federal claims but of his seeking to prevent the defendant from defending in the court that obtained jurisdiction of the case on his initiative. That is called pulling the rug out from under your adversary’s feet.” *Brown v. Calamos*, 664 F.3d 123, 131 (7th Cir. 2011).

Several courts have interpreted SLUSA to apply broadly to all mass actions not otherwise exempted in the text of the Act. *See, e.g., Brown*, 664 F.3d at 130-131 (holding that, despite complaint’s disclaimer of any fraud-based allegations, the breach of fiduciary duty claims pled in the complaint rested upon an allegation of fraud such that the suit was barred by SLUSA); *Miller v. Nationwide Life Ins. Co.*, 391 F.3d 698, 702 (5th Cir. 2004) (finding that a complaint using breach of contract language was still subject to SLUSA because “SLUSA was designed to ensure that all causes of action involving allegations of misrepresentation or omission in connection with covered securities would be subject to the requirements of the [PSLRA.]”); *Gibson v. PS Group Holdings, Inc.*, No. 00-CV-0372 W (RBB), 2000 U.S. Dist. LEXIS 3158, at *10-17 (S.D. Cal. Mar. 8, 2000) (refusing to allow circumvention of SLUSA by amending the complaint to seek only injunctive relief instead of damages, but allowing the state court action to proceed under the corporate law of the issuer’s home state); *Hines v. ESC Strategic Funds, Inc.*, No. 3:99-0530, 1999 U.S. Dist. LEXIS 15790, at *6-17 (M.D. Tenn. Sept. 17, 1999) (dismissing claims of state law violations, common law fraud and breach of implied contract; allowing state claim of breach of fiduciary duty because alleged conduct not related to purchase of securities).

II

Liabilities under the Securities Act

A. Overview of § 11 and § 12

1. Sections 11 and 12 Contrasted

Sections 11 and 12 are the basic private liability provisions of the Securities Act. In keeping with the general scheme of the Securities Act they protect only *buyers*, not sellers. The difference between the two sections is this: § 11 makes those responsible for a false or misleading registration statement liable in damages to any and all purchasers regardless of from whom they bought, while § 12 allows a purchaser to rescind his purchase of securities, or to get damages from his seller if he no longer holds the securities, if the seller used a false or misleading prospectus or false or misleading oral statements in making the sale. Section 11 deals with the “manufacturers” and “wholesalers” of securities (*i.e.*, issuers, underwriters and experts who aid them in preparing registration statements), has no privity requirement and provides a remedy in damages. Section 12 deals with “retailers” of securities (*i.e.*, the securities dealers who sell to the general public), requires privity and provides primarily for a remedy of rescission.

2. Overlap Between § 11 and § 12

While §§ 11 and 12 are designed to affect different participants in the securities distribution process, the two provisions overlap somewhat. Thus, anyone who buys a security directly from an issuer or underwriter that is unregistered in violation of § 5 of the Securities Act or on the basis of false or misleading oral representations or a false or misleading prospectus may have an action for rescission under § 12 as well as an action under § 11. *See, e.g., Sanders v. John Nuveen & Co.*, 619 F.2d 1222 (7th Cir. 1980) (underwriter liable under § 12(2)); *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269 (10th Cir. 1957) (issuer liable under § 12(1)); *cf. Akerman v. Oryx Commc’ns, Inc.*, 810 F.2d 336, 344 (2d Cir. 1987) (affirming that purchaser-plaintiffs could not maintain suit against issuer under § 12(2) in the absence of scienter where title to securities passed from issuer to underwriters and then from underwriters to purchaser-plaintiffs), *questioned in Credit Suisse First Boston Corp. v. ARM Fin. Group*, No. 99 Civ. 12046 (WHP), 2001 U.S. Dist. LEXIS 3332, at *29 n.2 (S.D.N.Y. Mar. 27, 2001) (questioning *Akerman’s* interpretation of the “substantial participant” test and rejecting the contention that allegations of active solicitation must be coupled with an allegation of scienter).

3. Exclusivity of § 11 or § 12 Remedies

A buyer may not rescind or recover damages from his seller under § 12 *and* recover damages from an issuer, underwriter or their advisors under § 11. Nothing prevents a litigant, however, from pursuing both § 11 and § 12 actions to judgment and then electing his remedy.

4. Rule 9(b) and § 11 and § 12

Sections 11 and 12 claims do not require an element of fraud to be averred in the complaint and thus, generally, pleading with particularity is not necessary. However, when the pleading “sounds in fraud,” many courts have held that the heightened pleading requirements of Fed. R. Civ. P. 9(b) must be met. *See Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156, 1161 (9th Cir. 2009) (holding that if “a complaint employs the exact same factual allegations to allege violations of section 11 as it uses to allege fraudulent conduct under section 10(b) of the Exchange Act, we can assume that it sounds in fraud” and must comply with Rule 9(b)); *Wagner v. First Horizon Pharm. Corp.*, 464 F.3d 1273, 1277 (11th Cir. 2006) (requiring that a non-fraud securities claim be pled with particularity when fraudulent conduct is alleged to support the claim); *In re Daou Sys.*, 411 F.3d 1006, 1027 (9th Cir. 2005) (“Although section 11 does not contain an element of fraud, a plaintiff may nonetheless be subject to Rule 9(b)’s particularity mandate if his complaint ‘sounds in fraud.’”); *CALPERS v. Chubb Corp.*, 394 F.3d 126, 144 (3d Cir. 2004) (requiring § 11 claims “based on averments of fraud” to meet the heightened pleading requirements of Rule 9(b)); *Kennedy v. Venrock Assocs.*, 348 F.3d 584, 593 (7th Cir. 2003) (“if, while the statute . . . doesn’t require proof of fraud, only a fraudulent violation is charged, failure to comply with Rule 9(b) requires dismissal of the entire charge”); *Greer v. Advanced Equities, Inc.*, 683 F. Supp. 2d 761, 767-68 (N.D. Ill. 2010) (holding that Rule 9(b) applies to all *allegations* of fraud, not just *claims* of fraud); *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 402-03 (D. Md. 2004) (citing *Rombach v. Chang*, 355 F.3d 164, 170-71 (2d Cir. 2004) along with cases from the Third, Fifth, Seventh, and Ninth Circuits). *But see In re Suprema Specialties Sec. Litig.*, 438 F.3d 256 (3d Cir. 2006) (declining to apply Rule 9(b) where plaintiffs expressly pled negligence and also alleged fraud). Although a claim that does not sound in fraud will not be subject to the heightened pleading requirements of Rule 9(b), a one-sentence disavowment of fraud is insufficient to divorce claims that sound in fraud from their fraudulent underpinnings. *Compare CALPERS*, 394 F.3d at 160 (claims clearly sound in fraud when examined as a whole, so Rule 9(b) applies despite disavowment of fraud) *with Bauer v. Prudential Financial, Inc.*, No. 09-1120, 2010 U.S. Dist. LEXIS 64384, at *14-16 (D.N.J. June 29, 2010) (plaintiff clearly bringing only strict liability and negligence claims and

disclaiming any allegation that could be construed as alleging fraud is not subject to Rule 9(b)). Pleading with particularity pursuant to Rule 9(b) is discussed further in Part III.A.7, *infra*.

B. Section 11

Section 11(a) makes specified persons liable for any untrue statement of material fact in a registration statement or any omission of any material fact required to be stated in a registration statement or necessary to make statements therein not misleading, to any person acquiring the relevant security unless the acquiror knew of such untruth or omission at the time of the acquisition.

1. Persons Liable

If a registration statement is false or misleading, § 11(a) makes liable:

- a. the issuer;
- b. the directors of the issuer;
- c. persons named, by their consent, in the registration statement as about to become directors of the issuer;
- d. every person who signs the registration statement;
- e. every expert (*e.g.*, accountant, engineer, appraiser, etc.) who is named by consent as having certified or prepared any part of the registration statement; and
- f. every underwriter of the relevant security.

All of the above, *except experts*, are responsible for all misstatements and omissions in the registration statement. Experts are responsible for misstatements and omissions only in those parts of the registration statement they are named as having prepared or certified. *See In re Lehman Bros. Mortg.-Backed Sec. Litig.*, 650 F.3d 167 (2d Cir. 2011) (ratings agencies are not underwriters under § 11); *Batwin v. Occam Networks, Inc.*, 2008 WL 2676364, at *20 (C.D. Cal. July 1, 2008) (rejecting the argument that venture capitalists who sold 1.5 million shares in secondary offering could be sued as “issuers” under Section 11; “[b]y its clear language, Section 11 limits liability to *signatory* issuers, officers and directors, underwriters and auditors.”).

2. Scierter

A § 11 plaintiff does not need to establish a defendant's scienter, or even negligence, to prove his case. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983); *Krim v. PCOrder.com*, 402 F.3d 489, 495 (5th Cir. 2005) (stating that § 11's liability provisions create "'virtually absolute' liability", quoting *Herman & MacLean*, 459 U.S. at 382); *In re Adams Golf, Inc. Sec. Litig.*, 381 F.3d 267, 274 (3d Cir. 2004) ("Sections 11 and 12(a)(2) are virtually absolute liability provisions, which do not require plaintiffs to allege that defendants possessed any scienter."); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 435 (N.D. Ill. 1995); *In re Worlds of Wonder Sec. Litig.*, 694 F. Supp. 1427, 1434 (N.D. Cal. 1988); *Ahern v. Gaussoin*, 611 F. Supp. 1465, 1479 (D. Or. 1985), *rev'd on other grounds, Sec. Investor Prot. Corp. v. Poirier*, 653 F. Supp. 63 (D. Or. 1986). But see *J&R Mktg., SEP v. Gen. Motors Corp.*, 549 F.3d 384 (6th Cir. 2008) (while Section 11 itself does not require scienter, if the claim is based on violation of a duty to disclose imposed by an SEC regulation that requires knowledge, the plaintiff must adequately plead scienter with respect to the alleged violation of that duty to disclose). It ordinarily is enough if the registration statement is shown to have contained material misstatements or omissions. However, all defendants except the issuer may escape liability by establishing certain defenses, among them one of "reasonable grounds for belief" in the truth of the registration statement. See 15 U.S.C.A. § 77k(b)(3); see also *supra* Section II.A.4 (discussing the duty to comply with Fed. R. Civ. P. 9(b) when pleading Section 11 claim that "sounds in fraud").

Section 27A(c) of the Securities Act, added by the Reform Act, allows an exception to § 11's scienter-less liability. It provides that no liability will attach in a private action based on certain statutorily defined "forward-looking statements" unless the plaintiff proves actual knowledge of the false or misleading nature of the statement on the part of a natural person making the statement or on the part of an executive officer approving the statement made on behalf of a business entity. 15 U.S.C.A. § 77z-2(c)(1)(B). See Part I.E. *supra*.

3. Defenses

An issuer has virtually no defenses under § 11: it is strictly liable for material misstatements and omissions in registration statements. *Herman & MacLean*, 459 U.S. at 382; *Degulis v. LXR Biotechnology, Inc.*, 928 F. Supp. 1301, 1314 (S.D.N.Y. 1996); *Worlds of Wonder*, 694 F. Supp. at 1434; *Competitive Assocs., Inc. v. Int'l Health Sciences, Inc.*, No. 72 Civ. 1848-CLB, 1975 U.S. Dist. LEXIS 14230, at *48-49 (S.D.N.Y. Jan. 22, 1975). However, a defendant can avoid liability by proving the plaintiff knew of the misstatements or omissions. *Gap*

Stores, 79 F.R.D. at 297; *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 575 (E.D.N.Y. 1971). The Second Circuit has also held that where a claim is based upon a belief or opinion alleged to have been communicated by a defendant, such as subjective statements regarding goodwill and the adequacy of loan loss reserves, it is insufficient to state a claim under Section 11 (or 12) unless the statement was both “objectively false and disbelieved by the defendant at the time it was expressed.” *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 110 (2d Cir. 2011). All other defendants have a variety of defenses under § 11(b), for all of which they bear the burden of proof. If a § 11(a) named party resigns and informs the SEC of the materially false or misleading statement before the registration statement becomes effective, he has a § 11(b) defense. In addition, if a § 11(a) named party informs the SEC and the public that a registration statement has become effective without his knowledge, a § 11(b) defense is available. But the most important defense is set out in § 11(b)(3): reasonable grounds for belief in the truth of the alleged misstatements or omissions—the so-called “due diligence” defense.

Section 11(b)(3) in effect divides the registration statement into three portions: (i) parts based on statements made by official persons or in official records; (ii) parts based on statements, reports or valuations made by experts; and (iii) all other parts. Section 11(b)(3) then gives different defenses to experts and non-experts with regard to misstatements or omissions in these different parts of the registration statement:

a. *Experts* — With regard to parts of the registration statement based on their own statements, reports or valuations, experts can establish a defense by showing either (i) that after reasonable investigation they had reason to believe in the truth of their statements, reports or valuations, or (ii) that the registration statement did not fairly represent their statements or reports. Experts have no liability for portions of the registration statement they are not named as having prepared or certified.

b. *Non-experts* — With regard to parts of the registration statement based either on official reports or statements or on the reports or statements of experts, a non-expert can establish a defense by showing that he had no reason to believe that such statements or reports were false or misleading or were inaccurately represented in the registration statement. To this extent non-experts are allowed to rely on experts and on official statements and reports. *See Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 688 (S.D.N.Y. 1968); *see also Worlds of Wonder*, 35 F.3d 1407, 1421 (affirming district court’s conclusion that all defendants except outside accounting firm were immunized from Section 11 liability for

errors in the 1987 financial statements); *In re Software Toolworks Inc.*, 50 F.3d 615, 623 (9th Cir. 1994) (“An underwriter need not conduct due diligence into the ‘expertised’ parts of a prospectus, such as certified financial statements.”); *cf. Herman & MacLean*, 459 U.S. at 386 n.22 (noting that certain individuals involved with preparing the registration statement, such as lawyers not acting as “experts,” nevertheless cannot be reached by a § 11 action). *But see In re World Com, Inc. Sec. Litig.*, 346 F. Supp. 2d 628, 672 (S.D.N.Y. 2004) (“[W]here ‘red flags’ regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability.”). With regard to other parts of the registration statement, a non-expert must show that he conducted a reasonable investigation, and that, after such investigation, he had reasonable grounds for believing, and did believe, that the registration statement was neither false nor misleading.

Section 11(c) sets the standard of reasonableness for both experts and non-experts as that required of a prudent man in the management of his own property. *See BarChris*, 283 F. Supp. at 688.

Cases construing § 11(b)(3) and 11(c) are few, and the leading cases are still *Leasco*, 332 F. Supp. 544, and *BarChris*, 283 F. Supp. 643. A recent and relatively comprehensive discussion is contained in *World Com, Inc.*, 346 F. Supp. 2d at 661-78. These cases establish that whether a § 11(b)(3) defense exists must be determined on a case-by-case basis and the magnitude of the duty imposed will vary by party. *Leasco*, 332 F. Supp. at 577-78; *BarChris*, 283 F. Supp. at 682-84. Nevertheless, some generalizations can be made. Management and inside directors of the issuer will be under the highest duty to investigate the truth of the registration statement. Indeed, the duty is so stringent it amounts almost to absolute liability. *Leasco* at 578; *Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101, 1131 (W.D. Mich. 1996) (under section 11, “[l]iability against the issuer of a security is almost absolute, even for innocent misstatements; other defendants may resort to a due diligence defense”). Outside directors are under a lesser duty to investigate than are inside directors. *Leasco* at 578; *Goldstein v. Alodex Corp.*, 409 F. Supp. 1201, 1203 n.1 (E.D. Pa. 1976); *Laven v. Flanagan*, 695 F. Supp. 800, 812 (D.N.J. 1988) (outside directors under “lesser obligation to conduct a painstaking investigation than an inside director with an intimate knowledge of the corporation”). Nevertheless, they must also investigate to some extent and cannot merely accept management’s representations that the registration statement is accurate. *BarChris*, 283 F. Supp. at 688; *see also Weinberger v. Jackson*, No. C-89-2301-CAL, 1990 U.S. Dist. LEXIS 18394, at *10-12 (N.D. Cal. Oct. 11, 1990); *Laven*, 695 F. Supp. at 811. Note that courts have articulated different tests for distinguishing between outside

and inside directors, and there is no “uniform understanding of who is an outside director within the case law.” *World Com, Inc.*, 2005 WL 638268, at *10.

Underwriters, to effectuate the statute’s purpose of providing full disclosure to investors, are placed under a high duty to investigate. *BarChris*, 283 F. Supp. at 697. They cannot accept an issuer’s representation of facts about itself at face value, but must make an independent attempt at verification. *Leasco*, 332 F. Supp. at 582; *BarChris*, 283 F. Supp. at 697; *Glassman v. Computervision Corp.*, 90 F.3d 617, 628 (1st Cir. 1996) (warning that it may be “a failure of due diligence to rely solely on management representations as to the state of the company where those representations can reasonably be verified.”). In *In re Int’l Rectifier Sec. Litig.*, 1997 WL 529600, at *8 (C.D. Cal. 1997), the court synthesized the case law and identified the following factors in assessing the reasonableness of an underwriter’s investigation: (1) whether it is familiar with the issuer’s finances, management, and operations; (2) whether it had relevant industry knowledge; (3) whether it interviewed the issuer’s employees; (4) whether it interviewed the issuer’s suppliers or customers or confirmed data with them; and (5) whether it obtained verification from the issuer and its outside accountant that the prospectus was accurate. The underwriter’s duty to investigate lasts up to the effective date of the offering. *Glassman*, 90 F.3d at 628.

It is still something of an open question whether each member of an underwriting group must investigate separately or whether the duty to investigate can be delegated to lead underwriters. *BarChris* ruled that where the lead underwriter fails to establish a due diligence defense, other underwriters who relied on the lead underwriter will also be liable, but it reserved the question of whether other underwriters would be shielded from liability if the lead underwriter established a due diligence defense. 283 F. Supp. at 697 n.26. It has been held elsewhere, however, that all underwriters may rely on a successful due diligence defense of lead underwriters to establish a § 11(b)(3) defense. *Competitive Assocs., Inc.*, 1975 U.S. Dist. LEXIS 14230, at *52-54; see *World Com*, 346 F. Supp. 2d 636 & n.4, 647, 653 (analyzing multiple underwriters as a unitary entity for purposes of assessing due diligence defense, where underwriting group relied on diligence performed by co-lead underwriters). Moreover, a number of courts have found a lead underwriter’s due diligence defense sufficiently “common” and “typical” to that of the other underwriters’ to meet the requirements of Fed. R. Civ. P. 23 class certification on the rationale that a finding of due diligence on the part of the lead underwriter could exonerate the class members as well. *In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 612 (E.D. Mich. 1985) (in finding typicality, the court noted that “[t]he underwriting syndicate members . . . sink or swim with the lead underwriter in the typical case.”); *Endo v. Albertine*, 147 F.R.D. 164, 171

(N.D. Ill. 1993); *In re Activision Sec. Litig.*, 621 F. Supp. 415, 434 (N.D. Cal. 1985); *In re Intel Sec. Litig.*, 89 F.R.D. 104, 111-13 (N.D. Cal. 1981); *Gap Stores*, 79 F.R.D. at 302. *But see In re Security Am. Corp. Sec. Litig.*, No. 81 C 3910, 1985 U.S. Dist. LEXIS 17024, at *16 (N.D. Ill. Aug. 8, 1985) (“[T]he duty of due diligence is imposed on all underwriters regardless of their agreements inter se.”). The SEC has suggested that each underwriter must satisfy itself that the lead underwriter’s investigation is sufficient. *The Obligations of Underwriters*, Securities Act Release No. 33-5275, 1972 SEC LEXIS 89, at *20 (July 26, 1972); *accord Gap Stores*, 79 F.R.D. at 302 (stating that each underwriter “must show that he conducted a reasonable investigation of the registration statement . . . or a reasonable investigation of the [lead underwriter’s] methods.”).

The degree of investigation required of experts, such as accountants, is largely determined by professional standards. *Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994); *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1108 (7th Cir. 1974), *rev’d on other grounds*, 425 U.S. 185 (1976); *Endo v. Albertine*, 863 F. Supp. 708, 728 (N.D. Ill. 1994), *aff’d sub nom. Endo v. Arthur Andersen & Co., S.C.*, 163 F.3d 463 (7th Cir. 1999); *BarChris*, 283 F. Supp. at 703; *see also Potts v. SEC*, 151 F.3d 810, 812-13 (8th Cir. 1998) (holding that even a concurring partner on an audit must adhere to norms of accounting profession); *Adair v. Kaye Kotts Assocs.*, No. 97 Civ. 3375 (SS), 1998 U.S. Dist. LEXIS 3900, at *14-15 (S.D.N.Y. Mar. 24, 1998) (limiting an accountant’s liability to the period his report appears to certify, without requiring him to disclose subsequent events).

In 1982, in connection with its adoption of the integrated disclosure system, the SEC adopted Rule 176 under the Securities Act, which sets forth certain circumstances affecting the determination of what constitutes reasonable investigation and reasonable grounds for belief under § 11. Rule 176 codifies, without elucidating, the vague guidelines established by the case law. As the release announcing adoption of the rule stated, determination of whether a § 11(b)(3) defense has been established must ultimately be made on a case-by-case basis. *Adoption of Integrated Disclosure System*, Securities Act Release No. 33-6383, 1982 SEC LEXIS 2190, at *118 (March 3, 1982). *See also In re WorldCom, Inc. Sec. Litig.*, 2005 U.S. Dist. LEXIS 4193, at *16-19 (S.D.N.Y. Mar. 23, 2005) (discussing Rule 176). Rule 176(e), by making the presence or absence of additional ties to the corporation one factor to be considered in determining whether a director has established a defense under § 11(b)(3), makes clear that outside directors are not held as strictly liable as insiders. *See General Rules and Regulations, Securities Act of 1933*, 17 C.F.R. § 230.176(e) (2002).

The one important change effected by the rule occurs in Rule 176(h). Traditionally, underwriters have attempted to establish a § 11(b)(3) defense by

conducting “due diligence.” *Gap Stores*, 79 F.R.D. at 297-98. With the advent of integrated disclosure and registration statements, consisting in large part of incorporations by reference of Exchange Act filings with which underwriters may have had no connection, this has become more difficult. Accordingly, the SEC was urged to adopt a “safe-harbor” provision for underwriters with regard to incorporations by reference in registration statements. Adoption of Integrated Disclosure System, Securities Act Release No. 33-6383, 1982 SEC LEXIS 2190, at *117 n.98 (March 3, 1982). The SEC refused, but it adopted Rule 176(h), which makes relevant in a § 11(b)(3) inquiry whether a defendant had responsibility for documents incorporated by reference at the time they were filed. 17 C.F.R. § 230.176(h).

4. Reliance

A plaintiff, in almost all cases, need not show that he relied on statements in a registration statement to recover under § 11. *See In re Constar Int'l, Inc. Sec. Litig.*, 585 F.3d 774, 783 (3d Cir. 2009); *Rombach v. Chang*, 355 F.3d 164, 169 n.4 (2d Cir. 2004); *Westinghouse Elec. Corp. v. '21' Int'l Holdings, Inc.*, 821 F. Supp. 212, 218 (S.D.N.Y. 1993); *Ahern*, 611 F. Supp. at 1479; *In re Disonics Sec. Litig.*, 599 F. Supp. 447, 452 (N.D. Cal. 1984). Courts have interpreted § 11 to establish a presumption of reliance upon the registration statement. *See, e.g., Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967). But, a plaintiff who enters into a binding investment agreement prior to the filing of the registration statement cannot rely on this presumption. *APA Excelsior III L.P. v. Premiere Techs., Inc.*, 476 F.3d 1261, 1272 (11th Cir. 2007) (“To say that reliance is ‘presumed’ is simply not the same thing as saying that reliance is ‘irrelevant.’”). *But see Westinghouse*, 821 F. Supp. at 218 (“Reliance is not a factor in a § 11 action, and thus impossibility of reliance can be no bar to a § 11 claim.”). Additionally, under § 11(a), when the plaintiff buys the security after an earnings statement has been published for the issuer covering at least twelve months since the effective date of the registration statement, the plaintiff must show reliance; but he need not, by the terms of the statute, show that he actually read the registration statement. *Shores v. Sklar*, 647 F.2d 462, 470 n.7 (5th Cir. 1981), *overruled on other grounds by Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372 (5th Cir. 2007); *Gap Stores*, 79 F.R.D. at 297 n.14.

5. Measure of Damages

Under § 11(e), the measure of a plaintiff’s damages is the decline in the value of his securities. This is measured as the difference between the price at which the securities were bought (not to exceed the price at which the securities were offered to the public) and the price at which the securities were sold, if the

securities were sold before suit was filed, or the price as of the date the suit was filed, if the securities are still held as of that date. *Akerman v. Oryx Commc'n, Inc.*, 810 F.2d 336, 341-42 (2d Cir. 1987). When a § 11 claim is added in an amended complaint, the filing date of the § 11 suit relates back to the filing date of the initial complaint for remedy purposes. *See Alpern v. UtiliCorp United, Inc.*, 84 F.3d 1525, 1542-44 (8th Cir. 1996). Section 11's method of measuring damages precludes "benefit-of-the-bargain" damages. *See McMahan & Co. v. Wherehouse Entm't, Inc.*, 65 F.3d 1044, 1048 (2d Cir. 1995). In addition, any price decline before disclosure of the material misstatement may not be charged to defendants. *Id.* at 1049; *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 429, 437 (S.D.N.Y. 2003); *see also Beecher v. Able*, 435 F. Supp. 397, 407 (S.D.N.Y. 1975). If the price of the securities declines after the suit is filed, the plaintiff cannot recover for this further decline. But if the price rises after the suit is filed, damages are reduced. *See In re Cendant Corp. Litig.*, 264 F.3d 201, 228 n.8 (3d Cir. 2001).

There is no upper limit, other than the total value of the offering in question, to the liability under § 11 of defendants other than underwriters. But under § 11(e) no underwriter can be liable for more than the offering value of the securities underwritten by that underwriter, unless such underwriter received special compensation from the issuer that other underwriters did not receive. Punitive damages are not recoverable under either the Securities Act or the Exchange Act. *See Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1284 (2d Cir. 1969) (the Securities Act); *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968) (the Exchange Act).

6. Causation and Standing

Under § 11(e), a plaintiff does not have to show that a decline in the value of his securities was caused by a material misstatement or omission in the registration statement. *In re Constar*, 585 F.3d at 783 ("In a § 11 case, plaintiffs do not have the burden of proving causation . . ."). But a defendant can mitigate damages by showing that such decline was due to factors other than the misstatement or omission. *Id.* This affirmative defense is referred to as "negative causation." *In re Adams Golf*, 381 F.3d at 277 (so holding but declining to allow the affirmative defense to be used to dismiss the complaint pursuant to Rule 12(b)(6)). *See also Akerman*, 810 F.2d at 340; *McMahan & Co. v. Wherehouse Entm't Inc.*, 65 F.3d 1044, 1048 (2d Cir. 1995); *Collins v. Signetics Corp.*, 605 F.2d 110, 114-16 (3d Cir. 1979), *overruling on other grounds recognized, Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628 (3d Cir. 1989). Since there is no causation requirement in § 11 cases, the Third Circuit has ruled that, in those cases, there is no need for a

determination of whether the market for a company's stock is efficient, as there would be in a § 10(b) case. *In re Constar*, 585 F.3d at 783.

Several courts have held, moreover, that to have standing to pursue a claim under § 11, a plaintiff "must plead that [his] stock was issued pursuant to the public offering[s] alleged to be defective." *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 972 (E.D.N.Y. 1988), *vacated on other grounds*, 714 F. Supp. 1285 (E.D.N.Y. 1989). Most courts have held that stock purchased in a secondary market is "issued pursuant to the public offering," *id.*, if the plaintiffs can "'trace' their securities to the challenged registration." *Adair v. Bristol Tech. Sys., Inc.*, 179 F.R.D. 126, 130-33 (S.D.N.Y. 1998); *see also Lee v. Ernst & Young, LLP*, 294 F.3d 969, 978 (8th Cir. 2002); *Joseph v. Wiles*, 223 F.3d 1155, 1159-61 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1079-82 (9th Cir. 1999); *Barnes v. Osofsky*, 373 F.2d 269, 271-73 (2d Cir. 1967); *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 338-39 (S.D.N.Y. 2001); *Giarraputo v. UNUMprovident Corp.*, No. 99-301-P-C, 2000 U.S. Dist. LEXIS 19138, at *32 (D. Me. Nov. 8, 2000); *Schwartz v. Celestial Seasonings, Inc.*, 178 F.R.D. 545, 555-56 (D. Colo. 1998); *In re ZZZZ Best Sec. Litig.*, No. CV-87-3574-RSWL (Bx), 1994 U.S. Dist. LEXIS 21590, at *11-12 (C.D. Cal. Oct. 26, 1994). A plaintiff must affirmatively plead this "tracing" requirement. *Crazy Eddie, Inc.*, 702 F. Supp. at 972. However, only purchasers, not sellers, of securities have standing under Sections 11 and 12. The Tenth Circuit has held that a "forced" sale due to a merger that changed the character of shares did not render the holder of those shares a "buyer" of a security so as to have standing under the Securities Act. *Katz v. Gerardi*, 655 F.3d 1212, 1221-23 (10th Cir. 2011).

In the wake of the *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995) opinion, discussed *infra*, which limited standing under § 12(2) to securities transactions that require a prospectus, some courts had restricted § 11 standing to primary purchasers from the initial offering. *See, e.g., McKowan Lowe & Co., Ltd. v. Jasmine Ltd.*, 127 F. Supp. 2d 516, 543-44 (D.N.J. 2000), *vacated in part on other grounds*, 295 F.3d 380 (3d Cir. 2002); *Warden v. Crown Am. Realty Trust*, No. 96-25J, 1998 U.S. Dist. LEXIS 16194, at *5-10 (W.D. Pa. Oct. 15, 1998), *aff'd mem.*, 229 F.3d 1140 (3d Cir. 2000). This interpretation of § 11 standing currently seems to be the law of the Third Circuit. *See Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 286 (3d Cir. 1992) ("If plaintiffs' shares were purchased in the secondary market, they would not be linked to a registration statement filed during the class period, and the § 11 claim would fail."). However, even after *Gustafson*, a majority of district courts in the Second Circuit held that § 11 standing is not limited to purchasers who directly participated in the public offering covered by the allegedly misleading registration statement and prospectus; instead, "secondary market purchasers" may sue "where a registration

statement was false or misleading.” *Dorchester Investors v. Peak TrENDS Trust*, No. 99 Civ. 4696 (LMM), 2002 U.S. Dist. LEXIS 3067, at *17-19 (S.D.N.Y. Feb. 25, 2002) (citing cases with similar holdings); *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 202 (E.D.N.Y. 2000) (holding that plaintiffs who purchased stock “pursuant to and/or traceable to the Registration Statement” have standing). The Second Circuit spoke definitively in *DeMaria v. Andersen*, holding that “aftermarket purchasers who can trace their shares to an allegedly misleading registration statement have standing to sue under § 11 of the 1933 Act.” 318 F.3d 170, 178 (2d Cir. 2003). *Cf. Krim v. pcOrder.com, Inc.*, 402 F.3d 489, 502 (5th Cir. 2005) (stating that aftermarket purchasers may have standing to sue but rejecting the statistical tracing method to establish the connection between the securities purchased and the allegedly misleading registration statement). Moreover, a plaintiff who participated in only some of the issuer’s multiple offerings still has standing to sue on behalf of all buyers who participated in all offerings if the plaintiff participated in at least one offering pursuant to each of the issuer’s shelf registration statements. *In re Citigroup, Inc. Bond Litig.*, No. 08 Civ. 9522, 2010 U.S. Dist. LEXIS 69257, at *41-44 (S.D.N.Y. Jul. 12, 2010). The Fifth, Eighth, Ninth and Tenth Circuits also have refused to limit § 11 standing after *Gustafson* to direct purchasers in the public offering. *See Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 871-73 (5th Cir. 2003); *Lee v. Ernst & Young, LLP*, 294 F.3d 969 (8th Cir. 2002); *Hertzberg*, 191 F.3d at 1080-81; *Joseph*, 223 F.3d at 1159.

Once other securities not issued pursuant to the offering in question enter the market, however, persons acquiring their shares in the aftermarket will not be able to trace those shares to the offering and, therefore, will not be able to establish a § 11 claim. *Krim*, 420 F.3d at 496, 500; *In re Dynegey, Inc. Sec. Litig.*, 2005 WL 807076 (S.D. Tex. Mar. 10, 2005); *In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65, 120 (S.D.N.Y. 2004), *vacated on other grounds and remanded*, 471 F.3d 24 (2d Cir. 2006); *see also Davidco Investors, LLC v. Anchor Glass Container Corp.*, 2006 WL 547989, at *23 (M.D. Fla., Mar. 6, 2006). A purchaser who acquired stock between the filing of an initial registration statement and the filing of a misleading amendment has also been held to be unable to trace his securities to a defective statement. *Guenther v. Cooper Life Sciences, Inc.*, 759 F. Supp. 1437, 1440 (N.D. Cal. 1990).

7. Statute of Limitations

Like actions brought under § 12, actions brought under § 11 are subject to the limitations period set forth in § 13 of the Securities Act. Actions under § 11 must be brought within one year from the time of discovery of the untrue statement or omission, or from the time such discovery should have been made by the exercise

of reasonable diligence, and in no case more than three years after the security was first offered to the public. *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1308 (9th Cir. 1982). Inquiry notice may be triggered by public disclosures about the financial condition of the corporation, other lawsuits alleging fraud committed by the defendants, suspension of trading in the issuer's stock, public reports of federal or state investigations of the issuer, notice that the issuer has filed for bankruptcy or a sharp decline in the issuer's stock value. *In re Infonet Servs. Corp. Sec. Litig.*, 310 F. Supp. 2d 1106, 1113-14, 1116 (C.D. Cal. 2003). While any one of these events may not be determinative, the cumulative effect of two or more of them may well require that a purchaser of a registered security commence a Section 11 action within one year of these events. *Id.* at 1114, 1116 (finding Section 11 claim time-barred under Section 13 due to ample "storm warnings" more than one year prior to filing); *see also Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 951 (9th Cir. 2005) (stating the Ninth Circuit standard as "inquiry-plus-due diligence" and holding that notice is not triggered by "financial problems alone"); *La Grasta v. First Union Sec. Inc.*, 358 F.3d 840, 849 (11th Cir. 2004) (refusing to "adopt a bright-line rule that a certain price drop within a certain period of time constitutes inquiry notice as a matter of law"); *In re CBT Group PLC Sec. Litig.*, No. C-98-21014-RMW, 2000 U.S. Dist. LEXIS 19214 (N.D. Cal. Dec. 29, 2000). *See generally Fogarazzo v. Lehman Bros., Inc.*, 341 F. Supp. 2d 274, 298 (S.D.N.Y. 2004) (defining as "extraordinary" defendant's burden for establishing that inquiry notice was triggered). While SEC Rule 430B "permits issuers to make disclosures by prospectus supplement that previously would have required a post-effective amendment to the registration statement," when information material to investors is provided only at the time securities are marketed to the public via lengthy prospectus supplements, the statute of limitations for Section 11 liability begins anew as of the date each prospectus supplement is filed. *Fed. Housing Fin. Agency v. UBS Ams., Inc.*, No. 11 Civ. 5201(DLC), 2012 WL 2400263, at *4-*5 (S.D.N.Y. June 26, 2012). The new Sarbanes-Oxley statute of limitations has been held not to apply to Section 11 of the Securities Act because claims based on this provision do not "sound in fraud," as required by Section 804 of Sarbanes-Oxley, but rather are based on strict liability or negligence. *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 431, 441 (S.D.N.Y. 2003), *vacated on other grounds and remanded*, 496 F.3d 245 (2d Cir. 2007); *In re Alstom SA*, 406 F. Supp. 2d 402, 414 (S.D.N.Y. 2005) (citing cases); *Friedman v. Rayovac Corp.*, 295 F. Supp. 2d 957 (W.D. Wis. 2003). *See also In re Enron Corp. Sec., Derivative & ERISA Litig.*, 2004 WL 405886, at *12 (S.D. Tex. Feb. 24, 2004) (stating that "where Section 11 and Section 12(a)(2) claims do not require a showing of fraudulent intent, but are based on negligence or strict liability, section 804's enlarged statute of limitations does not apply, but Section 13 governs.").

8. Contribution

Section 11(f) specifically states that any person who becomes liable under § 11 may recover contribution from any other person who, if sued separately, would have been liable for the same payment, unless the person seeking contribution was guilty of *fraudulent* misrepresentation and the other person was not. Thus, where liability is based on strict liability or negligent misrepresentation contribution is available, but where liability is based on fraud it may not be. By the terms of § 11(f), where contribution is available it is on a *pro rata* basis as in contract, rather than a fault basis as in tort. *But see* Section IV.E, *infra*.

C. Section 12

Under § 12(1) (renumbered § 12(a)(1) by the Reform Act but referred to herein as § 12(1) in keeping with current convention) any person who offers or sells a security required to be registered under the Securities Act but not registered is liable to the person purchasing the security. Section 12(1) creates a right of action only for the solicitation or sale of securities in violation of § 5. *Pinter v. Dahl*, 486 U.S. 622, 641-47 (1988).

Under § 12(2) (renumbered § 12(a)(2) by the Reform Act but referred to herein as § 12(2) in keeping with current convention) any person who by use of any means of interstate commerce offers or sells a security on the basis of a materially false or misleading prospectus or materially false or misleading oral statements is liable to the person purchasing from him, unless he can show that he did not know, and could not in the exercise of reasonable care have known, of the falsehood or omission. *See Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d Cir. 2011) (complaint adequately alleged violation of § 12(a)(2) for failure of initial public offering prospectus of private equity company to disclose material adverse trends concerning its investments in portfolio companies). Liability can be based on a prospectus other than that required under § 5 of the Securities Act; any offering circular will do. *See, e.g., Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1227 (7th Cir. 1980) (finding commercial paper reports to be prospectuses).

In *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), the Supreme Court resolved a long-standing split in the circuits by holding that § 12(2) does not apply to a private contract for a secondary market sale of securities. *Compare Pacific Dunlop Holdings Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993) (applying § 12(2) to secondary transactions), *abrogated by Gustafson*, with *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991) (holding § 12(2) inapplicable to secondary transactions). The Court concluded that, based on an examination of both the definition of “prospectus” in § 2(10) and the provisions

of § 10 (which describe the information that must be contained in a prospectus for registered securities), “the word ‘prospectus’ is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder.” *Gustafson*, 513 U.S. at 583-84. Thus, the Court held that a privately negotiated contract for the sale of corporate stock that included representations and warranties of the sellers that the buyers claimed were not true was not a “prospectus.” Accordingly, the buyers could not maintain a § 12(2) claim.

Unlike § 11 and § 12(1), which apply only to securities subject to the requirements of § 5 of the Securities Act, § 12(2) applies to all securities except those exempted from the Securities Act by § 3(a)(2). The Supreme Court’s decision in *Gustafson*, however, leaves unclear the applicability of § 12(2) to private placement offerings. While on its facts *Gustafson* addressed only a private contract for the sale of previously issued stock, the Court’s broad language, confining the term “prospectus” to “documents related to public offerings by an issuer or its controlling shareholders,” and stating that “the liability imposed by § 12(2) cannot attach unless there is an obligation to distribute the prospectus in the first place (or unless there is an exemption),” 513 U.S. at 569-571, could be read to preclude suit under § 12(2) by a plaintiff complaining of a misrepresentation in a private placement offering memorandum. Justice Ginsburg, in her dissent, read the Court’s decision in such a manner, stating that, according to the majority, “[c]ommunications during . . . a private placement are not ‘prospectuses’ . . . and thus are not covered by § 12(2).” *Id.* at 596 (Ginsburg, J., dissenting). Such a holding would conflict with the prior decisions of every court of appeals to consider the issue, each of which held that private placements are subject to § 12(2). *See id.* at 602 (Ginsburg, J., dissenting) (citing cases).

Since *Gustafson*, a number of courts have held that § 12(2) does not apply to offerings made by means of a private placement memorandum. *See, e.g., Lewis v. Fresne*, 252 F.3d 352, 358 (5th Cir. 2001); *Maldonado v. Dominguez*, 137 F.3d 1, 8-9 (1st Cir. 1998); *Whirlpool Fin. Corp. v. GN Holdings, Inc.*, 67 F.3d 605, 609 n.2 (7th Cir. 1995); *Joseph v. Wiles*, 223 F.3d 1155, 1161 (10th Cir. 2000); *Vannest v. Sage, Ruddy & Co.*, 960 F. Supp. 651, 655 (W.D.N.Y. 1997); *In re JWP, Inc. Sec. Litig.*, 928 F. Supp. 1239, 1259 (S.D.N.Y. 1996). Moreover, the Second Circuit has held that a § 12(2) action cannot be maintained by a plaintiff who acquires securities through a private transaction even where the marketing of the securities relied on a prospectus prepared for a public offering. *Yung v. Lee*, 432 F.3d 142 (2d Cir. 2005).

1. Persons Liable

Section 12 states that “[a]ny person who . . . offers or sells a security” in violation of its substantive provisions “shall be liable to the person purchasing such security from him.” This “privity” requirement has been interpreted to mean that underwriters could not be liable under § 12(2) to persons who did not purchase from them. *Competitive Assocs., Inc. v. Int’l Health Scis., Inc.*, 1975 U.S. Dist. LEXIS 14230, at *42-43. Prior to December 1, 2005, it had generally been held that an issuer that engages in no solicitation could not be liable under § 12(2) where the securities were distributed pursuant to a firm commitment underwriting. *Lone Star Ladies Inv. Club v. Schlotzsky’s Inc.*, 238 F.3d 363, 370 (5th Cir. 2001) (“a buyer cannot recover against *his* seller’s seller”) (emphasis in original); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1215-16 (1st Cir. 1996), *abrogated by statute on other grounds*, 15 U.S.C. § 78u(4)(b)(2); *Collins v. Signetics Corp.*, 605 F.2d 110, 113, *questioned in Pinter v. Dahl*, 486 U.S. at 644; *Credit Suisse First Boston Corp. v. ARM Fin. Group, Inc.*, No. 99 Civ. 12046 (WHP), 2001 U.S. Dist. LEXIS 3332, at *28-29 (S.D.N.Y. Mar. 27, 2001); *Lalor v. Omtool, Ltd.*, No. 99-469-M, 2000 U.S. Dist. LEXIS 18675, at *19-21 (D.N.H. Dec. 14, 2000); *PPM Am., Inc. v. Marriott Corp.*, 853 F. Supp. 860, 874-75 (D. Md. 1994). *See also In re Infonet Servs. Corp.*, 310 F. Supp. 2d at 1101 (serving on the Board of Directors and signing the Prospectus and Registration Statement does not constitute active solicitation). *But see Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1114 (5th Cir. 1988) (“It *might* be said that everyone who invested in the initial offering bought from the . . . issuer.”) (emphasis in original), *vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989); *Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, 229-30 (S.D.N.Y. 1999); *In re Portal Software, Inc. Sec. Litig.*, No. C-03-5138 VRW, 2006 U.S. Dist. LEXIS 61589, at *11-12 (N.D. Cal. Aug. 17, 2006) (denying motion to dismiss § 12(2) claims because plaintiffs had adequately alleged defendant’s “seller” status).

The SEC changed the rules in 2005 to hold issuers in primary offerings liable as sellers under § 12(2) even when the sales occur through underwriters. SEC Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, Fed. Sec. L. Rep. ¶ 87,421 (Dec. 1, 2005); 17 C.F.R. § 230.159A. The SEC believed that “an issuer offering or selling its securities in a registered offering pursuant to a registration statement containing a prospectus that it has prepared and filed, or by means of other communications that are offers made by or on behalf of or used or referred to by the issuer can be viewed as soliciting purchases of the issuer’s registered securities,” and thus the uncertainty regarding issuer liability in a primary offering was unwarranted. Release No. 33-8591 at 82,427. Under Rule 159A, the issuer of a security sold to a person in its primary offering or initial

distribution is considered a seller under § 12(2) if the securities were sold by means of any of a number of communications, which roughly include:

- (1) A preliminary prospectus or prospectus of the issuer required by Rule 424;
- (2) A free writing prospectus, as defined by Rule 405, prepared by or on behalf of the issuer or used or referred to by the issuer;
- (3) A part of any other free writing prospectus or advertisement pursuant to Rule 482 “relating to the offering and containing material information about the issuer or its securities provided by or on behalf of the issuer”; and
- (4) “Any other communication that is an offer in the offering made by the issuer to such person.”

17 C.F.R. § 230.159A.

In 1988, the Supreme Court resolved a conflict that had previously existed among the circuits regarding the privity requirement under § 12(1). The Court rejected the Fifth Circuit’s requirement that the defendant be a “substantial factor” in causing the plaintiff to purchase the security, holding instead that § 12(1) only applied to the “owner who passed title, or other interest in the security, to the buyer for value,” or a person “who successfully solicit[ed] the purchase, motivated at least in part by a desire to serve his own financial interest or those of the securities owner.” *Pinter*, 486 U.S. at 647; *see also Harelson v. Miller Fin. Corp.*, 854 F.2d 1141, 1142 (9th Cir. 1988). “The *Pinter* Court emphasized that Section 12 liability depends on the ‘defendant’s relationship with the plaintiff-purchaser.’” *In re Am. Bank Note Holographics, Inc. Sec. Litig.*, 93 F. Supp. 2d 424, 438 (S.D.N.Y. 2000) (quoting *Pinter*, 486 U.S. at 651).

Although the Court noted that most courts and commentators have not defined the defendant class of § 12(1) differently from that of § 12(2), it nonetheless expressly declined to decide the scope of a statutory “seller” for purposes of § 12(2). *See Pinter*, 486 U.S. at 642 n.20. After *Pinter*, it thus remained unclear whether the application of § 12(2) would be limited to the same defendants as under § 12(1). *See Schlifke v. Seafirst Corp.*, 866 F.2d 935, 940 (7th Cir. 1989).

Prior to *Pinter*, different courts defined the defendant class for a § 12(2) violation differently. The Second Circuit had found that “nonselling collateral participants” could be liable even in the absence of privity, provided that the plaintiff could show the defendant possessed the requisite scienter, *i.e.*, “knowing or intentional

misconduct.” *Wilson v. Ruffa & Hanover, P.C.*, 844 F.2d 81, 85 (2d Cir. 1988), *vacated sub nom.*, *Wilson v. Saintine Exploration and Drilling Corp.*, 872 F.2d 1124 (2d Cir. 1989). The Third and Seventh Circuits required that title pass directly from the defendant to the plaintiff for a § 12(2) claim to exist. *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1226 (7th Cir. 1980); *Collins v. Signetics Corp.*, 605 F.2d 110, 113 (3d Cir. 1979), *questioned in Pinter*, 486 U.S. at 622; *see also Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986) (stating that law firm and accounting firm which rendered services in connection with the sale of securities by a corporation cannot be § 12(2) sellers). *But cf. Schlueter v. Cozad*, 674 F. Supp. 1351, 1355-56 (C.D. Ill. 1987) (holding that privity requirement under *Sanders* can include active solicitation of sale even though someone else transfers title to purchaser). The Fourth, Fifth, Sixth, Eighth, Ninth and Eleventh Circuits did not require title to pass directly from the defendant to the plaintiff; rather, they only required that the defendant’s actions be both “necessary to” and be a “substantial factor” in causing (language that *Pinter* subsequently rejected in the § 12(1) context) the securities sale to take place. *See, e.g., Jett v. Sunderman*, 840 F.2d 1487, 1491 (9th Cir. 1988), *abrogated on other grounds by Moore v. Kayport Package Exp., Inc.*, 885 F.2d 531 (9th Cir. 1989); *Adalman v. Baker, Watts & Co.*, 807 F.2d 359, 363 (4th Cir. 1986); *Foster v. Jesup & Lamont Sec. Co.*, 759 F.2d 838, 843-44 (11th Cir. 1985); *Davis v. Avco Fin. Servs., Inc.*, 739 F.2d 1057, 1067-68 (6th Cir. 1984); *SEC v. Seaboard Corp.*, 677 F.2d 1289, 1294 (9th Cir. 1982); *Stokes v. Lokken*, 644 F.2d 779, 785 (8th Cir. 1981); *Pharo v. Smith*, 621 F.2d 656, 667 (5th Cir. 1980).

The trend since *Pinter* appears to be that courts will apply *Pinter*’s standard in the context of a § 12(2) claim. Indeed, the First, Second, Third, Fifth, Sixth, Seventh, Ninth and Eleventh Circuits have applied the Supreme Court’s § 12(1) holding to § 12(2). *See, e.g., Shaw*, 82 F.3d at 1214, *abrogated by statute on other grounds*, 15 U.S.C. § 78u(4)(b)(2); *Wilson*, 872 F.2d at 1126; *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988); *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 636 (3d Cir. 1989); *Abell*, 858 F.2d at 1115; *Smith v. Am. Nat’l Bank & Trust Co.*, 982 F.2d 936, 941-42 (6th Cir. 1992); *Ackerman v. Schwartz*, 947 F.2d 841, 844-45 (7th Cir. 1991); *Moore*, 885 F.2d at 536; *Ryder Int’l Corp. v. First Am. Nat’l Bank*, 943 F.2d 1521, 1527-30 (11th Cir. 1991); *see also In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 204-05 (E.D.N.Y. 2000) (holding that issuer could be held liable despite “firm commitment underwriting” when issuer solicited sales of its stock for financial gain). District courts in the Fourth, Eighth, Tenth and District of Columbia Circuits have also held that *Pinter* holds the answer in the context of § 12(2), thereby providing some support for this proposition in every circuit. *See, e.g., Allison v. Bank One*, No. 91-S-1422, 91-S-1423, 1994 U.S.

Dist. LEXIS 11265, at *6-7 (D. Colo. Jan. 7, 1994); *In re RAC Mortg. Inv. Corp. Sec. Litig.*, 765 F. Supp. 860, 865-66 (D. Md. 1991); *Suppa v. Montano*, No. 87-0636-CV-W-3, 1989 U.S. Dist. LEXIS 5682, at *13-16 (W.D. Mo. Feb. 28, 1989); *Mix v. E.F. Hutton & Co.*, 720 F. Supp. 8, 9 (D.D.C. 1989).

Courts applying the *Pinter* standard to § 12(2) claims have generally held that lawyers and accountants who merely perform professional services without active solicitation are not “sellers” under § 12(2). *See Ackerman*, 947 F.2d at 844-45; *Moore*, 885 F.2d at 537 (drawing distinction between the act of solicitation and assisting in the solicitation effort, and dismissing § 12(2) claim against attorneys and accountants); *Wilson*, 872 F.2d at 1127 (dismissing § 12(2) claim against law firm that committed “ministerial act” of mailing and copying private placement memorandum); *Buford White Lumber Co. Profit Sharing & Sav. Plan & Trust v. Octagon Props., Ltd.*, 740 F. Supp. 1553, 1558 (W.D. Okla. 1989) (holding that a law firm which prepares prospectus motivated by desire to benefit itself and/or its client is not a “seller” or “solicitor” under § 12(2)). Similarly, a broker acting merely as an agent of the purchaser who does not engage in any solicitation may avoid § 12(2) liability. *Montcalm County Bd. of Comm’rs v. McDonald & Co. Sec., Inc.*, 833 F. Supp. 1225, 1233 (W.D. Mich. 1993) (collection of a commission does not convert broker into seller under § 12(2)); *Ryder Int’l Corp.*, 943 F.2d at 1531; *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 697 F. Supp. 1224, 1228-29 (D.D.C. 1988).

Courts have not taken a uniform approach to the applicability of § 12(2) to parties whose major contribution to the sale of securities is participation in the preparation of the prospectus. *Compare Craftmatic Sec. Litig.*, 890 F.2d at 636 (stating that an issuer is not liable under § 12 solely on the basis of its involvement in preparation of the prospectus); *In re Westinghouse Sec. Litig.*, 832 F. Supp. 948, 985 (W.D. Pa. 1993) (“[P]reparation of financial statements and prospectuses . . . are not considered part of the solicitation process. . .”), *rev’d on other grounds*, 90 F.3d 696 (3d Cir. 1996); *In re Gas Reclamation, Inc. Sec. Litig.*, 733 F. Supp. 713, 724 (S.D.N.Y. 1990) (finding agent of surety who participated in preparation of prospectus not liable under § 12(2) absent evidence that he had more than minimal contact with investors), *appeal dismissed sub nom. Abish v. N.W. Nat’l Ins. Co.*, 924 F.2d 448 (2d Cir. 1991), *with Capri v. Murphy*, 856 F.2d at 478 (deciding that general partners of coal mining venture qualify as “sellers” under § 12(2) through preparation and circulation of misleading prospectus despite lack of direct communication with investors); *Suppa*, 1989 U.S. Dist. LEXIS 5682, at *16 (“The Court has little difficulty determining that those who prepare and disseminate a materially false prospectus, even though they do not actually sell the security, may be held liable as an offeror under section 12(2).”). As indicated by the cases cited above, a defendant’s liability

may depend on the extent to which that party engaged in activities involving the dissemination of the prospectus over and beyond its mere preparation.

Use of secondary liability concepts, discussed in Part V below, has also attenuated somewhat the privity requirement of § 12.

2. **Scienter and Defenses**

Under § 12(1) there is no requirement that plaintiff show scienter or even negligence: a person who sells securities in violation of the registration provisions of the Securities Act is strictly liable. *Pinter*, 486 U.S. at 638; *Raiford v. Buslease, Inc.*, 825 F.2d 351, 354 (11th Cir. 1987). The Supreme Court's decision in *Pinter* makes clear that an *in pari delicto* defense is available under § 12(1). See the discussion of defenses under Rule 10b-5, *infra* Section III.A.10.

Nor is there a requirement under § 12(2) that a plaintiff show scienter or negligence. However, under Section 27A(c) of the Securities Act, which was added by the Reform Act, no liability will attach in a private action based on certain statutorily defined "forward-looking statements" unless the plaintiff proves actual knowledge of the false or misleading nature of the statement on the part of a natural person making the statement or on the part of an executive officer approving the statement made on behalf of a business entity. 15 U.S.C.A. § 77z-2(c)(1)(B). See Part I.E. *supra*. Generally, a plaintiff who shows that his seller made materially false or misleading statements or used a materially false or misleading prospectus, and that the plaintiff had no knowledge of any untruth or omission, has established his case. *In re Adams Golf, Inc. Sec. Litig.*, 381 F.3d at 274; *Currie v. Cayman Res. Corp.*, 835 F.2d 780, 782-83 (11th Cir. 1988); *Hill York Corp. v. Am. Int'l Franchises, Inc.*, 448 F.2d 680, 695 (5th Cir. 1971), *abrogated on other grounds by Pinter*, 486 U.S. at 649-51, *as recognized in In re Enron Corp. Sec., Derivative & ERISA Litig.*, 540 F. Supp. 2d 759, 784 n.28 (S.D. Tex. 2007). However, defendant sellers have an affirmative defense under § 12(2) that they neither knew, nor could, in the exercise of reasonable care, have known, of the untruth or omission. *Gilbert v. Nixon*, 429 F.2d 348, 357 (10th Cir. 1970). The effect of this defense is to turn § 12(2) into a negligence statute, with the burden on defendants to prove lack of negligence. *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 507 (5th Cir. 1990).

A defense of estoppel has been recognized in a § 12(1) action where the plaintiff failed, until just before the expiration of the one-year statute of limitations, to assert his right under § 5 to receive a prospectus with the confirmation of his purchase of stock in an initial public offering and the market value of the shares declined precipitously in the interim. *Murken v. Barrow*, No. CV88-2492-PAR,

1989 U.S. Dist. LEXIS 16537, at *9-10 (C.D. Cal. Oct. 30, 1989); *cf. Straley v. Universal Uranium & Milling Corp.*, 289 F.2d 370, 372 (9th Cir. 1961).

Section 12(a)(2) liability may be avoided by way of an affirmative defense of lack of loss causation. The statute provides that if a person “proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication . . . not being true or omitting to state a material fact . . . then such portion or amount . . . shall not be recoverable.” 15 U.S.C. § 771(b). Consequently, “[a] Section 12 defendant is liable only for depreciation that results directly from the misrepresentation at issue.” *Miller v. Thane Int’l, Inc.*, 519 F.3d 879, 892 (9th Cir. 2008). In *Miller*, the court had to decide whether shareholders suffered an actionable loss from a material misrepresentation in a prospectus when the price of the company’s stock, which traded on the NASDAQ Over-the-Counter Bulletin Board rather than its National Market System, did not decline in the weeks immediately following disclosure of the correct information. In finding that the material misrepresentation in the prospectus did not cause actionable loss to the shareholders, the Court held that a determination of materiality did not foreclose a loss causation defense and stock prices in a less efficient market could be relied upon to determine loss causation. *Miller v. Thane Int’l, Inc.*, 615 F.3d 1095 (9th Cir. 2010).

3. Reliance

It is universally held that a plaintiff does not need to establish any form of reliance to recover under § 12(1) or (2). *See, e.g., Schlesinger v. Herzog*, 2 F.3d 135, 141 (5th Cir. 1993); *Currie*, 835 F.2d at 782; *Akerman v. Oryx Commc’ns, Inc.*, 810 F.2d 336, 344 (2d Cir. 1987); *Adalman*, 807 F.2d at 373; *Junker v. Crory*, 650 F.2d 1349, 1359 (5th Cir. 1981); *Sanders*, 619 F.2d at 1225; *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970); *Gilbert*, 429 F.2d at 356.

4. Remedies and Measure of Damages

The primary remedy provided by § 12 is rescission: plaintiff tenders his securities to defendant and receives his purchase price, with interest, in return. Interest is computed at what the court deems an equitable rate. *Commercial Union Assur. Co. v. Milken*, 17 F.3d 608, 615 (2d Cir. 1994). *See also SEC v. Tome*, 638 F. Supp. 638, 640 (S.D.N.Y. 1986), *aff’d*, 833 F.2d 1086 (2d Cir. 1987); *Koehler v. Pulvers*, 614 F. Supp. 829, 850 (S.D. Cal. 1985); *Scheve v. Clark*, 596 F. Supp. 592, 596 (E.D. Mo. 1984); *W. Fed. Corp. v. Davis*, 553 F. Supp. 818, 821 (D. Ariz. 1982), *aff’d sub nom, W. Fed. Corp. v. Erickson*, 739 F.2d 1439 (9th Cir.

1984); *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1229 (D. Md. 1968). But there are several wrinkles. First, where plaintiff has received income, *i.e.*, dividends or interest, on his securities, this income is subtracted from the purchase price in determining what he will get upon tendering his shares. Second, where plaintiff has, before the filing of suit, disposed of the relevant securities, and thus cannot rescind the sale, he may recover damages, measured as the difference between the purchase price and the disposal price of the securities, plus interest, and less any income from the security received by the plaintiff. *See, e.g., Cady v. Murphy*, 113 F.2d 988, 990-91 (1st Cir. 1940). This measure of damages is intended to provide the equivalent of rescission. In *Randall v. Loftsgaarden*, 478 U.S. 647, 659-60 (1986), the Supreme Court held that § 12(2) damages need not be reduced by the amount of tax benefits received from a tax shelter investment. *See also Volk v. D.A. Davidson & Co.*, 816 F.2d 1406, 1414 (9th Cir. 1987); *Freschi v. Grand Coal Venture*, 800 F.2d 305, 305-06 (2d Cir. 1986), *amended*, 806 F.2d 17 (2d Cir. 1986). However, a loss stemming from the disallowance of a tax deduction does not constitute an injury recognized by securities law. *See DCD Programs, Ltd. v. Leighton*, 90 F.3d 1442, 1447-48 (9th Cir. 1996).

Of course where the defendant is a person from whom plaintiff did not receive title, for example a broker, the result of the § 12 remedy is not strictly speaking rescission, though it will be the equivalent to the plaintiff.

Section 12 expressly provides only for remedies in rescission or damages. The Supreme Court has held, however, that in an appropriate case brought primarily for rescission or damages under § 12, ancillary relief, including injunctive relief, can be given. *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 287-90 (1940); *see In re Gartenberg*, 636 F.2d 16, 17-18 (2d Cir. 1980); *cf. SEC v. Beisinger Indus. Corp.*, 552 F.2d 15, 18-19 (1st Cir. 1977) (“It is well established that Section 22(a) of the Securities Act of 1933 and Section 27 of the Securities Exchange Act of 1934 confer general equity powers on the district courts.”) (citations omitted).

The Reform Act added § 12(b) of the Securities Act, which provides that if a defendant in a § 12(2) action shows that all or a part of the security’s diminished value was not caused by the misstatement or omission alleged in the complaint but rather by some other cause, the plaintiff may not recover damages attributable to that other cause. 15 U.S.C.A. § 771(b). The defendant bears the burden of showing this absence of loss causation. *See Laylor v. Omtool, Ltd.*, No. 99-469-M, 2000 U.S. Dist. LEXIS 18675, at *8-9 (D.N.H. Dec. 14, 2000) (“As to claims under § 11 and 12 of the Securities Act, ‘loss causation’ is not an essential element of a viable cause of action. It is, however, an affirmative defense that may be raised by a defendant.”); *Kennilworth Partners L.P. v. Cendant Corp.*, 59

F. Supp. 2d 417, 424 (D.N.J. 1999) (“If the person who sold or offered the security can prove that all or part of the depreciation in value was caused by factors other than the false or misleading statement, he is not liable for that amount.”). *But see In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 429, 437 (S.D.N.Y. 2003) (dismissing § 12(2) claim over plaintiff’s argument that defendants must show “negative causation,” where absence of causation is clear on face of complaint).

5. Statute of Limitations

Both § 12(1) and § 12(2) are subject to the limitations periods set forth in § 13 of the Securities Act. Actions under § 12(1) must be brought within the shorter of one year of the date of the violation, or three years from the date the security was first offered to the public. *See Pollack v. Laidlaw Holdings, Inc.*, No. 90 Civ. 5788 (DLC), 1995 U.S. Dist. LEXIS 5909, at *50 (S.D.N.Y. May 2, 1995). Actions under § 12(2) must be brought within one year of the discovery of the untruths or omissions, or one year from the time such discovery should with reasonable diligence have occurred, and in no event more than three years after the relevant sale. *See, e.g., In re Merrill Lynch*, 289 F. Supp. 2d at 432-34 (finding §§ 11 and 12(2) claims time-barred due to inquiry notice prior to one year before claim); *Dale v. Rosenfeld*, 229 F.2d 855, 858 (2d Cir. 1956); *Zola v. Gordon*, 685 F. Supp. 354, 360 (S.D.N.Y. 1988). Courts have held that the new Sarbanes-Oxley statute of limitations does not apply to Section 12, analogizing lawsuits brought under this provision to claims under Section 11, which do not “sound in fraud,” as required by Section 804 of Sarbanes-Oxley, but rather are based on strict liability or negligence. *See* statute of limitations discussion, Section II.B.7, *supra*.

D. Section 17

Section 17 is the general antifraud provision of the Securities Act. It governs all sales, not just those that are part of a public offering. Sections 17(a)(1), (2) and (3), respectively, prohibit use of any means of interstate commerce (1) to employ any device, scheme or artifice to defraud, (2) to obtain money or property by means of material misstatements or omissions, or (3) to engage in any course of business that would operate as a fraud upon a purchaser. In keeping with the general scheme of the Securities Act, § 17 protects only purchasers and operates only against sellers, unlike § 10(b) of the Exchange Act, which operates against both purchasers and sellers. The Supreme Court has emphasized that each of § 17(a)(1), (2) and (3) contain different prohibitions, to be interpreted separately. *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980); *United States v. Naftalin*, 441 U.S.

768, 773-74 (1979). The CFMA extended the coverage of § 17(a) to securities-based swap agreements. *See* 15 U.S.C.A. § 77q(a) (West Supp. 2004).

Section 17(b) prohibits publishing any description of any security without disclosing consideration received from any issuer, underwriter or dealer of such security.

1. Private Right of Action Under § 17(a)

Unlike §§ 11 and 12, § 17 does not expressly create a private right of action. It has been important primarily in actions brought by the SEC pursuant to § 20(b) of the Securities Act, which authorizes the SEC to seek injunctions against violations of the Act, and in criminal actions brought by the Justice Department pursuant to § 24, which imposes criminal liability for willful violations of the Act. The existence and scope of any private right of action under § 17(a), however, remains unclear.

The Supreme Court has several times reserved the issue of whether a private right of action under § 17(a) exists. *See, e.g., Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 304 n.9 (1985); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.2 (1983); *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 557 n.9 (1979). Lower courts were split for many years, but the growing consensus is that no private right of action exists under § 17(a). Eight circuits now refuse to recognize a right of action. *See Maldonado v. Dominguez*, 137 F.3d 1, 6-8 (1st Cir. 1998); *Finkel v. Stratton Corp.*, 962 F.2d 169, 174-75 (2d Cir. 1992); *Newcome v. Esrey*, 862 F.2d 1099, 1107 (4th Cir. 1988) (en banc) (overruling *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975)); *Corwin v. Marney, Orton Invs.*, 788 F.2d 1063, 1066 (5th Cir. 1986); *Sears v. Likens*, 912 F.2d 889, 893 (7th Cir. 1990); *Crookham v. Crookham*, 914 F.2d 1027, 1028 (8th Cir. 1990) (imposing Rule 11 sanctions against counsel for signing a § 17(a) complaint); *Krause v. Perryman*, 827 F.2d 346, 349 (8th Cir. 1987); *In re Wash. Pub. Power Supply Sys. Sec. Litig.*, 823 F.2d 1349, 1350-58 (9th Cir. 1987) (overruling *Mosher v. Kane*, 784 F.2d 1385, 1391 n.9 (9th Cir. 1986) and *Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981)); *Bath v. Bushkin, Gaims, Gaines & Jonas*, 913 F.2d 817, 819-20 (10th Cir. 1990), *overruled on other grounds by Rotella v. Wood*, 528 U.S. 549 (2000); *Currie*, 835 F.2d at 784-85; *see also CPC Int'l Inc. v. McKesson Corp.*, 514 N.E.2d 116 (N.Y. 1987) (same). Only in the Third, Sixth, and District of Columbia Circuits has the existence of a private right of action under § 17(a) not been completely foreclosed, mostly because the courts have chosen not to address the issue. *See, e.g., Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 492-93 (6th Cir. 1990). *But see Burns v. Price Waterhouse*, 48 F.3d 1219 (6th Cir. 1995) (unpublished table

decision, full text available on Lexis) (affirming the lower court's holding that no private cause of action exists under § 17(a) and thereby indicating a possible change in the view of the Sixth Circuit). Even in those Circuits, various district courts have routinely refused to allow private actions. *See, e.g., Degen v. Bunce*, No. 93-5674, 1995 U.S. Dist. LEXIS 3576, at *9-10 (E.D. Pa. Mar. 13, 1995); *Berk v. Ascott Inv. Corp.*, 759 F. Supp. 245, 250-51 (E.D. Pa. 1991); *In re Bexar County Health Facility Dev. Corp. Sec. Litig.*, 125 F.R.D. 625, 635-36 (E.D. Pa. 1989); *Media Gen., Inc. v. Tanner*, 625 F. Supp. 237, 245 (W.D. Tenn. 1985); *Jones v. First Equity Corp.*, 607 F. Supp. 350, 354-55 (E.D. Tenn. 1985); *Hammerman v. Peacock*, 607 F. Supp. 911, 914-15 (D.D.C. 1985). *But see Vennittilli v. Primerica, Inc.*, 943 F. Supp. 793, 800 (E.D. Mich. 1996) (holding that a private right of action does exist under § 17(a) and describing this as “established Sixth Circuit law”).

2. The Contrast Between § 17(a) and § 10(b)

The underdeveloped state of § 17(a) jurisprudence derives from the assumption, pervasive prior to *Aaron v. SEC*, 446 U.S. 680, that the elements of proof under § 17(a) were identical to those under § 10(b) of the Exchange Act. Because of this assumption, plaintiffs “piggy-backed” virtually all § 17(a) actions onto § 10(b) actions, and courts found it unnecessary to address the requirements of § 17(a) as opposed to § 10(b). *See Landry v. All Am. Assurance Co.*, 688 F.2d 381, 386 (5th Cir. 1982); *Spatz v. Borenstein*, 513 F. Supp. 571, 578 (N.D. Ill. 1981), *questioned by Frymire v. Peat, Marwick, Mitchell & Co.*, 657 F. Supp. 889, 894 (N.D. Ill. 1987).

The Supreme Court's decisions in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and *Aaron*, 446 U.S. 680, shattered the assumption that § 10(b) and § 17(a) are parallel provisions. In *Hochfelder*, the Court ruled that scienter is required to be shown in private actions under § 10(b). 425 U.S. at 193. In *Aaron*, the Court ruled that scienter is required in SEC injunctive actions under § 10(b) and under § 17(a)(1), but *not* under § 17(a)(2) or (3). 446 U.S. at 701-02. The result is that if an action can be framed under § 17(a)(2) or (3), as virtually any action against a seller under § 10(b) or § 17(a)(1) can be, it can be tried under a negligence, rather than a scienter, standard. *See SEC*, 550 F.3d 106, 125 (1st Cir. 2008) (holding that liability may be broader under § 17(a)(2) than under § 10(b), as it does not matter under § 17(a)(2) to whom the false statements were attributable because “liability attaches so long as the statement is *used* ‘to obtain money or property,’ regardless of its sources”), *aff'd in part and remanded in part*, 597 F.3d 436 (1st Cir. 2010) (en banc).

Aaron was an SEC injunctive action. But, because the decision was based on analysis of the language of § 10(b) and § 17(a), and because the *Aaron* Court refused to distinguish between SEC and private actions under § 10(b), there was little doubt that *Aaron* was to be applied to any private right of action found to exist under § 17. *Landry*, 688 F.2d at 387; *Hudson v. Capital Mgmt. Int'l, Inc.*, 565 F. Supp. 615, 625-26 (N.D. Cal. 1983); *Spatz*, 513 F. Supp. at 578 n.9. *But see, e.g., Dannenberg v. Dorison*, 603 F. Supp. 1238, 1241-42 n.5 (S.D.N.Y. 1985) (requiring scienter in a § 17(a) private action).

Thus the prospect existed after *Aaron* that there could be a private right of action against sellers under § 17(a)(2) or (3) that would be more attractive to plaintiffs than that under § 10(b). The reaction of lower courts to this prospect has been to shrink back, and either not to recognize a private right of action under § 17(a), or to limit it to actions that could in any case be brought under § 10(b). (See cases discussed above.) This reaction has stemmed mostly from the concern that to recognize a negligence-based cause of action under § 17(a) would circumvent the limits placed on § 10(b) actions by the Supreme Court in *Hochfelder* and other cases.

3. Scienter

As noted, the Supreme Court has held, based on an analysis of the language of § 17(a), that scienter is a necessary element of the SEC's case in an injunctive action under § 17(a)(1), but not under § 17(a)(2) or (3). *Aaron*, 446 U.S. at 701-02. Moreover, courts have recognized that virtually any action against a seller that can be brought under § 10(b) or § 17(a)(1) can also be brought under § 17(a)(2) or (3), since virtually any "device . . . to defraud" that violates the former provisions will "operate as a fraud" in violation of § 17(a)(3) or involve obtaining money or property by means of misstatements or omissions in violation of § 17(a)(2). *SEC v. Wash. County Util. Dist.*, 676 F.2d 218, 225 (6th Cir. 1982). Thus, the effect of *Aaron* is to encourage the SEC to plead under § 17(a)(2) or (3) rather than § 10(b) or § 17(a)(1). As shown by cases such as *Wash. County Util. Dist.*, the SEC has gotten the message. *But see SEC v. Milan Capital Group, Inc.*, No. 00 Civ. 108 (DLC), 2000 U.S. Dist. LEXIS 16204, at *10-11 (S.D.N.Y. Nov. 8, 2000) (proceeding under §§ 10(b) and 17(a)(1)); *SEC v. Pros Int'l, Inc.*, 994 F.2d 767 (10th Cir. 1993) (finding negligence under §§ 17(a)(2) and (3) insufficient for grant of injunctive relief).

4. Standing

A number of those courts that have implied private rights of action, mostly following the formerly accepted view that § 17(a) simply tracks § 10(b) but is

limited to actions against sellers, have held that there is a “purchaser” requirement under § 17(a), just as there is a “purchaser-seller” requirement under § 10(b), and hence that only one who has actually purchased securities can bring an action under § 17(a). *See, e.g., Bosse v. Crowell Collier & MacMillan*, 565 F.2d 602, 610 (9th Cir. 1977); *Simmons v. Wolfson*, 428 F.2d 455, 456 (6th Cir. 1970); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 790 (8th Cir. 1967); *Vennitilli*, 943 F. Supp. at 800; *Fuchs v. Swanton Corp.*, 482 F. Supp. 83, 88 n.10 (S.D.N.Y. 1979). This is probably still the majority view, but its soundness is open to question in view of the Supreme Court’s decision in *United States v. Naftalin*, 441 U.S. 768 (1979). In *Naftalin*, the Court held that a criminal action under § 17(a)(1) would lie where the victim of the fraud was a broker rather than a purchaser because “[t]he statutory language does not require that the victim of the fraud be an investor—only that the fraud occur ‘in’ an offer or sale.” *Id.* at 772.

Because the *Naftalin* holding is based on the language of § 17(a)(1), it should apply to private actions under § 17(a)(1), as well as in criminal proceedings. A few lower courts have distinguished between the “purchaser” provisions, § 17(a)(3), which refers explicitly to purchasers, and § 17(a)(2), which deals with obtaining money; and the broader provision § 17(a)(1), which speaks of offers and sales, to find that a private person who was merely an offeree may recover damages under § 17(a)(1). *See Doll v. James Martin Assocs.*, 600 F. Supp. 510, 524 (E.D. Mich. 1984); *see also Bosse*, 565 F.2d at 610 n.12 (stating that § 17 may authorize suits by *both* purchasers and offerees). But the dominant approach among those courts permitting private causes of action under § 17(a) was to limit standing to those who purchased in reliance upon a fraudulent offering, and thereby actually suffered cognizable damages. *See Gaff v. FDIC*, 814 F.2d 311, 318-19 (6th Cir. 1987). Yet another court, consonant with the overwhelming majority of courts today that refuse to imply a private right of action, held that the fact that § 17(a) may apply to unconsummated offers to sell is good reason to deny the existence of a private right of action under § 17(a) that would go further than that recognized under § 10(b). *N. Am. Fin. Group, Ltd. v. S.M.R. Enters., Inc.*, 583 F. Supp. 691, 696-97 (N.D. Ill. 1984).

5. Persons Liable

It is sometimes stated, again mostly by courts assuming that § 17(a) tracks § 10(b), that there is no privity requirement under § 17(a), and that a plaintiff is therefore not limited to suing his direct seller under § 17(a). *See, e.g., SEC v. Cavanagh*, 1 F. Supp. 2d 337, 381 (S.D.N.Y. 1998), *aff’d*, 155 F.3d 129 (2d Cir. 1998); *Hokama v. E.F. Hutton & Co.*, 566 F. Supp. 636, 642 (C.D. Cal. 1983); *Am. Bank & Trust Co. v. Barad Shaff Sec. Corp.*, 335 F. Supp. 1276, 1281 (S.D.N.Y. 1972). At other times, however, courts have appeared to impose a

strict privity requirement under all sections of § 17(a). *See SEC v. Am. Beryllium & Oil Corp.*, 303 F. Supp. 912, 918 (S.D.N.Y. 1969). A middle view imposes no privity requirement under § 17(a)(1) or (3), but imposes the privity requirement of § 12(2) to actions under § 17(a)(2), which penalizes “obtaining money or property” through misstatements or omissions and thus is held to limit liability to sellers. *See, e.g., Dorfman v. First Boston Corp.*, 336 F. Supp. 1089, 1095-96 (E.D. Pa. 1972). Individuals may be liable under § 17(a)(2) even if they did not prepare the statements themselves so long as they “used” them. *See SEC v. Stoker*, --- F. Supp. 2d ----, 2012 WL 2708391, at *7 (S.D.N.Y. July 9, 2012) (defendant sent a copy of materials to a prospective investor and had significant responsibility for marketing materials).

The range of views on whether privity is required under § 17(a) reflects the undeveloped status of § 17(a) jurisprudence, and the customary practice of courts to rely on the law of § 10(b) of the Exchange Act and § 12(2) of the Securities Act in considering many issues under § 17(a).

6. Reliance

In those courts, if any, in which a private right of action under § 17(a) still exists, plaintiffs will probably be required to plead and prove reliance. Those requirements were clear in the Ninth Circuit prior to its determination that a private right of action under § 17(a) did not exist. *See, e.g., Kramas v. Sec. Gas & Oil Inc.*, 672 F.2d 766, 770 (9th Cir. 1982); *Wright v. Schock*, 571 F. Supp. 642, 662 (N.D. Cal. 1983), *aff'd*, 742 F.2d 541 (9th Cir. 1984). However, the holding of *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972)—which was brought under § 10(b) of the Exchange Act—that, where material omissions are charged, reliance is presumed if materiality is shown, had also been applied under § 17(a). *Hokama*, 566 F. Supp. at 647; *Hudson v. Capital Mgmt. Int'l, Inc.*, No. C-81-1737 MHP, 1982 U.S. Dist. LEXIS 10071, *13-14 (N.D. Cal. Aug. 24, 1982); *Mills v. Roanoke Indus. Loan & Thrift*, 70 F.R.D. 448, 454 (W.D. Va. 1975).

By contrast, the government need never prove, in SEC injunctive or criminal actions under § 17, reliance by individual investors. *See, e.g., Kramas*, 672 F.2d at 770; *United States v. Amick*, 439 F.2d 351, 366 (7th Cir. 1971); *SEC v. Manus*, No. 80 Civ. 724, 1981 U.S. Dist. LEXIS 15317, at *20 (S.D.N.Y. Oct. 7, 1981).

7. Remedies and Damages

The remedies available in private rights of action under § 17(a) have included rescission and damages. The majority view is that punitive damages are not

available under § 17(a). *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1284-87 (2d Cir. 1969); *Ambrosino v. Rodman & Renshaw, Inc.*, 635 F. Supp. 968, 972 (N.D. Ill. 1986); *Hadad v. Deltona Corp.*, 535 F. Supp. 1364, 1371 (D.N.J. 1982), *aff'd*, 725 F.2d 668 (3d Cir. 1983); *Vogel v. Trahan*, No. 78-2724, 1980 U.S. Dist. LEXIS 10539, *26-27 (E.D. Pa. Jan. 11, 1980). *But see Anvil Inv. Ltd. P'ship v. Thornhill Condos., Ltd.*, 407 N.E.2d 645, 654 (Ill. Ct. App. 1980) (punitive damages available under § 17 for willful and malicious conduct).

8. Section 17(b)

Section 17(b) is a little used “anti-touting” provision. It is enforced entirely by the SEC in injunctive actions and the Justice Department in criminal proceedings. There is no private right of action under § 17(b). The statute was recently applied in *SEC v. Gagnon*, 2012 WL 994892, at *10-*11 (E.D. Mich. 2012) (finding violation of § 17(b) where website operator “represented to investors that he was recommending the [investment] program based on his personal investigation,” but did not disclose his personal financial interest in the program). *See also SEC v. Gane*, 2005 U.S. Dist. LEXIS 607, *46 (S.D. Fla. Jan. 4, 2005) (finding a violation of § 17(b)); *SEC v. Corporate Relations Grp., Inc.*, 2003 U.S. Dist. LEXIS 24925 (M.D. Fla. Mar. 28, 2003) (finding a violation); *SEC v. Omnigene Devs., Inc.*, 105 F. Supp. 2d 1316, 1320 (S.D. Fla. 2000), *aff'd*, 240 F.3d 1079 (11th Cir. 2000); *SEC v. Liberty Capital Group, Inc.*, 75 F. Supp. 2d 1160, 1162 (W.D. Wash. 1999) (denying motion to dismiss § 17(b) claim); *SEC v. Wall Street Publ'g Inst., Inc.*, 851 F.2d 365, 367-370 (D.C. Cir. 1988); *United States v. Wenger*, 427 F.3d 840 (10th Cir. 2006) (upholding statute’s constitutionality over defendant’s First Amendment and vagueness challenges).

9. Statute of Limitations

The limitations period for civil actions under § 17 is not expressly governed by the provisions of § 13 of the Securities Act. For years, courts looked to the most closely similar action of the state in which the court sat and borrowed that action’s limitations period for use under § 17. *See, e.g., Suslick v. Rothschild Sec. Corp.*, 741 F.2d 1000, 1074 (7th Cir. 1984), *overruled by Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385 (7th Cir. Jul 30, 1990); *cf. Geeting v. Prizant*, 664 F. Supp. 343, 347-48 (N.D. Ill. 1987) (applying state statute of limitations in a 10b-5 action). *But see Belleville Shoe*, 908 F.2d at 1389 (holding that “federal and not state law supplies the statute of limitations in suits under § 10(b) and Rule 10b-5.”). The majority view was that the state blue sky law’s statute of limitations, applied to private actions, should apply to § 17(a), rather than the limitations period applicable to state fraud actions generally. *See, e.g., Wachovia Bank & Trust Co. v. Nat’l Student Mktg. Corp.*, 650 F.2d 342, 346 (D.C. Cir. 1980);

Forrestal Vill., Inc. v. Graham, 551 F.2d 411, 413 (D.C. Cir. 1977), *abrogated by Lampf, Pleva, Likind, Prupis & Petrigrow v. Gilbertson*, 501 U.S. 350 (1991); *Newman v. Prior*, 518 F.2d 97, 99-100 (4th Cir. 1975), *overruled on other grounds by Newcome v. Esrey*, 862 F.2d 1099, 1101 (4th Cir. 1988); *cf. Carothers v. Rice*, 633 F.2d 7, 14-15 (6th Cir. 1980) (applying state statute of limitations in a 10b-5 action). In negligence-based actions under § 17(a)(2) or (3), however, at least one court applied the limitations period applicable to state negligence actions. *Hudson*, 1982 U.S. Dist. LEXIS 10071, *29-30. Where there was fraudulent concealment, the statute of limitations applied under § 17(a) was often tolled. *See, e.g., Hemmings v. Barian*, 822 F.2d 688, 690 (7th Cir. 1987); *Suslick*, 741 F.2d at 1004; *cf. Geeting*, 664 F. Supp. at 347-48.

It is unlikely that this reasoning or precedent would control the determination of the appropriate limitations period today. Rather, Sarbanes-Oxley's extended statute of limitations for securities law violations that sound in fraud to three and five years should apply to § 17 claims, as it does to claims under § 10 of the 1934 Act. *See* discussion Part III.A.9, *infra*.

III

Liabilities Under the Exchange Act

A. Section 10

Section 10(a) prohibits short-sales and use of stop-loss orders in contravention of rules prescribed by the SEC. Section 10(a) applies only to securities registered under the Exchange Act or traded on national security exchanges.

Section 10(b) prohibits use of manipulative or deceptive devices in contravention of rules prescribed by the SEC. Section 10(b) applies to all securities and to security-based swap agreements.

Like § 10(a), § 10(b) is not self-effecting; the statute by its terms requires the SEC to prescribe rules to implement it. Currently, there are 11 SEC-promulgated rules in force under § 10(b), the most important of which is the general antifraud rule, Rule 10b-5. Rule 10b-5, patterned closely after § 17(a) of the Securities Act, prohibits use of any means of interstate commerce to (1) employ any device, scheme or artifice to defraud, (2) make material misstatements or omissions, or (3) engage in any course of business that operates as a fraud against any person, in connection with the purchase or sale of any security or securities-based swap agreement.

In general, to prevail on a Rule 10b-5 claim, a plaintiff must prove that the defendant (1) made a false statement or an omission of material fact, (2) with scienter, (3) in connection with the purchase or sale of a security, (4) upon which the plaintiff justifiably relied, and (5) which proximately caused (6) the plaintiff's economic loss. *See, e.g., Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 341 (2005); *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, 75 F.3d 801, 808 (2d Cir. 1996); *Bruschi v. Brown*, 876 F.2d 1526, 1528 (11th Cir. 1989); *see also AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 207-08 (2d Cir. 2000) (finding that the false statement or omission must be "made in connection with the purchase or sale of securities . . . which [was] furthered through the defendant's use of the mails or a national securities exchange.").

Rule 10b-5 under § 10(b) is by far the most important civil liability provision of the securities laws. From its issuance in 1942, liability under Rule 10b-5 was continually expanded by lower courts, especially in the Second Circuit. Although beginning in the late 60s the Supreme Court has placed a number of important limitations on actions under Rule 10b-5, § 10(b) and Rule 10b-5 continue to dwarf in importance other liability provisions under the securities laws.

1. Private Right of Action Under Rule 10b-5

Essential to its importance has been the early and continued recognition of a private right of action under Rule 10b-5. Rule 10b-5 can be enforced by the SEC in injunctive and civil penalty actions, brought pursuant to § 21(d) of the Exchange Act, and by the Justice Department in actions pursuant to § 32(a) of the Exchange Act, which imposes criminal liability for willful violations of the Exchange Act. Over the years, courts in every circuit also implied a private right of action under Rule 10b-5. For some time, the Supreme Court did not directly address whether there is a private right of action under Rule 10b-5, while handing down rulings on other issues in a number of private Rule 10b-5 lawsuits. In 1983, it finally expressly recognized a private right of action under Rule 10b-5. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983); *see also Sonnenfeld v. City & County of Denver*, 100 F.3d 744, 746-47 (10th Cir. 1996) (finding that municipalities fell within the scope of § 10(b) and thus an implied right of action existed against them).

2. Standing

The Supreme Court has squarely held that the phrase “in connection with the purchase or sale of any security” used in Rule 10b-5 requires the plaintiff in a private action for damages under the rule to have been a purchaser or seller of securities in the transaction complained of. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-32 (1975). Thus, in *Blue Chip Stamps* the Court ruled that offerees of an unconsummated offer to purchase could not sue the offeror under the rule. But as the Court noted, § 3(a)(13) and (14) of the Exchange Act define “purchase” and “sale” to include contracts to purchase or sell. Thus, holders of puts, calls, options and other contractual rights or duties to purchase, or otherwise receive, or sell securities have standing to bring actions under Rule 10b-5. *Id.* at 750-51; *Griggs v. Pace Am. Group, Inc.*, 170 F.3d 877, 880 (9th Cir. 1999) (finding plaintiff with a contingent right to receive stock following a merger has standing to bring a 10b-5 action); *Fry v. UAL Corp.*, 84 F.3d 936, 939 (7th Cir. 1996) (holding that options traders have standing to sue under Rule 10b-5); *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 506-07 (3d Cir. 1988). *But see Fin. Sec. Assurance Inc. v. Stephens Inc.*, 500 F.3d 1276 (11th Cir. 2007) (holding that an insurer of municipal bonds that became owner of the bonds after default has no standing to pursue § 10(b) claims against the underwriter).

Further, issuances of securities and “forced sales” of securities in statutory merger transactions are normally held to be sales for purposes of § 10(b) standing. *See Herpich v. Wallace*, 430 F.2d 792, 810 (5th Cir. 1970); *In re Wash. Pub. Power Supply Sys. Sec. Litig.*, 623 F. Supp. 1466, 1483-84 (D. Wash. 1985), *aff'd*, 823

F.2d 1349 (9th Cir. 1987); *Rochelle v. Marine Midland Grace Trust Co.*, 535 F.2d 523, 527-28 (9th Cir. 1976). *But see Isquith v. Caremark Int'l Inc.*, 136 F.3d 531, 534-35 (7th Cir. 1998) (finding no “sale” where stockholders received shares in subsidiary in exchange for shares of parent in a spinoff); *Rathborne v. Rathborne*, 683 F.2d 914, 920 (5th Cir. 1992) (finding no “purchase” where stockholder received pro rata distribution of stock of controlled subsidiary); *Ontario Pub. Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27, 32-33 (2d Cir. 2004) (affirming dismissal of complaint for lack of standing where plaintiffs did not purchase securities of corporation alleged to have made misstatements, but instead purchased securities in that corporation’s supplier). Persons who decide *not* to buy or sell on the basis of misrepresentations or omissions, and shareholders in an issuer that is harmed by activities of insiders that would violate Rule 10b-5 as to persons who met the “purchaser-seller” requirement, do not have § 10(b) standing. *Blue Chip Stamps*, 421 U.S. at 737-38; *cf. Lawrence v. Cohn*, 325 F.3d 141, 154-55 (2d Cir. 2003) (holding that alleged fraud that induced plaintiff to forego purchase of shares in a partnership does not satisfy the “in connection with” requirement). Such shareholders, however, can bring a derivative action on behalf of the harmed corporation, if the corporation itself was a purchaser or seller. *Id.* at 738 (citing *Schoenbaum v. Firstbrook*, 405 F.2d 215, 219 (2d Cir. 1968); *Dudley v. Se. Factor & Fin. Corp.*, 446 F.2d 303, 306-08 (5th Cir. 1971).

The Supreme Court revisited the parameters of the “in connection with” requirement in *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588 (2001), which held that the sale of an option to buy stock while secretly intending never to honor it satisfies the “in connection with” requirement under § 10(b) and Rule 10b-5. *See id.* at 594-97. The Court ruled that the relevant security was the option, *not* the underlying stock in the defendant’s cable system, and rejected the defendant’s arguments that (1) § 10(b) does not cover oral contracts of sale, (2) the plaintiff did not have standing because the alleged misrepresentation did not “relate to the value of a security purchase or the consideration paid,” and (3) plaintiff’s claim was nothing but a breach of contract claim. *See id.* at 595-97.

The Supreme Court again considered the scope of the “in connection with” requirement in *SEC v. Zandford*, 535 U.S. 813 (2002), where the defendant broker stole money from a discretionary account he managed by selling the client’s securities and transferring the proceeds to the broker’s own account. The defendant argued that the securities “sales themselves were perfectly lawful and that the subsequent misappropriation of the proceeds, though fraudulent, is not properly viewed as having the requisite connection with the sales.” *Id.* at 820. In a unanimous decision, the Supreme Court rejected this argument and concluded that the securities sales and the defendant’s fraudulent practices were not

independent events. The Court held that the “in connection with” requirement is satisfied where securities sales coincide with the defendant’s overall scheme to defraud. *Id.* at 825. However, the Supreme Court was careful to state that § 10(b) “must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation” of the statute. *Id.* at 820. For example, the Court observed that this case was not one in which “after a lawful transaction had been consummated, a broker decided to steal the proceeds and did so. Nor is it a case in which a thief simply invested the proceeds of a routine conversion in the stock market. Rather, [the defendant’s] fraud coincided with the sales themselves.” *Id.* Drawing an analogy to its reasoning in *Wharf*, the Court stated: “Similarly, in this case the SEC claims [defendant] sold [the client’s] securities while secretly intending from the very beginning to keep the proceeds. In *Wharf*, the fraudulent intent deprived the purchaser of the benefit of the sale whereas here the fraudulent intent deprived the seller of that benefit, but the connection between the deception and the sale in each case is identical.” *Id.* at 823-24. *See also Grippio v. Perazzo*, 357 F.3d 1218, 1222-24 (11th Cir. 2004) (holding that the plaintiff “adequately pled fraud ‘in connection with the purchase or sale of any security,’ even though he failed to identify any particular security purchased, because [the defendant] accepted and deposited [plaintiff’s] monies as payment for securities,” citing the SEC’s position in *Zandford* that Rule 10b-5 covered a situation where a broker accepts payment for securities that he never intends to deliver).

The “in connection” with requirement is broadly construed, including to situations in which no securities were in fact purchased. For instance, the Tenth Circuit has held that where a Ponzi schemer “took investors’ money under the pretense that it would be invested in safe securities, like mutual funds[, t]he fact that he failed to actually buy or sell securities is not dispositive,” and affirmed entry of summary judgment for securities fraud. *SEC v. Smart*, 678 F.3d 850, 857 (10th Cir. 2012). *See also Roland v. Green*, 675 F.3d 503, 519-20 (5th Cir. 2012) (evaluating the meaning of SLUSA’s analogously interpreted “in connection with” requirement where Ponzi scheme victims were fraudulently induced into investing in an uncovered security that then had a relationship to transactions (real or fraudulent) in covered securities and adopting the Ninth Circuit’s view that the test is met where the fraud and covered security transactions are “more than tangentially related”) (citing *Madden v. Cowen & Co.*, 576 F.3d 957, 965-66 (9th Cir. 2009)).

At least two circuits have recognized that the time lapsed between the alleged fraud and the purchase or sale of securities is not determinative. *See Romano v. Kazacos*, No. 08-6187-cv, 2010 U.S. App. LEXIS 13220, at *28-30 (2d Cir. Jun. 29, 2010) (passage of eighteen months between the alleged fraud and the purchase or sale of securities does not necessarily defeat SLUSA’s “in connection with”

requirement; the time that lapsed was not determinative because complaint addressed “a string of events that were all intertwined”); *SEC v. Pirate Investor LLC*, 580 F.3d 233, 245 (4th Cir. 2009) (“in connection with” test satisfied when proscribed conduct and sale are part of the same fraudulent scheme). In *Romano*, the Second Circuit noted that the “in connection with” requirement does not turn on temporal limitations because a flexible approach is most consistent with *Zandford*, which requires the phrase “in connection with” to be construed “not technically and restrictively but flexibly to effectuate its remedial purposes,” 535 U.S. at 819.

Prior to *Blue Chip Stamps*, a number of cases held that the plaintiff in a private injunctive action under § 10(b) need not be a purchaser or seller. *See, e.g., Kahan v. Rosenstiel*, 424 F.2d 161, 173 (3d Cir. 1970); *Landy v. FDIC*, 486 F.2d 139, 156 (3d Cir. 1973); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 546-47 (2d Cir. 1967). Some courts have concluded that this line of cases does not survive *Blue Chip Stamps*. *See, e.g., Cowin v. Bresler*, 741 F.2d 410, 423 (D.C. Cir. 1984); *W.A. Krueger Co. v. Kirkpatrick, Pettis, Smith, Polian, Inc.*, 466 F. Supp. 800, 805-06 (D. Neb. 1979); *Wright v. Heizer Corp.*, 411 F. Supp. 23, 34 (N.D. Ill. 1975), *aff’d in part, rev’d in part*, 560 F.2d 236 (7th Cir. 1977). Others have held that *Blue Chip Stamps* does not control private injunctive actions. *See, e.g., United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981), *aff’d following remand*, 722 F.2d 729 (2d Cir. 1983); *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187, 194 (3d Cir. 1976); *Davis v. Davis*, 526 F.2d 1286, 1289-90 (5th Cir. 1976); *Granada Invs., Inc. v. DWG Corp.*, 717 F. Supp. 533, 535 (N.D. Ohio 1989), *aff’d*, 962 F.2d 1203 (6th Cir. 1992); *Warner Commc’ns, Inc. v. Murdoch*, 581 F. Supp. 1482, 1494-95 (D. Del. 1984); *Fuchs v. Swanton Corp.*, 482 F. Supp. 83, 90 (S.D.N.Y. 1979); *cf. Trump Hotels & Casino Resorts, Inc. v. Mirage Resorts, Inc.*, 140 F.3d 478, 486 (3d Cir. 1998) (finding no standing but reserving judgment on vitality of “relaxed” standing for injunctions after *Blue Chip Stamps*); *Advanced Res. Int’l, Inc. v. Tri-Star Petroleum Co.*, 4 F.3d 327, 332 (4th Cir. 1993) (noting that a narrow exception to *Blue Chip Stamps* is a situation involving “shareholder plaintiffs who claim that without injunctive relief to stop the defendants’ deceptive and unfair practices, they may in the future suffer monetary loss to their shares”); *Langner v. Brown*, 913 F. Supp. 260, 270 (S.D.N.Y. 1996); *John Labatt Ltd. v. Onex Corp.*, 890 F. Supp. 235, 247 (S.D.N.Y. 1995) (stating that injunctive relief under § 10(b) should generally be denied to targets in tender offer context).

There is no requirement that there have been any purchases or sales for SEC injunctive actions or criminal actions under Rule 10b-5. *Blue Chip Stamps*, 421 U.S. at 751 n.14; *United States v. Newman*, 664 F.2d at 17; *SEC v. Penn Cent. Co.*, 450 F. Supp. 908, 914 (E.D. Pa. 1978).

Several cases have also held that one who is not a purchaser or seller of securities has standing to bring a Rule 10b-5 action where the specific dangers discussed in *Blue Chip Stamps* are not present. See *Grubb v. FDIC*, 868 F.2d 1151, 1161-62 (10th Cir. 1989); *Norris v. Wirtz*, 719 F.2d 256, 259 (7th Cir. 1983); *United Dep't Stores, Inc. v. Ernst & Whinney*, 713 F. Supp. 518, 523-24 (D.R.I. 1989) (granting standing to shareholders who loaned funds to one corporation to purchase another). *But cf. Rayman v. Peoples Sav. Corp.*, 735 F. Supp. 842, 851 (N.D. Ill. 1990) (disapproving of the reasoning of *United Dep't Stores, Inc.*). In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006), the Court ruled that SLUSA, which effectively makes federal court the exclusive venue for nearly all securities fraud class actions, operates to preempt not only state law seller and purchaser claims, but “holder” claims which alleged injury based on the prolonged retention of stock due to fraud. Though Rule 10b-5 only establishes a private cause of action under federal law for purchaser-seller claims, and that rule uses the same “in connection with” language as SLUSA, the Court rejected the application of the *Blue Chip Stamps* standard to determine standing for holder claims under SLUSA. See *supra* Section I.F.

3. Persons Liable

Rule 10b-5 liability may be imposed on the “maker” of the statement alleged to be materially false or misleading. “For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not ‘make’ a statement in its own right.” *Janus Capital Group, Inc. v. First Derivatives Traders*, 131 S. Ct. 2296 (2011). (holding company that created mutual fund and acted as its investment adviser and administrator was not maker of allegedly false statement in fund’s prospectus.)

In contrast to the plaintiff, the defendant in an action under Rule 10b-5 need not have purchased or sold securities. It is enough that his conduct occurred “in connection with” purchases or sales of securities. The “in connection with” requirement is satisfied if the defendant purchased or sold fraudulently, but as the leading case, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), has held, it is satisfied more generally if false or misleading statements were made “in a manner reasonably calculated to influence the investing public.” 401 F.2d at 862, *aff'd in part, rev'd in part*, 446 F.2d 1301 (2d Cir. 1971); see also *In re Carter-Wallace Sec. Litig.*, 150 F.3d 153, 156 (2d Cir. 1998) (finding technical and detailed advertisements in sophisticated medical journals satisfy “in connection with” requirement), *aff'd following remand*, 220 F.3d 36 (2d Cir. 2000); *McGann v. Ernst & Young*, 102 F.3d 390, 392-96 (9th Cir. 1996) (holding

that *Texas Gulf* survived *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)); *United States v. Russo*, 74 F.3d 1383, 1392 (2d Cir. 1996) (holding fraudulent short sales satisfy the “in connection with” requirement); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35 (D.C. Cir. 1987), *abrogated on other grounds by Morrison*, 130 S. Ct. at 2869; *SEC v. C. Jones & Co.*, 312 F. Supp. 2d 1375 (D. Colo. 2004) (finding false allegations enabling a stock to be publicly traded are “reasonably calculated to influence the investing public”); *United States v. Ferrarini*, 9 F. Supp. 2d 284, 296-97 (S.D.N.Y. 1998) (holding that making false statements on annual reports filed with the SEC satisfies the requirement that action need only “touch” the purchase or sale of securities), *aff’d*, 219 F.3d 145 (2d Cir. 2000). *But see SEC v. Adoni*, 60 F. Supp. 2d 401, 409 (D.N.J. 1999) (dismissing complaint alleging company fraudulently induced factor to provide it with credit, finding it too remote from the company’s securities).

One court in the Second Circuit has ruled that in Rule 10b-5 actions the false and misleading statements must pertain to the securities themselves, rather than to the defendant’s capabilities as a broker or investment advisor. *Laub v. Faessel*, 981 F. Supp. 870, 871 (S.D.N.Y. 1997) (stating that “the misrepresentations [must] relate to the intrinsic investment characteristic or investment quality of the purchased security”). The Supreme Court’s opinion in *Wharf (Holdings) Ltd.* may cast doubt on this approach. In dicta, the Court questioned the notion that “the [Exchange] Act covers only misrepresentations likely to affect the value of securities.” *Wharf (Holdings) Ltd.*, 532 U.S. at 596. The *Wharf* Court did not, however, offer any alternative standard for determining the requisite nexus between the alleged misrepresentations and the impaired security. The Eleventh Circuit, at least, believes that actionable misrepresentations must pertain to an investment decision; “a misrepresentation that would only influence an individual’s choice of broker-dealers cannot form the basis for § 10(b) securities fraud liability.” *SEC v. Goble*. 682 F.3d 934, 944 (11th Cir. 2012).

4. Basis of Liability

Rule 10b-5 is a general antifraud rule and the range of conduct it prohibits is broad. Nonetheless, it is probably safe to say that the most important violations of the rule fall into three categories:

- (1) garden variety fraud in face-to-face transactions by sellers, purchasers, brokers and others;
- (2) false or misleading statements of material fact by corporate insiders or others that affect the prices at which securities

trade, *see, e.g., SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979), *overruling recognized on separate grounds in In re Livent, Inc. Sec. Litig.*, 148 F. Supp. 2d 331 (S.D.N.Y. 2001); included here is fraud by issuers and others in public offerings of securities that may also be actionable under § 11 of the Securities Act, *see Herman & MacLean v. Huddleston*, 459 U.S. 375;

- (3) trading on material nonpublic information by corporate insiders and their tippees (“insider trading”), about which more later.

At one time it appeared that ordinary corporate mismanagement might become actionable under Rule 10b-5 if it related in some fashion to a purchase or sale of securities. *See Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). The prospect developed of a federalization of state corporate law under the aegis of Rule 10b-5.

The Supreme Court ruled out that possibility, however, in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). There, a minority shareholder frozen out of a Delaware corporation in a short-form merger alleged a violation of Rule 10b-5 because the merger lacked a legitimate business purpose. The Supreme Court held that the complaint should be dismissed because it alleged a breach of fiduciary duty with no element of deceit or nondisclosure. 430 U.S. at 476-77.

After *Santa Fe*, it would appear that breaches of fiduciary duty by corporate insiders are not actionable under Rule 10b-5 unless they involve deceit. But an important twist was placed on the *Santa Fe* doctrine by *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977). There, a subsidiary entered into certain transactions with its parent involving sales of the subsidiary’s shares and announced that the transactions would benefit both the subsidiary and the parent. Shareholder approval of the transactions was neither required nor sought. Plaintiff, a minority shareholder in the subsidiary, brought a shareholder’s derivative suit under Rule 10b-5, claiming that in fact the transactions were designed solely to benefit the parent corporation at the expense of the subsidiary’s minority shareholders. The Second Circuit refused to dismiss the suit, holding that the *Santa Fe* deceit requirement is satisfied in a derivative suit where the shareholders of a corporation are deceived, even if its directors are not. Furthermore, the Second Circuit held that shareholders can prove materiality and reliance, even where they have no vote on a transaction, if, had they been given full and truthful disclosure, they could have brought an action to block the transaction under state corporation

law. *Goldberg* suggests that shareholders can bring derivative actions under Rule 10b-5 to challenge many transactions involving sales or purchases of shares by corporations, and thus Rule 10b-5 could be used to make substantial inroads into state corporation law in spite of *Santa Fe*.

The Second Circuit's holding in *Goldberg* has been accepted by other circuits at various times. See, e.g., *Estate of Soler v. Rodriguez*, 63 F.3d 45, 55-56 (1st Cir. 1995); *Mayer v. Oil Field Sys. Corp.*, 721 F.2d 59, 67-68 (2d Cir. 1983); *United States v. Margala*, 662 F.2d 622, 626 (9th Cir. 1981); *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641, 646 (3d Cir. 1980); *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273, 1292 (9th Cir. 1979). The Seventh Circuit, however, has called into question the *Goldberg* court's guidance concerning adequate disclosure. See, e.g., *Harris Trust & Sav. Bank v. Ellis*, 810 F.2d 700, 704 (7th Cir. 1987) (holding that amount of disclosure required in actions to appraise the value of stock are matters of state law alone); *Ray v. Karris*, 780 F.2d 636, 641-43 (7th Cir. 1985) (finding no cause of action under Rule 10b-5 when plaintiffs were aware of alleged fraud but failed to pursue an effective state court litigation strategy); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 288 (7th Cir. 1981) (noting that plaintiff may not bootstrap a fiduciary duty action into one for securities fraud merely by alleging failure to reveal a breach of duty); see also *Isquith v. Caremark Int'l*, 136 F.3d 531, 534 (7th Cir. 1998) (stating that 7th Cir. has rejected the *Goldberg* doctrine insofar as it holds that an option to sue to stop corporate action, in the absence of an investment choice, is sufficient to establish the materiality of a misleading statement regarding that action); *Krieger v. Gast*, No. 98 C 3182, 1998 U.S. Dist. LEXIS 15422, at *18 (N.D. Ill. Sept. 18, 1998) ("Goldberg is not respected authority in the Seventh Circuit."). The Second Circuit, however, continues to recognize the *Goldberg* exception. See, e.g., *Field v. Trump*, 850 F.2d 938, 948-49 (2d Cir. 1988).

5. Scierter

The Supreme Court has held that scierter is required for a violation of Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976). This is true for SEC injunctive actions as well as for private actions under the rule. *Aaron v. SEC*, 446 U.S. 680, 695 (1980).

Hochfelder ruled that the language of § 10(b), which prohibits "manipulative or deceptive" conduct, limits the scope of any rule issued thereunder to conduct that would constitute fraud at common law and precludes any action under Rule 10b-5 for negligent conduct. 425 U.S. at 212-14. Since *Hochfelder* and *Aaron*, lower courts have had to decide whether the scierter required under Rule 10b-5 includes recklessness, that is, whether making statements with reckless disregard for, or no

belief in, their truth is prohibited under the rule. *See Hochfelder*, 425 U.S. at 193 n.12 (reserving the question of whether recklessness suffices for 10b-5 liability). All circuit courts have held that recklessness in some form does satisfy the scienter requirement of Rule 10b-5, though some decisions suggest the recklessness must be severe. *See, e.g., Auto. Indus. Pension Trust Fund v. Textron Inc.*, 682 F.3d 34, 39 (1st Cir. 2012) (noting that “negligence or puffing are not enough for scienter”); *Dolphin and Bradbury, Inc. v. SEC*, 512 F.3d 634, 639 (D.C. Cir. 2008) (requiring “[e]xtreme recklessness,” defined as “an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”) (internal quotation marks and citations omitted); *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (requiring “severe recklessness”); *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 681 (6th Cir. 2004) (defining as a mental state akin to “conscious disregard”); *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 344 (4th Cir. 2003) (requiring “severe recklessness [which] is, in essence, a slightly lesser species of intentional misconduct”) (internal quotation marks and citations omitted); *SEC v. Rubera*, 350 F.3d 1084, 1094 (9th Cir. 2003) (requiring recklessness to reflect “some degree of intentional or conscious misconduct”); *Wortley v. Camplin*, 333 F.3d 284, 294 (1st Cir. 2003) (requiring “high degree of recklessness”); *Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 828 (8th Cir. 2003) (requiring “severe recklessness”); *In re Ikon Office Solutions, Inc.*, 277 F.3d 658, 672 n.16 (3d Cir. 2002) (requiring recklessness “bordering on an intent to deceive”); *City of Phila. v. Fleming Cos.*, 264 F.3d 1245, 1258 (10th Cir. 2001) (defining recklessness as “conduct that is an extreme departure from the standards of ordinary care”); *Ziembra v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1202 (11th Cir. 2001) (requiring “severe recklessness”); *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 99-100 (2d Cir. 2001) (requiring conscious misbehavior or recklessness); *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir. 1995) (requiring “recklessness so severe that it is the functional equivalent of intent”).

The Eighth Circuit has applied its “severe recklessness” standard to protect directors’ reliance on advisors in the case of an outside director who chaired the company’s compensation committee and was charged with making material misstatements based on options backdating. *SEC v. Shanahan*, 646 F.3d 536 (8th Cir. 2011). The panel affirmed the district court’s finding that the SEC had not proven scienter where the director testified that he relied on the finance and accounting departments, counsel, and auditors to ensure that the options plans were properly administered and disclosures appropriate, and none of those advisors raised any concerns. The court noted that “[d]epending on others to

ensure the accuracy of disclosures to purchasers and sellers of securities — even if inexcusably negligent — is not severely reckless conduct that is the functional equivalent of intentional securities fraud.” *Id.* at 544. However, auditors themselves may be liable for securities fraud where they behave recklessly, including by failing to review or check information that they had a duty to monitor or otherwise “consciously ignor[ing]” a fraud. *See Gould v. Winstar Commc’ns, Inc.*, --- F.3d ----, 2012 WL 2924254, at *8 (2d Cir. July 19, 2012) (vacating summary judgment in auditor’s favor where there was evidence that it “repeatedly failed to scrutinize serious signs of fraud by an important client,” including, *inter alia*, the absence of documents confirming orders and the company’s repeated failure to provide requested documentation); *see also Meridian Horizon Fund, LP v. KPMG (Cayman)*, Nos. 11-3311-cv, 11-3725-cv, 2012 WL 2754933, at *3 (2d Cir. July 10, 2012) (affirming dismissal of securities fraud claims against auditors where plaintiffs’ allegations of recklessness did not constitute “conduct that is highly unreasonable, representing an extreme departure from the standards of ordinary care” so as to “approximate an actual intent to aid in the fraud being perpetrated by the audited company”) (quoting *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000)).

Under Section 21E(c) of the Exchange Act, which was added by the Reform Act, no liability will attach in a private action based on certain statutorily defined “forward-looking statements” unless the plaintiff proves actual knowledge of the false or misleading nature of the statement on the part of a natural person making the statement or on the part of an executive officer approving the statement made on behalf of a business entity. *Employers Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1134 (9th Cir. 2004); *Champion Enters.*, 346 F.3d at 672; *Theoharous v. Fong*, 256 F.3d 1219, 1124-1125 (11th Cir. 2001), *abrogated on other grounds by Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (2010); *Hockey v. Medhekar*, No. C-96-0815 MHP, 1997 WL 203704, at *4-9 (N.D. Cal. Apr. 15, 1997) (finding certain statements forward-looking but not misleading); *In re Valujet Sec. Litig.*, 984 F. Supp. 1472, 1478 (N.D. Ga. 1997). However, this safe harbor may not be available on a motion to dismiss when the relevant forward-looking statements are spoken, rather than written, because such statements are subject to material dispute. *See In re Silicon Graphics*, No. C 96-0393 FMS, 1996 U.S. Dist. LEXIS 16989, at *39-40 (N.D. Cal. Sept. 25, 1996), *aff’d*, 183 F.3d 970 (9th Cir. 1999). *But see Coble v. Broadvision Inc.*, No. C 01-01969 CRB, 2002 U.S. Dist. LEXIS 17495, at *27-29 (N.D. Cal. Sept. 11, 2002); *Karacand v. Edwards*, 53 F. Supp. 2d 1236, 1243, 1245-46 (D. Utah 1999); *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1240-43, 1248 (N.D. Cal. 1998).

In the insider trading context, at least one court has ruled that a tippee's "conscious and deliberate choice not to ask" about a tip, regardless of how far down that tippee stood in the "chain of tippees," is enough to establish scienter for Rule 10b-5. *SEC v. Musella*, 678 F. Supp. 1060, 1062-63 (S.D.N.Y. 1988); *SEC v. Musella*, 578 F. Supp. 425, 442 (S.D.N.Y. 1984); *see also SEC v. Credit Bancorp, Ltd.*, 195 F. Supp. 2d 475, 493 (S.D.N.Y. 2002) (finding in the non-insider trading context that "[t]he conscious avoidance of knowledge constitutes sufficient scienter under the federal securities laws.").

6. Reliance and Causation

a. Transaction Causation

It is often stated that reliance is a necessary element of a Rule 10b-5 case, *see, e.g., Currie v. Cayman Res. Corp.*, 835 F.2d 780, 784-85 (11th Cir. 1988); *Kramas v. Sec. Gas & Oil, Inc.*, 672 F.2d 766, 770 (9th Cir. 1982), or that a Rule 10b-5 plaintiff must show that the prohibited conduct of defendants was a substantial factor in causing the transaction complained of, *see, e.g., Wilson v. Comtech Telecomms. Corp.*, 648 F.2d 88, 92 (2d Cir. 1981); *Feinberg Testamentary Trust v. Carter*, 652 F. Supp. 1066, 1079 (S.D.N.Y. 1987). Courts refer to this requirement as "transaction causation" or "reliance." *See, e.g., Grace v. Rosenstock*, 228 F.3d 40, 46-47 (2d Cir. 2000); *In re N. Telecom Ltd. Sec. Litig.*, 116 F. Supp. 2d 446, 455-56 (S.D.N.Y. 2000).

The requirement of reliance or transaction causation must be carefully explained after both *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), and *Basic Inc. v. Levinson*, 485 U.S. 224, 241-50 (1988). *Affiliated Ute Citizens* held that where a Rule 10b-5 claim is based on omissions, rather than misrepresentations, proof of reliance is not necessary once the materiality of the omissions is shown. 406 U.S. at 153-54. Although the Court did not explain its holding in this way, *see id.*, lower courts have uniformly taken the case to mean that in omission cases under Rule 10b-5 there is a rebuttable presumption of reliance once materiality is shown. *See, e.g., Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001); *Binder v. Gillespie*, 184 F.3d 1059, 1063 (9th Cir. 1999); *Grubb v. FDIC*, 868 F.2d 1151, 1163 (10th Cir. 1989); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1118-19 (5th Cir. 1988), *vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989); *Lipton v. Documentation, Inc.*, 734 F.2d 740, 742 n.3 (11th Cir. 1984); *Biechele v. Cedar Point, Inc.*, 747 F.2d 209, 214-15 (6th Cir. 1984); *Miller v. Grigoli*, 712 F. Supp. 1087, 1094 (S.D.N.Y. 1989) (finding that defendants rebutted the *Ute* presumption); *Sanders v. Robinson Humphrey/Am. Exp., Inc.*, 634 F. Supp. 1048, 1063 (N.D. Ga. 1986), *aff'd in part and rev'd in part on other grounds sub nom. Kirkpatrick v. J.C.*

Bradford & Co., 827 F.2d 718, 721-22 (11th Cir. 1987). Some courts have held *Affiliated Ute Citizens* to create a rebuttable presumption of reliance on particular omissions only upon a showing that the plaintiff relied on the defendant in general. E.g., *Cavalier Carpets, Inc. v. Caylor*, 746 F.2d 749, 756 (11th Cir. 1984); see also *Fogarazzo v. Lehman Bros.*, 232 F.R.D. 176, 186 (S.D.N.Y. 2005) (discussing appropriateness of the *Ute* presumption where plaintiffs' claims are based on a combination of omissions and misstatements).

In ordinary cases involving misrepresentations rather than omissions, the *Ute* presumption does not relieve the plaintiff of the burden of proving reliance. See *Abell*, 858 F.2d at 1118-19; *State Teachers Ret. Bd. v. Fluor Corp.*, 654 F.2d 843, 853 (2d Cir. 1981). In *In re Interbank Funding Corp. Securities Litig.*, the D.C. Circuit held that the *Affiliated Ute* presumption did not apply because the auditor's failure to disclose the alleged Ponzi scheme was not an omission but, rather, an affirmative misrepresentation by the auditor in expressly attesting that the company's financial statements fairly presented its financial position. 629 F.3d 213 (D.C. Cir. 2010). In cases involving both misrepresentations and omissions, several courts have held that dual jury instructions, requiring reliance to be shown on misrepresentations but not on omissions, are improper. See, e.g., *Austin v. Loftsgaarden*, 675 F.2d 168, 178 n.21 (8th Cir. 1982) (finding district court's instruction to jury to presume reliance on omissions but requiring proof of reliance on misstatements was legally correct, but confusing and therefore inappropriate), *rev'd on other grounds sub nom. Randall v. Loftsgaarden*, 478 U.S. 647 (1986); *Flamm v. Eberstadt*, 814 F.2d 1169, 1173 (7th Cir. 1987) (emphasizing need to avoid confusing split jury instructions); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 188 (3d Cir. 1981) (criticizing split instruction as "hav[ing] great appeal to graduate logicians in a classroom."), *overruled on other grounds, In re Data Access Sys. Sec. Litig.*, 843 F.2d 1537 (3d Cir. 1988) (en banc); *Cavalier Carpets*, 746 F.2d at 757. In order to avoid such instructions, some courts apply the approach set forth by the Third Circuit in *Sharp*, "analyz[ing] the plaintiff's allegations in light of the likely proof at trial, and determin[ing] the most reasonable placement of the burden of proof of reliance." *Sharp*, 649 F.2d at 188; *Austin*, 675 F.2d at 178. Other courts limit the *Affiliated Ute* presumption to cases that primarily involve allegations of omission. *Joseph v. Wiles*, 223 F.3d 1155, 1162 (10th Cir. 2000) (indicating that a unitary burden of proof should be set according to fact-specific determination of whether offenses alleged in complaint "can be characterized primarily as omissions or misrepresentations"); *Binder*, 184 F.3d at 1064; *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 359-60 (5th Cir. 1987); *Cavalier Carpets*, 746 F.2d at 756.

Affiliated Ute Citizens rested on the rationale that reliance should be presumed where it is so difficult to prove that the reliance requirement threatens to render

Rule 10b-5 ineffectual. Applying this rationale, the Supreme Court in *Basic* held that “[i]t is not inappropriate to apply a [rebuttable] presumption of reliance supported by the fraud-on-the-market theory” in Rule 10b-5 cases. 485 U.S. at 250. While the Court did not discuss in detail the particular elements of a “fraud-on-the-market theory,” it did quote and affirm the holding of the court of appeals that in order to invoke the presumption, the plaintiff must allege and prove: (1) that a “defendant made public misrepresentations,” (2) that the misrepresentations were material, (3) that the securities involved “were traded on an efficient market,” and (4) that “the plaintiff traded the [securities] between the time the misrepresentations were made and the time the truth was revealed.” 485 U.S. at 248 n.27. The Court explained that “[a]n investor who buys or sells stock at the price set by the market does so in reliance upon the integrity of that price.” *Id.* at 247. Thus, the “fraud-on-the-market” theory requires that the securities in question are traded on an efficient market. *George v. Cal. Infrastructure and Econ. Dev. Bank*, 2010 WL 2383520 (E.D. Cal. June 10, 2010). An event study may be required to show that the market is efficient, as indicated by whether the “market price responds to most new, material news.” *See In re Fed. Home Loan Mortg. Corp. (Freddie Mac) Sec. Litig.*, 281 F.R.D. 174, (S.D.N.Y. 2012) (finding that plaintiff could not benefit from the fraud-on-the-market presumption of collective reliance where the market reacted to news only 28% of the time). The Seventh Circuit rejected the holding of the Fifth Circuit in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), that class action plaintiffs must first establish loss causation in order to be entitled to the “fraud-on-the-market” presumption and have the class certified. *Schleicher v. Wendt*, 618 F.3d 679 (7th Cir. 2010). The Seventh Circuit’s position was subsequently upheld by the Supreme Court. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011). The Ninth Circuit has agreed with the Third and Seventh Circuits in holding that plaintiffs must show that the security was traded in an efficient market and that the alleged misrepresentations were public; however, it has held that plaintiffs “need not *prove* materiality to avail themselves of the fraud-on-the-market presumption of reliance at the class certification stage,” but rather need only allege materiality with sufficient plausibility to withstand a Rule 12(b)(6) motion. *Conn. Ret. Plans and Trust Funds v. Amgen Inc.*, 660 F.3d 1170, 1177 (9th Cir. 2011).

As with the *Ute* presumption, *Basic*’s fraud-on-the-market presumption is rebuttable. “Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.” 485 U.S. at 248; *see also Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 661-62 (5th Cir. 2004); *Semerenko v. Cendant Corp.*, 223 F.3d 165,

179 (3d Cir. 2000) (holding that presumption of reliance may be rebutted “by showing that the market did not respond to the alleged misrepresentations, or that the plaintiff did not actually rely on the market price when making his or her investment decision”); *Provenz v. Miller*, 102 F.3d 1478, 1492-93 (9th Cir. 1996); *Bell v. Ascendant Solutions, Inc.*, 422 F.3d 307 (5th Cir. 2005) (affirming district court’s refusal to certify class when plaintiffs alleged, but failed to demonstrate, market efficiency required for application of presumption of reliance under fraud-on-the-market theory). Moreover, “if, despite [defendants’] allegedly fraudulent attempt to manipulate market price, [the truth] credibly entered the market and dissipated the effects of the misstatements, those who traded . . . after the corrective statements would have no direct or indirect connection with the fraud.” *Basic, Inc. v. Levinson*, 485 U.S. 224, 248-49 (1988). This truth-on-the-market defense is a rebuttal of the materiality element of the fraud-on-the-market presumption, *see, e.g., Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1097-98 (1991); *Provenz v. Miller*, 102 F.3d 1478, 1492 (9th Cir. 1996), and therefore may not be used to defeat class certification. *Amgen*, 660 F.3d at 1177 .

By adopting the fraud-on-the-market theory, the Supreme Court implicitly approved a line of lower court cases growing out of *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), in which the Ninth Circuit held that in plaintiffs’ class action suits under Rule 10b-5, reliance should be presumed, and separate proof of reliance by each class member not required, once materiality is shown, where defendants’ conduct had an effect on the price of the relevant security in an open market. 524 F.2d at 906-08. The ruling in *Blackie v. Barrack* was followed by several other circuits. *Finkel*, 817 F.2d at 362-63 (adopting the Ninth Circuit’s view only as to Rule 10b-5(1) and (3) but not under 10b-5(2)); *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 529 (7th Cir. 1985), *overruled on other grounds by Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385, 1387-89 (7th Cir. 1990); *Lipton*, 734 F.2d at 747; *T.J. Raney & Sons, Inc. v. Fort Cobb, Okla. Irrigation Fuel Auth.*, 717 F.2d 1330, 1332-33 (10th Cir. 1983); *Panzirer v. Wolf*, 663 F.2d 365, 368 (2d Cir. 1981), *vacated as moot sub nom. Pricewaterhouse v. Panzirer*, 529 U.S. 1027 (1982); *Shores v. Sklar*, 647 F.2d 462, 469 (5th Cir. 1981) (en banc), *overruled on other grounds by Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372.

Congress, by enacting the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), also appears to have endorsed a version of the fraud-on-the-market theory, at least in the context of insider trading. Section 4 of ITSFEA adds § 20A to the Exchange Act and provides that insider traders are liable to “contemporaneous traders” regardless of whether or not such plaintiff can prove reliance on any misinformation. *See* 15 U.S.C.A. § 78t-1(a) (West 2004).

As indicated in *Basic*, the fraud-on-the-market theory is best applied where securities are traded in established, efficient markets, *Basic, Inc. v. Levinson*, 485 U.S. 224, 246-47 (1988), but prior to *Basic* several courts had extended it to cases involving new issues. See, e.g., *Kirkpatrick*, 827 F.2d at 721-22 (indicating that recovery is possible on a fraud-on-the-market claim where named plaintiffs may have relied on factors other than the market's integrity); *T.J. Raney & Sons, Inc.*, 717 F.2d at 1333 (extending theory to securities newly and unlawfully issued, and fraudulently marketed); *Shores*, 647 F.2d at 469. Since *Basic*, several courts have continued this line of reasoning, holding that if the "fraud created the market," reliance by each plaintiff need not be specifically shown. See, e.g., *Abell*, 858 F.2d at 1122-23, *vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989) (holding, without using "fraud-created-the-market" term, that reliance may be presumed if the promoter knew despite an inefficient market that the "enterprise was worthless when . . . securities were issued"); *Ross v. Bank South, N.A.*, 885 F.2d 723, 729 (11th Cir. 1989); *Stinson v. Van Valley Dev. Corp.*, 719 F. Supp. 362, 366 (E.D. Pa. 1989), *aff'd mem.*, 897 F.2d 524 (3d Cir. 1990); *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 377 n.143 (S.D.N.Y. 2003) (applying fraud-on-the-market presumption to newly issued securities without relying on fraud created-the-market theory). The Ninth Circuit, however, somewhat reined in the fraud-on-the-market approach to reliance when it held the theory not applicable to sales of over-the-counter issues, where the plaintiff failed to show an adequate number of factors associated with the efficiency of its market. See *Binder*, 184 F.3d at 1065 (citing five factors indicative of a market's efficiency, including high weekly trading volume and the presence of market makers and arbitrageurs). Similarly, the Second Circuit has rejected the fraud-on-the-market theory with respect to debt securities that were not shown to have traded in an efficient market. See *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, 546 F.3d 196 (2d Cir. 2008); see also *Unger v. Amedisys Inc.*, 401 F.3d 316, 323 (5th Cir. 2005) (listing several factors to determine whether the securities traded in an efficient market and acknowledging but not resolving the question of whether OTC markets are inefficient as a matter of law); *Krogman v. Sterritt*, 202 F.R.D. 467, 473-78 (N.D. Tex. 2001) (indicating that OTC markets are not *per se* inefficient, but finding market for relevant issue not efficient under particular circumstances); cf. *Epstein v. Am. Reserve Corp.*, No. 79 C 4767, 1988 U.S. Dist. LEXIS 3382, at *14-15 (N.D. Ill. April 22, 1988) (concluding that an OTC market is incapable of meeting the *Basic* definition of an efficient market).

In contrast to the fraud-on-the-market theory, which states that the investor relied on the integrity of the security's market price, the "fraud-created-the-market" theory states that the investor relies on the integrity inhering in the very existence

of a market in the security. *Rosenthal v. Dean Witter Reynolds, Inc.*, 945 F. Supp. 1412, 1417-18 (D. Colo. 1996); *Alter v. DBLKM, Inc.*, 840 F. Supp. 799, 805 (D. Colo. 1993) (citing *Shores*, 647 F.2d at 470). Thus the theory is applied narrowly and will generally excuse a lack of specific reliance only when the plaintiff can show that the securities would have been “unmarketable” absent the defendant’s misrepresentations. *See, e.g., Joseph*, 223 F.3d at 1163-64; *Lipton*, 734 F.2d at 745-47; *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 200 (6th Cir. 1990); *Hamilton Partners, Ltd. v. Sunbeam Corp.*, No. 99-CV-8275, 2001 WL 34556527, *10-12 (S.D. Fla. July 3, 2001) (finding allegations of unmarketability insufficient and refusing to apply fraud created the market presumption); *In re Newbridge Networks Sec. Litig.*, 767 F. Supp. 275, 283 (D.D.C. 1991) (noting cases that held purchasers of a new issue cannot reasonably rely on the pricing of the issue and thus, to show reliance, purchaser must show securities were not entitled to be marketed at any price); *Dalton v. Alston & Bird*, 741 F. Supp. 1322, 1327-29 (S.D. Ill. 1990) (summarizing case law and indicating that a purchaser of a new issue may rely on the integrity of the market with respect to the validity of the securities under state substantive law, their terms, their tax status, and the promoter’s intent to carry out the project for which the securities are sold); *cf. Wade v. Indus. Funding Corp.*, No. C 92-0343 TEH, 1993 U.S. Dist. LEXIS 21245, at *21-24 (N.D. Cal. Aug. 30, 1993) (holding that plaintiffs are entitled to a presumption of reliance if securities were brought to the market fraudulently). Certain other courts have applied the fraud-created-the-market theory only in cases where the promoter knew that the securities were worthless, hence unmarketable in the absence of the fraud. *See, e.g., Abell*, 858 F.2d at 1122; *Stinson*, 719 F. Supp. 365-66.

The Seventh Circuit has renounced the fraud-created-the-market theory. *See Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1130 (7th Cir. 1993). The Third Circuit has also rejected the fraud-created-the-market theory for establishing a presumption of reliance, *Malack v. BDO Seidman, LLP*, 617 F.3d 743 (3d Cir. 2010), as has a district court in the Ninth Circuit. *George v. Cal. Infrastructure and Econ. Dev. Bank*, 2010 WL 2383520 (E.D. Cal. 2010). The Sixth Circuit has also questioned the theory’s validity, although refraining from rejecting it outright. *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1160 (6th Cir. 1994). It is unclear whether the fraud-created-the-market theory is good law in the Second Circuit. *See, e.g., Initial Pub. Offering*, 241 F. Supp. 2d at 377 n.143; *In re Towers Fin. Corp. Noteholders Litig.*, No. 93 Civ. 0810 (WK) (AJP), 1995 U.S. Dist. LEXIS 21147, at *67-68 (S.D.N.Y. Sept. 20, 1995) (noting that “[c]ourts in the Second Circuit have implicitly rejected the fraud-created-the-market theory”). The Eighth Circuit has acknowledged the disagreement among the courts without

deciding to accept or reject the theory. *In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309, 321 (8th Cir. 1997).

The fraud-on-the-market theory will rarely be applicable in garden variety, face-to-face fraud cases, but will often apply where it is claimed that corporate insiders or others have made misrepresentations to the public at large. *See, e.g., Basic*, 485 U.S. at 245-47; *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1266 (9th Cir. 1979); *Freeman*, 915 F.2d at 198; *see also, In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 480 (2d Cir. 2008) (“It . . . does not matter, for purposes of establishing entitlement to the [*Basic*] presumption, whether the misinformation was transmitted by an issuer, an analyst, or anyone else.”).

There is no requirement that reliance be shown in SEC injunctive or criminal actions under Rule 10b-5. *United States v. Haddy*, 134 F.3d 542, 544 (3d Cir. 1998); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363-64 (9th Cir. 1993); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985) (*per curiam*); *SEC v. N. Am. Research and Dev. Corp.*, 424 F.2d 63, 84 (2d Cir. 1970).

b. Loss Causation

In addition to transaction causation, a plaintiff must provide evidence of “loss causation” in order to satisfy the causation element of a securities fraud claim. *See Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005); *In re Omnicon Group, Inc. Sec. Litig.*, 597 F.3d 501 (2d Cir. 2010) (explaining the principle of loss causation); *Ind. State Dist. Council of Laborers v. Omnicare, Inc.*, 583 F.3d 935, 944-45 (6th Cir. 2009) (dismissing claims for failure to plead loss causation); *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1063-64 (9th Cir. 2008) (discussing standard of loss causation). The Reform Act memorialized this requirement in Section 21D(b)(4) of the Exchange Act, which states: “In any private action under [the Exchange Act], the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate [the Exchange Act] caused the loss for which the plaintiff seeks to recover damages.” 15 U.S.C.A. § 78u-4(b)(4); *see also Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 830 n.3 (8th Cir. 2003) (noting that PSLRA does not change pleading standards with respect to loss causation and materiality). In other words, “[t]o establish causation, a plaintiff must prove ‘that the economic harm that it suffered occurred as a result of the alleged misrepresentations’ and that ‘the damage suffered was a foreseeable consequence of the misrepresentation.’” *Rothman v. Gregor*, 220 F.3d 81, 95 (2d Cir. 2000) (quoting *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992)); *see also In re Omnicon*, 597 F.3d at 512 (holding that “negative characterization of already-public information” does not establish loss causation). Some courts have held that the plaintiff need not prove the

misrepresentations were the sole cause of the damages, and that proof that they were a “substantial” contributing cause is enough. *Miller v. Asensio & Co.*, 364 F.3d 223, 232 (4th Cir. 2004); *see also Semerenko*, 223 F.3d at 186-87; *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 n.5 (11th Cir. 1997). Class action plaintiffs do not need to establish loss causation in order to trigger the fraud-on-the-market presumption and obtain class certification. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011), *overruling Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010).

Circuit courts had been split on how loss causation is established in a fraud-on-the-market case, and the Supreme Court resolved this split in 2005. In *Dura*, 544 U.S. 336, a unanimous Supreme Court rejected the Ninth Circuit’s rationale and held that “an inflated purchase price will not itself constitute or proximately cause the relevant economic loss.” 544 U.S. at 341. The Supreme Court reasoned that at the moment of purchase of the inflated stock, no economic loss has been experienced because the stock owned “at that instant possesses equivalent value.” 544 U.S. at 342 (emphasis omitted). The Supreme Court also held that even if the share price drops after the truth begins to come out, this price drop does not itself prove loss causation. Rather, “that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events, which taken separately or together account for some or all of that lower price.” 544 U.S. at 343. With respect to timing, “the longer the time between purchase and sale . . . the more likely that [factors other than the misrepresentation] caused the loss.” *Id.* The Court warned against using private securities actions as “broad insurance against market losses” when they are only meant to “protect [investors] against those economic losses that misrepresentations *actually* cause.” 544 U.S. at 345 (emphasis added). While “conced[ing] that ordinary pleading rules are not meant to impose a great burden,” the Court held that a plaintiff must “provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.” 544 U.S. at 347.

The Third Circuit has applied *Dura* even to markets in private securities, where *Dura* “is not directly controlling [because Plaintiffs] could not simply turn around and resell the unregistered . . . shares they had received,” noting cryptically that it “[n]evertheless . . . believe[d] the logic of *Dura* is persuasive.” *McCabe v. Ernst & Young, LLP*, 494 F.3d 418, 433 (3d Cir. 2007). The Fourth Circuit extended *Dura*’s reasoning to require that plaintiffs “plead [loss causation] with sufficient specificity to enable the court to evaluate whether the necessary causal link

exists.” *Teachers’ Ret. Sys. of LA v. Hunter*, 477 F.3d 162, 186 (4th Cir. 2007); *see also In re Williams Sec. Litig.*, 558 F.3d 1130, 1137 (10th Cir. 2009) (“The plaintiff bears the burden of showing that his losses were attributable to the revelation of the fraud and not the myriad other factors that affect a company’s stock price. Without showing a causal connection that specifically links losses to misrepresentations, he cannot succeed.”); *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049 (9th Cir. 2008) (affirming dismissal of complaint where public announcements pled to establish loss causation did not reveal the alleged fraud).

The District Courts for the Southern and Eastern Districts of New York have repeatedly held that *Dura* adopted the Second Circuit’s existing loss causation jurisprudence without disturbing it, and as such have continued to apply Second Circuit jurisprudence pre-dating *Dura*. *See, e.g., In re Initial Pub. Offering Sec. Litig.*, 544 F. Supp. 2d 277, 288 n.69 (S.D.N.Y. 2008) (citing both *Dura* and preexisting Second Circuit cases); *In re AOL Time Warner, Inc. Sec. Litig.*, 503 F. Supp. 2d 666 n.9 (S.D.N.Y. 2007) (“While *Dura* addresses allegations that are insufficient to prove and plead loss causation, the Second Circuit . . . provides a more detailed account of the type of allegations that will suffice to plead that element.”) (internal citation omitted); *In re Comverse Tech., Inc. Sec. Litig.*, No. 06-CV-1825, 2007 WL 680779, *4 (E.D.N.Y. Mar. 2, 2007) (citing both *Dura* and preexisting Second Circuit cases); *In re Initial Pub. Offering Sec. Litig.*, 399 F. Supp. 2d 298, 301 (S.D.N.Y. 2005) (“*Dura* did not disturb Second Circuit precedent regarding loss causation.”), *aff’d sub nom. Tenney v. Credit Suisse First Bos. Corp.*, 2006 WL 1423785 (2d Cir. 2006). *See also Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172-77 (2d Cir. 2005) (describing the Second Circuit’s requirements of loss causation and foreseeability). *See generally Emergent Capital Inv. Mgmt, LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003) (clarifying *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 96 (2d Cir. 2001)); *Lentell*, 396 F.3d at 173 (characterizing *Suez Equity*’s holding as requiring that “the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security. Otherwise, the loss in question was not foreseeable.”); *Initial Pub. Offering Sec. Litig.*, 297 F. Supp. 2d at 672-74 (finding it “clear” under *Emergent Capital* that allegations of artificial inflation alone are insufficient in a case involving misstatements or omissions, but holding that bare allegations of inflation are sufficient in a case involving manipulation); *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 366 n.28 (S.D.N.Y. 2003) (discussing dangers of allowing loss causation to be satisfied in a fraud-on-the-market case with a showing of inflated purchase price alone), *aff’d, Lentell*, 396 F.3d 161.

The Third and Eleventh Circuits can also claim to have been on the winning side of the circuit split at issue in *Dura*, and as such their preexisting jurisprudence may also remain valid. *See generally Semerenko*, 223 F.3d at 185 (“Where the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to the misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.”); *Robbins*, 116 F.3d at 1448 (holding that a “showing of price inflation . . . does not satisfy the loss causation requirement. Our decisions explicitly require proof of a causal connection between the misrepresentation and the investment’s subsequent decline in value.”). The Eleventh Circuit has further held that, in order to prove loss causation adequately, the plaintiff must separate portions of the price decline attributable to the alleged fraud from those based on other factors. *See Hubbard v. BankAtlantic Bancorp, Inc.*, --- F.3d ----, 2012 WL 2985112, at *9-*10 (11th Cir. July 23, 2012) (affirming judgment as a matter of law in 10b-5 action where defendant bank’s assets were concentrated in loans tied to Florida real estate but plaintiff’s expert did not account for general decline in that market).

While those cases suggest that a price “correction” can affect the economic loss determination, the Second Circuit has held that price recovery after corrective disclosures does not defeat an inference of economic loss. *Acticon AG v. China N.E. Petroleum Holdings Ltd.*, --- F.3d ----, 2012 WL 3104589 (2d Cir. Aug. 1, 2012). The court explained that “it is improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers value for completely unrelated reasons,” as to do so would put the plaintiff in a worse position because in the absence of fraud the plaintiff would have benefitted both from purchasing the security at an uninflated price and from the unrelated gain in stock price. *Id.* at *6. Because it was unclear at the motion to dismiss stage “whether the price rebounds represent the market’s reactions to the disclosure of the alleged fraud or whether they represent unrelated gains,” the recovery was insufficient to negate the inference of economic loss. *Id.* at *7. In addition, the mere fact that the market already reflects false information does not, in the Eleventh Circuit’s view, cleanse the dissemination of confirmatory false information: “Defendants whose fraud *prevents* preexisting inflation in a stock price from dissipating are just as liable as defendants whose fraud introduces inflation into the stock price in the first instance. We decline to erect a *per se* rule that, once a market is already misinformed about a particular truth, corporations are free to knowingly and intentionally reinforce material

misconceptions by repeating falsehoods with impunity.” *FindWhat Investor Grp. v. FindWhat.com*, 658 F.3d 1282, 1317 (11th Cir. 2011).

There is a disagreement among the circuits as to whether *Dura*’s loss causation principle applies to sentencing enhancements in criminal securities fraud cases. The Second and Fifth Circuits have applied *Dura* in criminal cases on the grounds that such application furthers the law’s goal of tying the magnitude of a defendant’s sentence to the magnitude of actual loss caused in the marketplace. *United States v. Rutkoski*, 506 F.3d 170 (2d Cir. 2007) (“[W]e see no reason why considerations relevant to loss causation in a civil fraud case should not apply, at least as strongly, to a sentencing regime in which the amount of loss caused by a fraud is a critical determinant of the length of a defendant’s sentence.”); *United States v. Olis*, 429 F.3d 540, 546-47 (5th Cir. 2005) (“The civil damage measure should be the backdrop for criminal responsibility because it furnishes the standard of compensable injury for securities fraud victims and because it is attuned to stock market complexities.”). The Ninth Circuit, however, has declined to adopt the *Dura* loss causation principle, instead opting for a “more general loss causation principle, permitting a district court to impose sentencing enhancements only for losses that ‘resulted from’ the defendant’s fraud.” *United States v. Berger*, 587 F.3d 1038, 1043 (9th Cir. 2009). The Ninth Circuit concluded that the *Dura* principle was designed for the civil context in which a private plaintiff sought recovery for individual losses. *Id.* However, because criminal actions are brought by the government on behalf of society at large, sentencing should depend on the total amount of loss *caused* by the defendant and not on the amount of loss *sustained* by a particular plaintiff. *Id.* at 1044.

7. Heightened Pleading Requirements Under the Reform Act

a. Pleading Fraudulent Conduct with Particularity

Because § 10(b) claims sound in fraud, plaintiffs have always had to satisfy the pleading requirements of Fed. R. Civ. P. § 9(b), which requires plaintiffs to plead all of the elements of fraud with particularity. Under the particularity requirement, a complaint must “adequately specify the statements it claims were false or misleading, give particulars as to the respect in which plaintiff contends the statements were fraudulent, state when and where the statements were made, and identify those responsible for the statements.” *Jordan (Bermuda) Inv. Co. v. Hunter Green Invs. Ltd.*, 205 F. Supp. 2d 243, 247 (S.D.N.Y. 2002) (quoting *Cosmas v. Hassett*, 886 F.2d 8, 11 (2d Cir. 1989)).

The Reform Act both codified and extended these pleading requirements. Like Rule 9(b), “the PSLRA requires the complaint first to specify each misleading

statement and then to specify the reason(s) why the statement was misleading.” *In re Splash Tech. Holdings, Inc. Sec. Litig.*, 160 F. Supp. 2d 1059, 1072 (N.D. Cal. 2001); *see also In re AMDOCS Ltd. Sec. Litig.*, 390 F.3d 542, 549 (8th Cir. 2004) (Wollman, concurring); 15 U.S.C.A. § 78u-4(b)(1). One court of appeals case summarized the requirements of Fed. R. Civ. P. § 9(b) and the PSLRA as follows: the claim must: “(1) specify . . . each statement alleged to have been misleading, i.e., contended to be fraudulent; (2) identify the speaker; (3) state when and where the statement was made; (4) plead with particularity the contents of the false representations; (5) plead with particularity what the person making the misrepresentation obtained thereby; and (6) explain the reason or reasons why the statement is misleading, i.e., why the statement is fraudulent.” *Goldstein v. MCI WorldCom*, 340 F.3d 238, 245 (5th Cir. 2003). This is the “who, what, when, where, and how: the first paragraph of any newspaper story.” *In re CDNOW, Inc. Sec. Litig.*, 138 F. Supp. 2d 624, 640 (E.D. Pa. 2001) (quoting *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999)) (internal quotations omitted). Mere boilerplate recitations that a misstatement or omission was known to be false or misleading do not satisfy the heightened pleading requirement. *Brody v. Stone & Webster, Inc.*, 414 F.3d 187, 206 (1st Cir. 2005); *The Cascade Fund, LLP v. Absolute Capital Mgmt. Holdings, Ltd.*, No. 08-CV-01381, 2010 U.S. Dist. LEXIS 32255, at *32 (D. Colo. Mar. 31, 2010). *Cf. SEC v. Lucent Techs., Inc.*, 363 F. Supp. 2d 708 (D.N.J. 2005) (holding and collecting cases supporting the proposition that the SEC is not required to satisfy the Reform Act’s heightened requirements for pleading scienter). Where scienter is pled based on information allegedly obtained from a confidential source, the allegations must make clear the reliability of the source and the facts supplied or the complaint may not satisfy the PSLRA’s heightened pleading standard. *City of Livonia Employees’ Retirement System v. The Boeing Co.*, No. 09 C 7143, 2011 WL 824604 (7th Cir. 2011).

Additionally, plaintiffs must also allege that the “true facts” existed before the purportedly misleading statement. *Splash Tech.*, 160 F. Supp. 2d at 1072. “This requirement helps guard against pleading fraud by hindsight, and helps prevent providing a complaint passageway through the pleading stage merely because it alleges that the allegedly fraudulent statements conflict with the current state of facts.” *Id.* (citation omitted) (citing *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 988 (9th Cir. 1999)); *see also Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1250 (N.D. Cal. 1998) (dismissing complaint where plaintiff failed to allege that true facts existed prior to misrepresentation). In other words, “[a] plaintiff may not simply contrast a defendant’s past optimism with less favorable actual results, and then ‘contend[] that the difference must be attributable to fraud.’” *Miss. Pub. Employees’ Ret. Sys. v. Boston Scientific Corp.*, 523 F.3d 75, 90 (1st

Cir. 2008) (alteration in original) (quoting *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1223 (1st Cir. 1996)). However, the fraud by hindsight doctrine does not apply “when plaintiffs provide[] ‘a series of factual allegations relating to a combination of developments known to the company . . . that could have provided a basis for advance knowledge of the information.’” *Id.*

Finally, “whenever plaintiffs allege, on information and belief, that defendants made material misstatements or omissions, the complaint must ‘state with particularity all facts on which that belief is formed.’” *Novak v. Kasaks*, 216 F.3d 300, 312 (2d Cir. 2000) (quoting 15 U.S.C. § 78u-4(b)(1)); *see also In re Autodesk, Inc. Sec. Litig.*, 132 F. Supp. 2d 833, 838-40 (N.D. Cal. 2000) (dismissing § 10(b) claims for failing to include sufficient factual basis for information and belief as required by Reform Act). Some courts have interpreted the requirement of stating “all facts” loosely, and have “evaluat[ed] the facts alleged in a complaint to determine whether, taken as a whole, they support a reasonable belief that the defendant’s statements identified by the plaintiff were false or misleading.” *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1099 (10th Cir. 2003). *Accord Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1016 (11th Cir. 2004) (collecting cases and stating that the court will permit “aggregation of facts to infer scienter”). *See also Novak*, 216 F.3d at 313-14 (indicating that plaintiffs need not plead with particularity “every single fact upon which their beliefs . . . are based,” and stating that “where plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants’ statements were false,” and that “even if personal sources are identified, there is no requirement that they be named, provided they are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged”); *In re Daou Sys.*, 411 F.3d 1006, 1015 (9th Cir. 2005) (stating that the Ninth Circuit adopts the Second Circuit “standard for evaluating personal sources of information”); *CALPERS v. Chubb Corp.*, 394 F.3d 126, 146-47 (3d Cir. 2004) (adopting Second Circuit standard as announced in *Novak v. Kasaks* “when assessing the sufficiency of allegations made on information and belief”); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 29-30 (1st Cir. 2002); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 353 (5th Cir. 2002); *In re Theragenics Corp. Sec. Litig.*, 137 F. Supp. 2d 1339, 1345-46 (N.D. Ga. 2001).

b. Pleading Scienter

Prior to the passage of the Reform Act, the level of particularity required to plead scienter under Rule 10b-5 was not uniform across the circuits. *Compare Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (requiring “strong

inference of fraudulent intent”), with *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (stating that “the complaint still must afford a basis for believing that plaintiffs could prove scienter”). The Ninth Circuit required plaintiffs to plead the allegedly false or misleading statement and why the statement was false or misleading; plaintiffs were allowed to aver scienter generally. See, e.g., *In re Glenfed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545-49 (9th Cir. 1994). In contrast, the Second Circuit required plaintiffs to allege facts “that [gave] rise to a strong inference of fraudulent intent.” *Shields*, 25 F.3d at 1128. This “strong inference” could be demonstrated by alleging facts that either (a) showed that defendants had both motive and opportunity to commit fraud, or (b) constituted strong circumstantial evidence of conscious misbehavior or recklessness. *Id.* Of all the circuits, the Second Circuit’s standard was by far the most influential.

To eliminate the lack of uniformity among the circuits, Congress adopted the “strong inference” pleading standard of the Second Circuit in new Section 21D(b)(2) of the Exchange Act. 15 U.S.C.A. § 78u-4(b)(2). The Reform Act requires a plaintiff in a securities fraud case to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” *Id.* However, the Reform Act did not define what pleaded facts are sufficient to give rise to a “strong inference” of scienter. See *In re Microstrategy, Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 628 (E.D. Va. 2000). Compounding the uncertainty, Congress took several actions during passage of the Reform Act that indicated its intent to deviate somewhat from the Second Circuit’s pleading standard: the Conference Committee explicitly declined in its report to adopt the case law of the Second Circuit; the Committee observed in a footnote to the report that the Second Circuit’s pleading rules should be strengthened; Congress abandoned an amendment that would have codified the Second Circuit’s case law, H.R. Conf. Rep. No. 104-369, at 41, n.23 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740, 747; and Congress overrode President Clinton’s veto of the Reform Act, a veto President Clinton made based on the belief that Congress had elevated the pleading standard above that required in the Second Circuit, see *Silicon Graphics Inc.*, 183 F.3d at 979. Later, however, the Senate Banking Committee noted that the statute did in fact adopt the Second Circuit’s “strong inference” standard, rather than “a new and untested pleading standard that would generate additional litigation.” S. Rep. No. 104-98, at 15 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 694. Three years later, when Congress passed the Uniform Standards Act of 1998, the accompanying reports again indicated Congress’s “clear . . . and continuing intent . . . that neither the Reform Act nor S. 1260 [later the Uniform Standards Act of 1998] in any way alters the scienter standard in Federal securities fraud suits.” 144 Cong. Rec. S12589 (daily ed. Oct. 14, 1998) (correcting the Joint Explanatory Statement in H.R. Conf. Rep. 105-803), LEXIS

144 Cong. Rec. S 12589 at *S12590. Despite this attempted clarification, confusion on this issue persists among the federal courts.

Federal courts had differed on the question of whether the Exchange Act's pleading standard for scienter is equivalent to, or stricter than, the pre-Reform Act Second Circuit standard. In 2007, the Supreme Court ruled that in order to qualify as "strong," "an inference of scienter must be more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313-14 (2007). In *Tellabs*, the Court rejected the Seventh Circuit's standard that allowed a complaint to survive a motion to dismiss as long as a reasonable person could infer from the facts alleged, if true, that the defendant acted with the requisite intent. *Id.* at 321-22. Instead the Court adopted a standard that requires courts to "consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff." *Id.* at 324. Under this standard, a complaint will survive a motion to dismiss "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* When applying the *Tellabs* analysis, courts should look at all of the facts, "taken collectively," to determine if the plaintiff adequately pleaded scienter. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1324-25 (2011) (rejecting bright-line rule that withheld information must be statistically significant to establish strong inference of scienter). See also *Frank v. Dana Corp.*, 646 F.3d 954, 961 (6th Cir. 2011) (scienter pleadings should be considered "holistically"); *South Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008).

Prior to *Tellabs*, courts applying the "strong inference" requirement had split generally into three groups, each interpreting the standard differently: the first adopted the pre-Reform Act Second Circuit standard; the second did not allow a showing of motive and opportunity to be sufficient in itself; and the third required a detailed showing of conscious misconduct or deliberate recklessness. *Svezzese v. Duratek, Inc.*, 67 F. App'x 169, 172 (4th Cir. 2003) (unpublished opinion); see also *Microstrategy, Inc.*, 115 F. Supp. 2d at 628-29. Whether *Tellabs* will result in a uniform application of the "strong inference" standard across the Circuits remains to be seen.

The Second and Third Circuits have held that the Second Circuit's standard for pleading scienter survives the Reform Act intact. *Kalnit v. Eichler*, 264 F.3d 131, 138-39 (2d Cir. 2001); *Novak*, 216 F.3d at 310; *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 169-70 (2d Cir. 2000); *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 237 (3d Cir. 2004); *Oran v. Stafford*, 226 F.3d 275, 288 (3d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999); see also *San*

Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris, 75 F.3d 801, 812-13 (2d Cir. 1996) (setting out pre-Reform Act “strong inference” standard). Under this standard, a plaintiff may raise a strong inference of scienter in either of two ways: “(a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.” *Kalnit*, 264 F.3d at 138-39; *GSC Partners*, 368 F.3d at 237. Some district courts in the Seventh Circuit and one district court in the Ninth Circuit have also followed this approach, although they have emphasized that a showing of motive and opportunity must be sufficiently compelling to meet the “strong inference” requirement. *See, e.g., Ong v. Sears, Roebuck & Co.*, 388 F. Supp. 2d 871 (N.D. Ill. 2004) (“The Seventh Circuit has not addressed the proper test for scienter in light of the PSLRA, and courts in this district are split. Most courts, however have adopted the standard enunciated by the Second Circuit . . .”); *In re Spiegel, Inc. Sec. Litig.*, 382 F. Supp. 2d 989 (N.D. Ill. 2004) (collecting cases); *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 815, 823 (N.D. Ill. 2000); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1310-11 (C.D. Cal. 1996) (holding that Congress did not intend to abandon the Second Circuit’s pleading rule and that allegations of recklessness, as well as motive and opportunity, are sufficient to plead scienter), *aff’d mem.*, 234 F.3d 1277 (9th Cir. 2000).

Although included in the above group, the Second Circuit has reformulated its “strong inference” test, complicating any effort to strictly categorize the prevalent approaches to pleading scienter. In *Novak*, 216 F.3d 300, the Second Circuit concluded that the Reform Act “raised the nationwide pleading standard to that previously existing in [the Second Circuit] and no higher (with the exception of the ‘with particularity’ requirement).” *Id.* at 310. To this extent, the *Novak* approach is consistent with the approach taken by courts in the first group discussed above. However, the *Novak* court expressly distinguished its approach from that of those courts, stating that other courts have concluded that “[t]he statute effectively adopts the Second Circuit’s pleading standard wholesale, and thus plaintiffs may continue to state a claim by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior.” *Id.* at 309-10 (citing *Advanta* and *Press* as examples); *see also Lentell*, 396 F.3d at 168 (stating that the Second Circuit’s pleading requirements “were (*essentially*) codified in the [PSLRA]”) (emphasis added). The court also distinguished its approach from that of courts that have ruled that “[t]he Statute strengthens the Second Circuit’s standard by rejecting the simple pleading of motive and opportunity.” *Novak*, 216 F.3d at 310 (citing *Bryant*, *Silicon Graphics*, and *Comshare* as examples, *see discussion infra*). Instead, the Second Circuit adopted a “middle ground” approach, reasoning that “Congress’s failure to

include language about motive and opportunity suggests that we need not be wedded to these concepts in articulating the prevailing standard.” *Id.* Under the *Novak* court approach, plaintiffs and lower courts “need and should not employ or rely on magic words such as “motive and opportunity.” *Id.* at 311. Instead, the strong inference may arise when the complaint sufficiently alleges that the defendants: “(1) benefitted [sic] in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behavior; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information they had a duty to monitor.” *Id.* (internal citations omitted); *see also Campo v. Sears Holdings Corp.*, 371 F. App’x 212, 217-18 (2d Cir. 2010) (affirming dismissal of plaintiff’s complaint where chairman was not shown to have access to certain reports and information related to the chairman’s public statements regarding the fair market value of the company’s real estate); *South Cherry Street, LLC v. Hennessee Group, LLC*, 573 F.3d 98, 113 (2d Cir. 2009) (affirming dismissal because, *inter alia*, plaintiff did not plead sufficient facts to show that defendant “failed to take obvious investigative steps and ignored clear red flags”); *Kalnit*, 264 F.3d at 139-41 (affirming dismissal where motive and opportunity allegations failed to show concrete and personal benefits); *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 308 F. Supp. 2d 249, 259 (S.D.N.Y. 2004) (dismissing complaint where allegations of scienter fail to meet *Novak* standard); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 289 F. Supp. 2d 416, 428 (S.D.N.Y. 2003) (dismissing plaintiff’s complaint where motive and opportunity allegations failed to show concrete and personal benefits); *cf. Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 827 (8th Cir. 2003) (using the four-part *Novak* standard “as an aid to interpreting the strong-inference standard and not as a substitute for it.”) (quoting *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 746 (8th Cir. 2002)). In its first decision following *Tellabs* that addressed the sufficiency of a complaint’s scienter allegations, the Second Circuit did not alter its standard, but cited *Tellabs* in ruling that “[a] strong inference of scienter is not raised by alleging that a legitimate investment vehicle” created an opportunity for profit through manipulation. *ATSI Commc’ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 104 (2d Cir. 2007); *see also Globis Capital Partners, L.P. v. Stonepath Group, Inc.*, 241 F. App’x 832 (3d Cir. 2007) (*Tellabs* standard was not met even though the complaint alleged that the defendant company had restated its financial results three times in thirteen months).

A second group of courts—including the First, Fifth, Sixth, Seventh, Eighth, and Eleventh Circuits and various district courts—has interpreted the Reform Act as incorporating the Second Circuit “strong inference” standard, but has held that allegations of motive and opportunity are not enough by themselves to create a

“strong inference” of scienter. *See, e.g., Thompson v. RelationServe Media, Inc.*, 610 F.3d 628, 634 (11th Cir. 2010) (citing *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999) (“[W]e hold that the Reform Act . . . does not codify the ‘motive and opportunity’ test formulated by the Second Circuit.”)); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 437 F.3d 588, 603 (7th Cir. 2006) (summarizing circuit splits), *vacated and remanded*, 551 U.S. 308 (2007); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 867 (5th Cir. 2003) (“bare allegations of motive and opportunity will not suffice to demonstrate scienter”); *Navarre Corp.*, 299 F.3d at 747 (“[A]n allegation that defendants had the motive and opportunity to make false or misleading statements is insufficient to support the strong inference of scienter required after the PSLRA.”); *Geffon v. Micrion Corp.*, 249 F.3d 29, 36 (1st Cir. 2001) (“At the pleading stage, an allegation that defendants had the motive and opportunity to make false or misleading statements is insufficient to support the ‘strong inference’ of scienter required after [the Reform Act.]”); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999) (“[M]erely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough.”); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 549 (6th Cir. 1999) (“Plaintiffs may plead scienter . . . by alleging facts giving rise to a strong inference of recklessness, but not by alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud.”).

However, courts taking this second approach often consider allegations of motive and opportunity *relevant* to a totality of the circumstances “strong inference” inquiry. *See, e.g., Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 82 (1st Cir. 2002) (“[W]hile mere allegations of motive and opportunity alone may be insufficient, together with additional factual support, evidence of motive and opportunity may establish a strong inference of scienter.”); *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 430 (5th Cir. 2002) (“[A]ppropriate allegations of motive and opportunity may enhance other allegations of scienter.”); *Glaser v. Enzo Biochem, Inc.*, 303 F. Supp. 2d 724, 732 (E.D. Va. 2003) (“If the totality of the circumstances alleged raises a strong inference of the requisite state of mind, it is immaterial whether plaintiffs satisfy their burden by pleading motive and opportunity, conscious misbehavior, recklessness, or by impressing upon the court a novel legal theory.”) (quoting *In re MicroStrategy, Inc.*, 115 F. Supp. 2d 620, 627, *aff’d in part and rev’d in part on other grounds*, 126 F. App’x 593 (4th Cir. 2005); *Frank v. Dana Corp.*, 649 F. Supp. 2d 729, 737 (N.D. Ohio 2009) (factors to consider when applying *Tellabs* include “self-interested motivation of defendants” and “personal interest of certain directors”), *rev’d*, 646 F.3d 954 (6th Cir. 2011); *Angres v. Smallworldwide PLC*, 94 F. Supp. 2d 1167, 1174 (D. Colo. 2000) (rejecting per se motive and opportunity test, but indicating that “in those

cases where motive and opportunity allegations do not alone create a strong inference of scienter, the allegations will nonetheless be relevant in determining whether the totality of allegations permits a strong inference of fraud”). *But see In re Kindred Healthcare, Inc.*, No. 3:02CV-600-H, 2004 U.S. Dist. LEXIS 775 at *9 (W.D. Ky. Jan. 12, 2004) (distinguishing the Sixth Circuit’s approach from that of the First Circuit).

Thus, there is an emerging view, now held by the First, Fourth, Sixth, Seventh, Eighth and Tenth Circuits, rejecting a per se rule that allegations of motive and opportunity alone are sufficient to satisfy the scienter pleading requirements — a rule that cannot be sustained following *Tellabs* — and instead holding that motive and opportunity may or may not establish scienter, depending upon the facts of the particular case — an approach that appears to be consistent with *Tellabs*. *See Ottmann*, 353 F.3d at 345-46; *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1191 (10th Cir. 2003); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 38-39 (1st Cir. 2002); *In re 2007 Novastar Fin., Inc., Sec. Litig.*, 579 F.3d 878, 882-84 (citing *In re K-Tel Int’l, Inc. Sec. Litig.*, 300 F.3d 881, 894 (8th Cir. 2002)); *Konkol v. Diebold*, 590 F.3d 390, 399-404 (6th Cir. 2009) (citing *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-51 (6th Cir. 2001)). The *Ottmann* court, for example, surveyed the split authority and “conclud[ed] that courts should not restrict their scienter inquiry by focusing on specific categories of facts, such as those relating to motive and opportunity, but instead should examine all of the allegations in each case to determine whether they collectively establish a strong inference of scienter.” *Ottmann*, 353 F.3d at 345 (affirming dismissal of claim for failure to raise strong inference of fraud). This holding follows several years of uncertainty in the Fourth Circuit. *See, e.g., Phillips v. LCI Int’l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999) (declining to determine the standard because most lenient Second Circuit standard was not met); *In re Humphrey Hospitality Trust, Inc. Sec. Litig.*, 219 F. Supp. 2d 675 (D. Md. 2002) (applying Second Circuit test in absence of circuit court guidance); *In re First Union Corp. Sec. Litig.*, 128 F. Supp. 2d 871, 885-86 (W.D.N.C. 2001) (noting that the Second Circuit test is the minimum standard and applying a more stringent amalgam of Third and Ninth Circuit standards). The Seventh Circuit, the court that was reversed in *Tellabs*, subsequently issued a particularly strong opinion applying *Tellabs* in affirming dismissal of a securities class action. *Higginbotham v. Baxter Int’l Inc.*, 495 F.3d 753 (7th Cir. 2007). In doing so, the Seventh Circuit: (1) stated that “[o]ne upshot of the approach that *Tellabs* announced is that we must discount allegations that the complaint attributes to . . . ‘confidential witnesses,’” *id.* at 756; (2) stated that the fact that the defendants did not disclose the accounting issues alleged in the complaint immediately upon learning of them, but waited until its next 10Q filing, did not create a strong inference of scienter, *id.* at 760-61; and (3) rejected plaintiffs’

argument that the company’s senior management must have known of the alleged fraud at the time of multi-million-dollar stock sales by the company’s CEO and a senior VP, and made clear that such trading would not support a strong inference of scienter unless senior management *as a whole* had made “abnormally high” or demonstrated “an unusual period for managerial sales” before public disclosure of the problem, *id.* at 759. More recently, the Seventh Circuit has found that an allegation that “top managers had an incentive to make [the company] look good in order to keep their jobs, improve their bonuses, and increase the value of their stock options” was “too generic to satisfy *Tellabs*. A similar assertion could be made about every firm in the world, but the fact that managers benefit from higher stock prices does not imply that any particular manager committed fraud.” *Plumbers and Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc.*, 679 F.3d 952, 956 (7th Cir. 2012).

The third group of courts—primarily the Ninth Circuit and district courts in the First Circuit—has concluded that the Reform Act requires a more stringent pleading rule than the pre-Reform Act Second Circuit standard adopted by other courts. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 932 n.8 (9th Cir. 2003). These courts have held “that the [Reform Act] eliminated *both* the ‘motive and opportunity’ test *and* nondeliberate recklessness as a possible substantive ground for securities fraud liability.” *Microstrategy, Inc.*, 115 F. Supp. 2d at 629; *see also Am. W.*, 320 F.3d at 943 (reversing motion to dismiss and holding that plaintiffs “sufficiently raised a strong inference of deliberate recklessness”); *Livid Holdings, Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 948 (9th Cir. 2005) (stating that the PSLRA requires “deliberate[] reckless[ness]” or “conscious misconduct” and though “motive to mislead, standing alone” is insufficient, it may be a relevant consideration for the court); *Lipton v. PathoGenesis Corp.*, 284 F.3d 1027, 1038 (9th Cir. 2002) (“[G]eneralized assertions of motive, without more, are inadequate to meet the heightened pleading requirements of [the Reform Act.]”); *In re Seebeyond Techs. Corp. Sec. Litig.*, 266 F. Supp. 2d 1150, 1169 (C.D. Cal. 2003) (finding plaintiff’s allegations in totality sufficient to raise strong inference of deliberate recklessness). To satisfy this more stringent pleading rule plaintiffs must plead in “great detail” facts providing “strong circumstantial evidence of deliberately reckless or conscious misconduct,” which is more than “mere recklessness.” *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 974, 983 (9th Cir. 1999); *see also WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1055 (9th Cir. 2011) (affirming dismissal of claim where the “strong inference” standard was not met; while one “plausible” explanation for defendant’s statement was an intent to defraud, another plausible explanation was confusion); *In re Wash. Mut., Inc. Sec. Deriv. & ERISA Litig.*, 694 F. Supp. 2d

1192, 1226-27 (W.D. Wash. 2009) (denying defendant's motion to dismiss complaint that satisfies the *Silicon Graphics* standard); *In re Read-Rite Corp. Sec. Litig.*, 335 F.3d 843, 846 (9th Cir. 2003) (citing *Silicon Graphics* and dismissing complaint); *In re Nike, Inc. Sec. Litig.*, 181 F. Supp. 2d 1160, 1164 (D. Or. 2002) (same). *But cf. Gebhart v. SEC*, 595 F.3d 1034, 1041 n.9 (9th Cir. 2010) (because the SEC is not required to satisfy the Reform Act's heightened pleading requirements, it can establish scienter by either knowledge or recklessness); *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1064 (9th Cir. 2000) (limiting *Silicon Graphics*' holding to a heightened pleading standard and stating that "the [Reform Act] did not alter the substantive requirements for scienter under § 10(b)"). The First Circuit Court of Appeals also appears to have moved in the direction of the Ninth Circuit, writing that although it examines each case on its facts, "scienter . . . may extend to a form of extreme recklessness that is closer to a lesser form of intent." *Cabletron Sys.*, 311 F.3d at 38-39 (internal quotations omitted); *Rosen v. Textron, Inc.*, 321 F. Supp. 2d 308, 322 (D.R.I. 2004) (citing *Cabletron*, the court stated, "the First Circuit has specifically rejected the contention that facts showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter.") (internal quotation marks omitted); *Fitzer v. Sec. Dynamics Techs, Inc.*, 119 F. Supp. 2d 12, 19 n.4 (D. Mass. 2000) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)).

After *Tellabs*, the Ninth Circuit issued two decisions explaining how *Tellabs* impacted the Ninth Circuit's analysis of the scienter pleading requirement. *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156 (9th Cir. 2009); *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981 (9th Cir. 2009). In *Zucco*, the Ninth Circuit stated that the overall requirements for pleading scienter are similar to those established in previous decisions. *Zucco*, at 987 ("[W]e hold that the Court's decision in *Tellabs* does not materially alter the particularity requirements for scienter claims established in our previous decisions."). Additionally, the Ninth Circuit acknowledged in both cases that *Tellabs* requires a court to conduct an additional "holistic" analysis when reviewing scienter allegations on a motion to dismiss. *Rubke*, at 1165 ("[W]e must perform a second holistic analysis to determine whether the complaint contains an inference of scienter that is greater than the sum of its parts."); *Zucco*, at 987 ("*Tellabs* . . . adds an additional 'holistic' component to those requirements [for scienter claims].")

Courts considering actions under Rule 10b-5 for forward-looking statements have held that the heightened pleading requirements of the Reform Act apply to these statements. See *No. 84 Employer-Teamster Joint Council Pension Trust Fund*, 320 F.3d at 930-31; *Hockey v. Medhekar*, No. C-96-0815 MHP, 1997 U.S. Dist. LEXIS 8558, at *12-13 (N.D. Cal. Apr. 14, 1997); *In re Silicon Graphics*, No. C 96-0393 FMS, 1996 U.S. Dist. LEXIS 16989, at *21 (N.D. Cal. Sept. 25, 1996),

aff'd, 183 F.3d 970 (9th Cir. 1999). However, the plaintiff must allege particular facts that give rise to a strong inference that the allegedly false or misleading forward-looking statements were made with actual knowledge of their falsity. Allegations of mere recklessness will *not* suffice in this instance. *Hockey*, 1997 U.S. Dist. LEXIS 8558, at *30-33 (holding that neither insider trading nor allegations of unidentified negative internal reports were sufficient to raise a “strong inference” of actual knowledge of negative conditions); *see also Queen Uno Ltd. P’ship v. Coeur D’Alene Mines Corp.*, 2 F. Supp. 2d 1345, 1356 (D. Colo. 1998), *abrogated on other grounds by Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1097-98 (10th Cir. 2003). *But see Fugman v. Aprogenex, Inc.*, 961 F. Supp. 1190, 1197 (N.D. Ill. 1997) (conflating erroneously bespeaks caution doctrine and Reform Act safe harbor and holding, under the PSLRA safe harbor, that “when forward-looking statements are alleged to be fraudulent, the plaintiffs must allege specific facts which illustrate that [the defendant’s] predictions lacked a *reasonable basis*”) (alteration in original) (emphasis added) (internal quotation marks omitted).

The Second Circuit has addressed the pleading of corporate scienter — that is, scienter on the part of the corporation itself. “To prove liability against a corporation, . . . a plaintiff must prove that an agent of the corporation committed a culpable act with the requisite scienter, and that the act (and accompanying mental state) are attributable to the corporation.” *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008). Although the Second Circuit stated that “the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter,” *id.*, the court also observed that “it is possible to raise the required inference with regard to a corporate defendant without doing so with regard to a specific individual defendant” or “an expressly named officer.” *Id.* *Dynex* thus takes a middle ground on the question of corporate scienter. It spells an end in the Second Circuit to a doctrine, which had been accepted in some district court opinions, that imputed the knowledge of all employees to the corporation without regard to whether any particular employee intended to mislead, but does not necessarily require that the complaint expressly name a specific individual officer who acted with scienter. *See also Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008) (holding that a corporation cannot be held liable unless the plaintiff pleaded facts raising strong inference that officer who made the alleged misrepresentation knew that it was false); *Pugh v. Tribune Co.*, 521 F.3d 686, 697 (7th Cir. 2008) (“[T]he corporate scienter inquiry must focus on ‘the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective

knowledge of all the corporation's officers and employees acquired in the course of their employment.”).

A hint of this corporate scienter doctrine can also be found in *Tellabs* on remand to the Seventh Circuit: “Suppose the false communication by the low-level employee to his superiors had been deliberate. . . . Nevertheless, even if his superiors were careless in failing to detect the embezzlement, the corporation would not be guilty of fraud . . . ; deliberate wrongs by an employee are not imputed to his employer unless they are not only within the scope of his employment but in attempted furtherance of the employer's goals.” *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 708 (7th Cir. 2008).

c. The Group Pleading Doctrine

Prior to passage of the Reform Act, federal courts adopted the so-called “group pleading” doctrine as a partial exception to the particularity requirements of Fed. R. Civ. P. § 9(b). Under this doctrine, a plaintiff could satisfy Rule 9(b) through reliance on a presumption that allegedly false and misleading “group published information” is the collective action of officers and directors of a corporation. *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 593 (9th Cir. 1995). Under the doctrine, “group published information” includes prospectuses, registration statements, annual reports, press releases and other materials prepared by officers and directors collectively. *See id.*; *see also Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986) (“[N]o specific connection between fraudulent representations in [an] Offering Memorandum and particular defendants is necessary, where . . . defendants are insiders or affiliates participating in the offer of the securities in question.”). The doctrine generally applies only to corporate insiders, *see In re CellCyte Genetics Sec. Litig.*, No. C08-0047RSL, 2009 U.S. Dist. LEXIS 87828, at *13 (W.D. Wash. Sept. 24, 2009); *Irvine v. ImClone Sys.*, Nos. 02 Civ. 109, 02 Civ. 7499, 2003 U.S. Dist. LEXIS 9342, at *5 (S.D.N.Y. June 3, 2003); *In re Premiere Techs. Inc.*, No. 1:98-CV-1804-JOF, 2000 U.S. Dist. LEXIS 19207, at *30 (N.D. Ga. Dec. 8, 2000) (collecting cases), but may reach outside directors if those directors “participate[] in . . . day-to-day corporate activities, or ha[ve] a special relationship with the corporation, such as participation in preparing or communicating group information at particular times.” *In re GlenFed*, 60 F.3d at 593; *accord In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 527, 546 (S.D. Ohio 2000). The doctrine does not cover oral statements made by management. *See Elliott Assocs., L.P. v. Covance, Inc.*, No. 00 Civ. 4115 (SAS), 2000 U.S. Dist. LEXIS 17099, at *38 (S.D.N.Y. Nov. 28, 2000); *In re HI/FN, Inc. Sec. Litig.*, No. C 99-4531 SI, 2000 U.S. Dist. LEXIS 11631, at *36 (N.D. Cal. Aug. 9, 2000). When applicable, the doctrine enabled plaintiffs to satisfy the particularity requirements of Rule 9(b) “by pleading the misrepresentations with

particularity and where possible the roles of the individual defendants in the misrepresentations.” *In re GlenFed*, 60 F.3d at 593.

Because the Reform Act was intended in part to heighten pleading requirements, *see* H.R. Conf. Rep. No. 104-369, at 41 (1995), courts are divided over whether the group pleading doctrine survived its passage. Six circuit courts have addressed this issue since the passage of the Reform Act. Some of the remaining circuits appear to have reached consensus at the district court level; others are driven by intra-circuit splits.

The Tenth Circuit has held that the group pleading doctrine survived the Reform Act. *Schwartz v. Celestial Seasonings, Inc.*, 124 F.3d 1246, 1254 (10th Cir. 1997) (identifying “the individual sources of statements is unnecessary when the fraud allegations arise from misstatements or omissions in group-published documents such as annual reports, which presumably involve collective actions of corporate directors or officers”).

The Third and Fifth Circuits, on the other hand, have found the group pleading doctrine inconsistent with the Reform Act. In *Winer Trust Family v. Queen*, the Third Circuit held that “the group pleading doctrine is no longer viable in private securities actions after the enactment of the PSLRA.” 503 F.3d 319, 337 (3d Cir. 2007) (footnote omitted). In *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, the Fifth Circuit court held that the group pleading doctrine was flatly inconsistent with its particularity and scienter requirements. 365 F.3d 353, 364 (5th Cir. 2004). Under the PSLRA, “the plaintiffs [must] distinguish among those they sue and enlighten *each defendant* as to his or her particular part in the alleged fraud.” *Id.* at 365 (emphasis in original). To comport with the PSLRA, the court held that unattributed corporate documents needed to be tied to individual defendants through signatures or detailed factual allegations. *Id.* The court found inadequate the plaintiffs’ attribution of INSpire’s SEC filings and reports to its senior leadership, and it affirmed the district court’s dismissal of the complaint against all executive defendants except for the CEO. *Id.* at 380 (finding that CEO’s stock sales, leadership position, and personal role in touting the spin-off, “suffice, albeit barely so, to create a strong inference of the requisite scienter . . .”). Four years later, the circuit reaffirmed this position in *Fin. Acquisition Partners L.P. v. Blackwell*, 440 F.3d 278, 287 (5th Cir. 2006) (“For the claimed fraud, Plaintiffs must distinguish among defendants and allege the role of each. Corporate officers are not liable for acts solely because they are officers, even where their day-to-day involvement in the corporation is pleaded.”) (internal citations and emphasis omitted).

The First, Fourth and Eleventh Circuits have declined to settle the matter, resolving cases that have raised the issue without relying on the group pleading theory. *See Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1018-19 (11th Cir. 2004) (finding that complaint alleged scienter for each defendant and each statutory violation but nevertheless remarking in dicta that “a plaintiff, to proceed beyond the pleading stage, must allege facts sufficiently demonstrating each defendant’s state of mind regarding his or her alleged violations”); *Dunn v. Borta*, 369 F.3d 421, 434 (4th Cir. 2004) (“We have never addressed the issue of whether the group pleading presumption should be recognized in this Circuit . . . we need not decide that issue today.”); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 40 (1st Cir. 2002) (“For purposes of this opinion, we will set the issue aside without deciding it, because we determine without reference to the group pleading presumption whether the complaint states a claim against each defendant.”).

Notwithstanding the Fourth Circuit’s equivocation, district courts in the circuit have consistently held that the group pleading doctrine did not survive the enactment of the Reform Act. *See, e.g., Glaser*, 303 F. Supp. 2d 724, 734, *aff’d in part and rev’d in part on other grounds*, 126 F. App’x 593 (4th Cir. 2005) (finding group pleading fails Fed. R. Civ. P. 9(b)’s particularity requirement); *First Union Corp.*, 128 F. Supp. 2d at 888 (finding group pleading fails Rule 9(b) particularity requirement as well as the Reform Act’s scienter requirements). Many district courts in other circuits have also found the doctrine barred by the Reform Act, at times conflicting with other district court decisions in the same circuit. *See, e.g., In re Syncor Int’l Corp. Sec. Litig.*, 327 F. Supp. 2d 1149, 1171 (C.D. Cal. 2004) (expressly adopting the Fifth Circuit holding in *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.* and finding that group pleading did not survive the PSLRA), *aff’d in part, rev’d in part*, 239 F. App’x 318 (9th Cir. 2007); *D.E. & J. Ltd. P’ship v. Conaway*, 284 F. Supp. 2d 719, 730 (E.D. Mich. 2003), *aff’d*, 133 F. App’x 994 (6th Cir. 2005); *In re Digital Island Sec. Litig.*, 223 F. Supp. 2d 546, 553 (D. Del. 2002) (finding group pleading doctrine invalid under PSLRA and citing Third Circuit cases), *aff’d*, 357 F.3d 322 (3d Cir. 2004); *In re Premiere Techs. Inc. Sec. Litig.*, No. 1:98-CV-1804-JOF, 2000 WL 33231639 at *11 (N.D. Ga. 2000) (“[T]he group pleading doctrine did not survive the enactment of the PSLRA.”); *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 827, 835-37 (N.D. Ill. 2000). These courts contend that the group pleading presumption is inconsistent with the Reform Act’s requirement that sufficient facts be alleged to raise a strong inference of scienter with respect to *each* defendant. *See, e.g., Conaway*, 284 F. Supp. 2d at 731 (“[I]t would be nonsensical to require that a plaintiff specifically allege facts regarding scienter as to each defendant, but to allow him to rely on group pleading in asserting that the defendant made the statement or omission.”) (internal quotations omitted).

District courts in the First Circuit have held that the group pleading doctrine survived the enactment of the Reform Act. *See, e.g., In re Allaire Corp. Sec. Litig.*, 224 F. Supp. 2d 319, 340 (D. Mass. 2002) (citing *Raytheon* and recognizing group pleading doctrine after PSLRA); *In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 152-53 (D. Mass. 2001) (surveying conflicting cases and deciding that “the rationale behind the group pleading doctrine remains sound in the wake of the passage of [the Reform Act]”).

District courts in the remaining circuits disagree over whether the group pleading doctrine survived the Reform Act. Some continued support for the doctrine can be found in district courts in all but the Third, Fourth and Fifth Circuits. *See, e.g., In re FirstEnergy Corp. Sec. Litig.*, 316 F. Supp. 2d 581, 599 (N.D. Ohio 2004) (“The Court finds that the group-pleading doctrine has continued viability post-PSLRA.”); *In re Vivendi Universal, S.A.*, 381 F. Supp. 2d 158, 190 (S.D.N.Y. 2003) (citing Second Circuit cases upholding group pleading doctrine after Reform Act) (unpublished opinion); *In re Metawave Commc’ns. Corp. Sec. Litig.*, 298 F. Supp. 2d 1056, 1087-89 (W.D. Wash. 2003); *In re Sprint Corp. Sec. Litig.*, 232 F. Supp. 2d 1193, 1225 (D. Kan. 2002); *Allaire Corp.*, 224 F. Supp. 2d at 340; *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308, 1327-28 (M.D. Fla. 2002); *In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 17 (D.D.C. 2000); *Danis v. USN Commc’ns, Inc.*, 73 F. Supp. 2d 923, 939 n.9 (N.D. Ill. 1999); *In re Digi Intern., Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1101 (D. Minn. 1998), *aff’d*, 14 F. App’x 714 (8th Cir. 2001); *cf. Berry v. Valence Tech., Inc.*, 175 F.3d 699, 706 (9th Cir. 1999) (holding that the group pleading doctrine applies to outside directors if plaintiffs make specific allegations indicating that the outside directors “either participated in the day-to-day corporate activities, or had a special relationship with the corporation, such as participation in preparing or communicating group information at particular times”). *But see In re Huffy Corp. Sec. Litig.*, 577 F. Supp. 2d 968, 986 (S.D. Ohio 2008) (“The group pleading doctrine is antithetical to the pleading requirement for scienter set forth in § 21D(b) of the PSLRA. Accordingly, this Court concludes that . . . the group pleading doctrine has not survived [the adoption of the PSLRA].”). A number of courts have interpreted the group pleading doctrine narrowly in light of the PSLRA without abolishing it. *See, e.g., In re Cross Media Mktg. Corp. Sec. Litig.*, 314 F. Supp. 2d 256 (S.D.N.Y. 2004); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 437 F.3d 588, 603 (7th Cir. 2006), *rev’d on other grounds*, 551 U.S. 308 (2007); *Friedman v. Rayovac Corp.*, 291 F. Supp. 2d 845, 852 (W.D. Wis. 2003). Other courts allow plaintiffs to use group pleading to satisfy Rule 9(b)’s particularity requirement, but not to satisfy the Reform Act’s scienter requirement. *See, e.g., Druskin v. Answerthink, Inc.*, 299 F. Supp. 2d 1307, 1322 (S.D. Fla. 2004).

8. Remedies and Measure of Damages

Remedies available in private actions under Rule 10b-5 include injunctive relief as well as damages. *See, e.g., Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187, 194 (3d Cir. 1976). Where damages are sought, the measure of damages is governed by § 28(a) of the Exchange Act, which limits recovery in cases under the Exchange Act to “actual damages.” The Supreme Court has stated that the correct measure of damages under Rule 10b-5 for a defrauded seller or purchaser is the “out-of-pocket” measure, that is, the difference between the price paid or received and the true value at the time of purchase (*i.e.*, the fair value in the absence of fraudulent conduct). *Affiliated Ute Citizens of Utah*, 406 U.S. at 155. Although this measure of damages is generally seen as precluding an expectancy measure of damages, some courts have allowed a benefit-of-the-bargain measure in special circumstances. *See McMahan & Co. v. Warehouse Entm’t, Inc.*, 65 F.3d 1044, 1049-50 (2d Cir. 1995) (allowing benefit-of-the-bargain damages where premium redemption provision in a debenture conditioned on change in control without independent director approval was breached); *Pelletier v. Stuart-James Co.*, 863 F.2d 1550, 1558 (11th Cir. 1989); *Osofsky v. Zipf*, 645 F.2d 107, 111-14 (2d Cir. 1981) (applying benefit-of-the-bargain measure in special situation where plaintiffs were fraudulently promised securities of a specific value in the tender offer and proxy solicitation materials regarding an upcoming merger; noting that benefit-of-the-bargain damages may be awarded “only when they can be established with reasonable certainty”). The Supreme Court has held that a § 10(b) damage claim need not be reduced by the amount of tax benefits received from a tax shelter investment. *Randall v. Loftsgaarden*, 478 U.S. 647, 656-57 (1986); *see also DCD Programs, Ltd. v. Leighton*, 90 F.3d 1442, 1447-48 (9th Cir. 1996) (holding that federal taxes paid because of disallowance of a deduction do not constitute out-of-pocket damages). Lower courts, however, have added several glosses to the “out-of-pocket” rule.

Thus, it is well accepted that when a defendant has defrauded a plaintiff into selling his shares to the defendant, and the defendant has resold the shares for a profit, the defrauded seller can recover the profit. *See, e.g., Robertson v. White*, 81 F.3d 752, 758 (8th Cir. 1996) (“In instances where the application of rescissory damages result[s] in an undeserved windfall remaining with the defendant, it is proper to use the defendant’s profits as the measure of damages[, even if it] may cause the plaintiff to receive more than necessary to make him whole for the economic loss”); *Ansin v. River Oaks Furniture, Inc.*, 105 F.3d 745, 758 (1st Cir. 1997); *Pidcock v. Sunnyland Am., Inc.*, 854 F.2d 443, 446 (11th Cir. 1988); *Pittsburgh Terminal Corp. v. Balt. & Ohio R.R. Co.*, 824 F.2d 249, 255 (3d Cir. 1987) (“Where there is a possibility that one or the other party in a securities action will receive a windfall, the victim is favored over the violator.”); *Siebel v.*

Scott, 725 F.2d 995, 1001 (5th Cir. 1984) (holding that valuation of a security *may* include later developments in its price); *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965). While “there are limits to this disgorgement principle,” *Pidcock*, 854 F.2d at 447 (“Certain actions taken by defrauding purchasers after the fraudulent transaction will limit the plaintiff’s recovery of subsequent profits”); *see also SEC v. MacDonald*, 699 F.2d 47, 55 (1st Cir. 1983) (limiting profits required to be disgorged to “reasonable time after public dissemination”); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 412 (3d Cir. 1973) (same); *Janigan*, 344 F.2d at 786 (same), mere “price rises, increased efficiency, and an improvement in the business cycle are not the kinds of events that will allow a defrauding purchaser to keep resulting profits.” *Pidcock*, 854 F.2d at 448.

The “disgorgement” remedy is often applicable to insider trading cases. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474-75 (2d Cir. 1996). One court has held a defendant in an insider trading case liable for prejudgment interest on profits made by his tippees, even though he did not receive a share of these profits. *SEC v. Tome*, 638 F. Supp. 638, 639 (S.D.N.Y. 1986), *aff’d*, 833 F.2d 1086 (2d Cir. 1987). The Ninth Circuit held that the SEC may seek disgorgement from a nominal defendant, upon a showing that the nominal defendant has received ill-gotten funds to which he does not have a legitimate claim. *See SEC v. Colello*, 139 F.3d 674, 676-77 (9th Cir. 1998); *see also SEC v. Chem. Trust*, No. 00-8015-CIV-(Ryskamp/Vitunac), 2000 U.S. Dist. LEXIS 19786, at *31 (S.D. Fla. Dec. 19, 2000) (finding disgorgement appropriate in Ponzi scheme case without any charge of wrongdoing when defendant “‘posses[ed] illegally obtained profits but ha[d] no legitimate claim to them’”) (quoting *SEC v. Cherif*, 933 F.2d 403, 414 n.11 (7th Cir. 1991)). *Cf. SEC v. Calvo*, 378 F.3d 1211, 1217 (11th Cir. 2004) (in the context of a § 5(a) suit, “[t]he SEC is entitled to disgorgement upon producing a reasonable approximation of a defendant’s ill-gotten gains.”).

Courts will use discretion in awarding prejudgment interest on the defendant’s ill-gotten gains according to considerations of fairness, in addition to the need to fully compensate the wronged party for the actual damages suffered. *First Jersey Sec.*, 101 F.3d at 1476-77; *Commercial Union Assurance Co. v. Milken*, 17 F.3d 608, 613 (2d Cir. 1994); *Rolf v. Blyth, Eastman Dillon & Co.*, 637 F.2d 77, 86-87 (2d Cir. 1980); *SEC v. Pierce*, 95 Civ. 8215 (SHS), 1998 U.S. Dist. LEXIS 7463, at *1-3 (S.D.N.Y. May 20, 1998); *In re Crazy Eddie Sec. Litig.*, 948 F. Supp. 1154, 1166 (E.D.N.Y. 1996). Proof of scienter is sufficient to justify an award of prejudgment interest in the § 10(b) and Rule 10b-5 context. *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 612-13 (S.D.N.Y. 1993), *aff’d sub nom. SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994).

It is accepted that, at least where the plaintiff dealt face-to-face with the defendant and the securities purchased or sold have not been re-transferred, the plaintiff may at his option sue for rescission rather than damages. *In re Letterman Bros. Energy Sec. Litig.*, 799 F.2d 967, 972 (5th Cir. 1986); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 554 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983). However, a plaintiff suing under § 10(b) for rescission (or its monetary equivalent if true rescission is not possible) must prove both economic loss and loss causation. *See Strategic Diversity, Inc. v. Alchemix Corp.*, 666 F.3d 1197, 1207-08 (9th Cir. 2012).

It is universally accepted, however, that § 28(a)'s reference to "actual damages" precludes an award of punitive damages under Rule 10b-5. *See, e.g., Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1139 (5th Cir. 1988), *vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989); *Straub v. Vaisman & Co.*, 540 F.2d 591, 599 (3d Cir. 1976); *Green v. Wolf Corp.*, 406 F.2d 291, 302-03 (2d Cir. 1968). Several circuits have held that punitive damages may be imposed for state law and/or common law claims pendent on a federal securities law claim. *See, e.g., Cyrak v. Lemon*, 919 F.2d 320, 326 (5th Cir. 1990); *MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Exp., Inc.*, 962 F.2d 1470, 1474 (10th Cir. 1992); *Grogan v. Garner*, 806 F.2d 829, 838 (8th Cir. 1986); *Aldrich v. Thomson McKinnon Sec., Inc.*, 756 F.2d 243, 246 n.3 (2d Cir. 1985); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 329-30 (5th Cir. 1981), *abrogated by Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985); *Young v. Taylor*, 466 F.2d 1329, 1337 (10th Cir. 1972) (allowing plaintiff to recover 10b-5 damages plus attorneys' fees and punitive damages where pendent state securities fraud claim provided for former and state common law claim provided for latter); *Pelletier*, 863 F.2d at 1557 n.12 (dictum).

In creating new Section 21D(e) of the Exchange Act, the Reform Act adopted a cap on damages in an attempt to account for a "bounce-back" in a security's price after full or corrective disclosure is made. Under the provision, if following the corrective disclosure of unfavorable information the security recovers all or a portion of the initial price decrease, damages will be capped by the difference between the plaintiff's purchase or sale price and the mean trading price of the security over the 90-day period beginning on the date of the corrective disclosure. *See* 15 U.S.C.A. § 78u-4(e)(1). When the plaintiff sells or repurchases the security before expiration of the 90-day period, the plaintiff may recover no more than the difference between the purchase or sale price and the appropriate mean trading price. *See id.* § 78u-4(e)(2); *see also In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 235, 262 n.10, 273 (D.N.J. 2000), *aff'd*, 264 F.3d 201 (3d Cir. 2001).

9. Statute of Limitations

For years there was controversy about the correct period of limitation on actions under Rule 10b-5. Some courts, following the general policy expressed in the Rules of Decision Act, 28 U.S.C.A. § 1652, applied the state statute of limitations applicable to the most closely similar action of the state in which the court sat. *See, e.g., Corwin v. Marney, Orton Invs.*, 788 F.2d 1063, 1067 (5th Cir. 1986); *Diamond v. Lamotte*, 709 F.2d 1419, 1424 (11th Cir. 1983); *In re Prof'l Fin. Mgmt., Ltd.*, 703 F. Supp. 1388, 1392-93 (D. Minn. 1989); *Geeting v. Prizant*, 664 F. Supp. 343, 347-48 (N.D. Ill. 1987); *cf. Dingler v. T.J. Raney & Sons, Inc.*, 708 F. Supp. 1044, 1053-55 (W.D. Ark. 1989) (criticizing that approach, but following it as required by precedent). Of these courts, some applied the limitation period specified for private actions under the state's blue sky laws. *See, e.g., Diamond*, 709 F.2d at 1424; *Breen v. Centex Corp.*, 695 F.2d 907, 910-11 (5th Cir. 1983); *O'Hara v. Kovens*, 625 F.2d 15, 18 (4th Cir. 1980). Others, however, used the statute of limitations for general fraud actions. *See, e.g., Nesbit v. McNeil*, 896 F.2d 380, 384 (9th Cir. 1990); *Corwin*, 788 F.2d at 1067; *Hackbart v. Holmes*, 675 F.2d 1114, 1120 (10th Cir. 1982). Rejecting this approach entirely, other courts, most notably the Third Circuit, refused to apply a state statute of limitations; instead they looked to other provisions of the federal securities laws, namely, the one-year/three-year limitations period applicable to actions under §§ 11 and 12 of the Securities Act and § 18 of the Exchange Act. *See In re Data Access Sys. Sec. Litig.*, 843 F.2d 1537, 1545 (3d Cir. 1988); *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385, 1389 (7th Cir. 1990); *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 981 (E.D.N.Y. 1988) ("This court finds the Third Circuit's reasoning sound and believes it highly likely that the Second Circuit will follow suit.") (*obiter dicta*), *vacated on other grounds sub nom. In re Crazy Eddie Sec. Litig.*, 714 F. Supp. 1285 (E.D.N.Y. 1989).

The Supreme Court resolved this divergence of opinion in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). The Court there held that the appropriate statute of limitations for the implied private right of action under § 10(b) is the limitation period provided for the express causes of action under the federal securities laws. "[T]here can be no doubt that the contemporaneously enacted express remedial provisions represent 'a federal statute of limitations actually designed to accommodate a balance of interests very similar to that at stake here. . ..'" *Id.* at 359 (quoting *DelCostello v. Int'l Bhd. of Teamsters*, 462 U.S. 151, 169 (1983)). Thus, the Court adopted the one-year/three-year limitation period codified for provisions that expressly allow private rights of action, such as §§ 11 and 12 of the Securities Act and § 18 of the Exchange Act. *See id.* at 360 n.7. Moreover, the Court held that the limitation period was not subject to equitable tolling. *Id.* at 363. This latter holding overrules a long line of lower-

court precedent. See, e.g., *Hill v. Equitable Trust Co.*, 851 F.2d 691, 694, 698-99 (3d Cir. 1988); *Hemmings v. Barian*, 822 F.2d 688, 690 (7th Cir. 1987); *Suslick v. Rothschild Sec. Corp.*, 741 F.2d 1000, 1001 (7th Cir. 1984); *Hackbart*, 675 F.2d at 1120.

Congress reacted to the decision in *Lampf* rather swiftly. It enacted Section 27A of the Exchange Act, which protects against retroactive application of the *Lampf* decision, only six months after the Supreme Court's ruling. Thus, for actions filed before *Lampf* was decided, the applicable limitations period depends on the pre-*Lampf* case law of the Circuit in which the action is pending. See 15 U.S.C.A. § 78aa-1. This provision has been upheld by every circuit court in which it has been challenged. See *Axel Johnson, Inc. v. Arthur Andersen & Co.*, 6 F.3d 78, 82 (2d Cir. 1993); *Cooperativa de Ahorro y Credito Aguada v. Kidder, Peabody & Co.*, 993 F.2d 269, 273 (1st Cir. 1993), *aff'd following remand*, 129 F.3d 222 (1st Cir. 1997); *Cooke v. Manufactured Homes, Inc.*, 998 F.2d 1256, 1264 (4th Cir. 1993); *Pac. Mut. Life Ins. Co. v. First RepublicBank Corp.*, 997 F.2d 39, 46 n.10, 51 (5th Cir. 1993), *aff'd by an equally divided court sub nom. Morgan Stanley & Co. v. Pac. Mut. Life Ins. Co.*, 511 U.S. 658 (1994); *Berning v. A.G. Edwards & Sons, Inc.*, 990 F.2d 272, 277 (7th Cir. 1993); *Gray v. First Winthrop Corp.*, 989 F.2d 1564, 1573 (9th Cir. 1993); *Anixter v. Home-Stake Prod. Co.*, 977 F.2d 1533, 1547 (10th Cir. 1992); *Henderson v. Scientific-Atlanta, Inc.*, 971 F.2d 1567, 1575 (11th Cir. 1992).

Section 27A(b) permitted plaintiffs to reinstate § 10(b) claims that were filed before *Lampf* but which were dismissed as time-barred after *Lampf* if the pre-*Lampf* law in the Circuit would have permitted the action to continue. The Supreme Court declared this provision unconstitutional in *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211 (1995), holding that it violated the separation of powers doctrine. The Court, in its 7-2 decision, stated that “[b]y retroactively commanding the federal courts to reopen final judgments,” Congress had unconstitutionally encroached on the Judiciary’s power “not merely to rule on cases, but to decide them, subject to review only by superior courts in the Article III hierarchy.” *Id.* at 218-19. The Court cited the *Federalist Papers* for the proposition that a “legislature without exceeding its province cannot reverse a determination once made, in a particular case; though it may prescribe a new rule for future cases,” *id.* at 222 (quoting *The Federalist No. 81*, at 545 (Alexander Hamilton) (J. Cooke ed., 1961)), and concluded that “Section 27A(b) is unconstitutional to the extent that it requires federal courts to reopen final judgments entered before its enactment.” *Id.* at 240. The decision is unlikely to have any impact on the constitutionality of § 27A(a), whose validity was not before the Court, and the premise of which appears to have been accepted by the Court, at least implicitly. See *id.* at 226 (“Congress can always revise the

judgments of Article III courts in one sense: When a new law makes clear that it is retroactive, an appellate court must apply that law in reviewing judgments still on appeal that were rendered before the law was enacted”); *see also id.* at 265 n.19 (Ginsburg, J., dissenting) (“By striking down § 27A(b) on a ground that would leave § 27A(a) intact, the Court indulges litigants who protracted proceedings but shuts the courthouse door to litigants who proceeded with diligence and respect for the *Lampf* judgment.”).

Section 27A(a) cases that have been transferred between jurisdictions with different pre-*Lampf* limitations periods present difficult choice of law issues. The Circuits are currently split as to whether the limitations period of the transferor or transferee jurisdiction should apply. Currently, the Second Circuit applies the transferee court’s (*i.e.*, its own) pre-*Lampf* statute of limitations. *See Menowitz v. Brown*, 991 F.2d 36, 41 (2d Cir. 1993). The Seventh and Tenth Circuits instead apply the transferor jurisdiction’s limitations period. *See Olcott v. Del. Flood Co.*, 76 F.3d 1538, 1546-47 (10th Cir. 1996); *Eckstein v. Balcov Film Investors*, 8 F.3d 1121, 1126-27 (7th Cir. 1993), *aff’d following remand*, 58 F.3d 1162 (7th Cir. 1995); *see also In re United Mine Workers of Am. Employee Benefit Plans Litig.*, 854 F. Supp. 914, 919 (D.D.C. 1994) (adopting the *Eckstein* court’s analysis and holding that the transferor jurisdiction’s statute of limitations should apply).

The Sarbanes-Oxley Act of 2002 amended 28 U.S.C. § 1658 to extend the statute of limitations to two years after “the discovery of the facts constituting the violation,” and not later than five years after the violation, for a “private right of action [commenced on or after July 30, 2002] that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in Section 3(a)(47) of the Securities Exchange Act of 1934.” Pub. L. 107-204, § 804; 116 Stat. 745 (2002). Accordingly, private § 10(b) actions are henceforth subject to a two-year/five-year statute of limitations. *See, e.g., In re Initial Pub. Offering Sec. Litig.*, 341 F. Supp. 2d 328, 344 (S.D.N.Y. 2004). However, most courts have held that § 804 does not apply retroactively to securities fraud claims that were stale at the time the provision went into effect. *See In re ADC Telecoms, Inc. Sec. Litig.*, 409 F.3d 974 (8th Cir. 2005); *Enterprise Mortg. Acceptance Co., LLC, Sec. Litig. v. Enterprise Mortg. Acceptance Co.*, 391 F.3d 401 (2d Cir. 2004). The Supreme Court has not settled what, if any, statute of limitations applies to SEC enforcement actions under § 10(b). This issue obviously does not present a problem with respect to SEC actions based on existing or prospective violations, but it has generated some controversy with regard to SEC civil enforcement actions seeking injunctive relief based on past violations or disgorgement of profits generated from past wrongs. The Ninth Circuit has held that since SEC

enforcement actions are brought to “vindicate a public right or interest,” it would presume that there is no statute of limitations governing such actions absent a clear showing of congressional intent to the contrary. *SEC v. Rind*, 991 F.2d 1486, 1490-91 (9th Cir. 1993). The court did note, however, that a court of equity ought to consider the elapsed period in fashioning remedies. *Id.* at 1492. In so holding, the Ninth Circuit agreed with all district courts that had previously addressed the issue. *See, e.g., SEC v. Toomey*, 866 F. Supp. 719, 724-25 (S.D.N.Y. 1992); *SEC v. O’Hagan*, 793 F. Supp. 218, 220 (D. Minn. 1992), *rev’d on other grounds*, 92 F.3d 612 (8th Cir. 1996), *rev’d on other grounds*, 521 U.S. 642 (1997); *SEC v. Keating*, No. CV 91-6785 (SVW), 1992 U.S. Dist. LEXIS 14630, at *6-7 (C.D. Cal. July 23, 1992); *SEC v. Glick*, No. Civ. LV-78-11, 1980 U.S. Dist. LEXIS 12141, at *3 (D. Nev. June 12, 1980); *SEC v. Penn Cent. Co.*, 425 F. Supp. 593, 599 (E.D. Pa. 1976). *Rind* has been subsequently criticized, most notably by commentators arguing that the federal “catch-all” statute of limitations, 28 U.S.C.A. § 2462 (placing a five-year statute of limitations, in the face of congressional silence, on all actions that seek to “enforce[] . . . any civil fine, penalty, or forfeiture”), should apply to SEC disgorgement actions. *See, e.g.,* Jonathan Eisenberg & Benjamin Haskin, *Securities Enforcement: A Statute of Limitations Made Applicable to SEC Actions*, 8 No. 7 Insights 4 (July 1994); Edward Brodsky, *Statute of Limitations and Civil Enforcement*, N.Y.L.J., Sept. 21, 1993 at 3, n.6. *See generally SEC v. Lorin*, 869 F. Supp. 1117, 1121 (S.D.N.Y. 1994) (discussing the controversy). Resolution of this issue will turn on whether disgorgement constitutes a “fine, penalty, or forfeiture.” *Id.* The only two courts to address this issue have answered in the negative, holding that since disgorgement only returns the wrongdoer to the status quo before any wrongdoing had occurred, it is purely “remedial,” rather than “punitive,” and thus does not meet any of the § 2462 criteria. *SEC v. McCaskey*, 56 F. Supp. 2d 323, 326 (S.D.N.Y. 1999) (citing prior decisions of Southern District Court of New York); *SEC v. Williams*, 884 F. Supp. 28, 30 (D. Mass. 1995). *But cf. Johnson v. SEC*, 87 F.3d 484, 486-92 (D.C. Cir. 1996) (applying § 2462 limitation period to SEC administrative proceeding that resulted in a censure and six-month disciplinary suspension of a securities industry supervisor). The *Williams* court also found § 2462 inapplicable to SEC injunctive actions in general. *Id.* at 31; *see also Glick*, 1980 U.S. Dist. LEXIS 12141, at *3 (same). Moreover, post-*Rind* courts have found that SEC disgorgement actions are brought pursuant to a public right or interest, thereby making it inappropriate to borrow a statute of limitations from any similar state cause of action. *Lorin*, 869 F. Supp. at 1127; *SEC v. Antar*, 831 F. Supp. 380, 403 (D.N.J. 1993); *see also SEC v. Downe*, No. 92 Civ. 4092 (PKL), 1994 U.S. Dist. LEXIS 2292, at *3-4 (S.D.N.Y. Mar. 3, 1994) (no statute of limitations in SEC civil enforcement actions), *aff’d sub nom. SEC v. Warde*,

151 F.3d 42 (2d Cir. 1998); *SEC v. Sprecher*, No. 92-2860 LFO, 1993 U.S. Dist. LEXIS 18116, at *4-5 (D.D.C. Dec. 15, 1993) (same).

As to when the statute of limitations period should begin to run, a majority of circuits have used an “inquiry notice” standard, with disagreement as to the precise definition of the term. *See, e.g., LC Capital Partners v. Frontier Ins. Group*, 318 F.3d 148, 154 (2d Cir. 2003) (“The one-year limitations period applicable to discovery of the violation begins to run after the plaintiff ‘obtains actual knowledge of the facts giving rise to the action or notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge.’”) (quoting *Kahn v. Kohlberg, Kravis, Roberts & Co.*, 970 F.2d 1030, 1042 (2d Cir. 1992)) (internal emphasis omitted); *In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1325 (3d Cir. 2002) (“To the extent a securities fraud plaintiff was on inquiry notice of the basis for claims more than one year prior to bringing the action, his or her claim is subsequently time-barred by the requisite statute of limitations.”); *Ritchey v. Horner*, 244 F.3d 635, 638-39 (8th Cir. 2001); *Rothman*, 220 F.3d at 97; *Berry v. Valence Tech., Inc.*, 175 F.3d 699, 704 (9th Cir. 1999); *Sterlin v. Biomune Sys., Inc.*, 154 F.3d 1191, 1204-05 (10th Cir. 1998); *see also Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 951 (9th Cir. 2005) (stating that the Ninth Circuit has not yet determined whether actual notice or “inquiry-plus-due diligence” is the proper standard to trigger the statute of limitations and the Circuit may apply either standard depending on the case); *La Grasta v. First Union Sec., Inc.*, 358 F.3d 840, 849 (11th Cir. 2004) (refusing to hold that a substantial or sudden drop in the price of the securities “constitutes inquiry notice as a matter of law”); *Tello v. Dean Witter Reynolds, Inc.*, 410 F.3d 1275 (11th Cir. 2005) (discussing inquiry notice and the enlarged Sarbanes-Oxley statute of limitations described *infra*), *further considered after remand*, 494 F.3d 956 (11th Cir. 2007) (finding action barred by statute of limitations under both one-year/three-year limitations period and Sarbanes-Oxley’s limitations period).

In *Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (2010), a unanimous Supreme Court weighed in on the issue and held that the two-year statute of limitations for a securities fraud claim, set forth in 28 U.S.C. § 1658, begins running “(1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, the ‘facts constituting the violation’ — whichever comes first.” *Id.* at 1785 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 1984 n.12 (1976)). To prevent fraudulent actors from maneuvering to avoid liability by running out the statute of limitations, the Court defined “facts constituting the violation” to include facts demonstrating the existence of scienter. *Id.* (“It would . . . frustrate the very purpose of the discovery rule in this provision . . . if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter. So long as a defendant concealed for two years that

he made a misstatement with an intent to deceive, the limitations period would expire before the plaintiff had actually discover[ed] the fraud.”). *See City of Pontiac Gen. Emps. Ret. Sys. v. MBIA, Inc.*, 637 F.3d 169 (2d Cir. 2011) (limitations period does not begin to run until reasonably diligent plaintiff can plead facts constituting a securities fraud violation with sufficient detail and particularity to survive a motion to dismiss). The Seventh Circuit has since held that the date of the violation for purposes of the statute of limitations set forth in 28 U.S.C. § 1658(b)(2) (providing that actions must be brought within (1) two years after the discovery of the violation or (2) five years after the violation) is determined by the date of the fraud or misrepresentation constituting the violation, not the date of the *injury* from such a violation. *McCann v. Hy-Vee, Inc.*, 663 F.3d 926, 931-32 (7th Cir. 2011).

10. Defenses

Defendants in a Rule 10b-5 action may be able to raise one or more of several defenses that turn on the conduct of the plaintiffs, such as *in pari delicto*, due diligence, estoppel, or unclean hands. In the cases of *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310-11 (1985), and *Pinter v. Dahl*, 486 U.S. 622, 633-35 (1988), the Supreme Court held that the defense of *in pari delicto* was available generally to defendants in actions under Rule 10b-5 of the Exchange Act and § 12(1) of the Securities Act, respectively. *See also Rothberg v. Rosenbloom*, 808 F.2d 252, 257-58 (3d Cir. 1987) (rejecting *in pari delicto* defense by tipper against tippee after applying the *Bateman Eichler* test described *infra*); *Ansin v. River Oaks Furniture, Inc.*, 105 F.3d 745, 757 (1st Cir. 1997) (holding that equitable defenses of waiver, estoppel and laches are themselves barred by doctrine of unclean hands); *Regional Props., Inc. v. Fin. & Real Estate Consulting Co.*, 752 F.2d 178, 182-83 nn. 8-9 (5th Cir. 1985) (same); *Wolf v. S. D. Cohn & Co.*, 515 F.2d 591, 605 (5th Cir. 1975) (rejecting *in pari delicto* defense), *vacated on other grounds*, 426 U.S. 944 (1976); *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 703-05 (5th Cir. 1969) (deciding that defenses of unclean hands and *in pari delicto* are available in 10b-5 action).

In *Bateman Eichler*, the Court formulated standards for determining when the *in pari delicto* defense should be available in securities litigation generally. In order to establish the defense, a defendant must show that (1) “as a direct result of [the plaintiff’s] own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress”; and (2) barring the plaintiff’s recovery would not offend the underlying statutory policies by interfering “with the effective enforcement of the securities laws and protection of the investing public.” 472 U.S. at 310-11.

The first element of the test requires that the plaintiff be an “active, voluntary participant of the unlawful activity that is the subject of the suit.” *Pinter*, 486 U.S. at 636. Thus, under § 12(1), the mere fact that a plaintiff-buyer knew the purchased securities were unregistered is not enough to satisfy the test. *Id.*; see also *Rothberg*, 808 F.2d at 257-58 (refusing to allow defense to claim by tippee against tipper). But where the plaintiff actually “induced [a defendant-issuer] not to register, he well might be precluded from obtaining § 12(1) rescission.” *Pinter*, 486 U.S. at 637; see also *UCAR Intern., Inc. v. Union Carbide Corp.*, 2004 WL 137073, *10 (S.D.N.Y. Jan. 26, 2004) (applying *Bateman* and holding corporation’s claims barred by *in pari delicto* defense, where payments sought to be recovered were illegal because of a price-fixing conspiracy in which plaintiff had pled guilty), *aff’d*, 119 F. App’x 300 (2d Cir. 2004).

Under the second prong of the *Bateman Eichler* test, the court should weigh the deterrent effect of allowing the defense on the improper conduct of the plaintiff against the deterrent effect of denying the defense and allowing the private suit to go forward. Thus, in *Bateman Eichler* itself, the Supreme Court rejected the *in pari delicto* defense to a Rule 10b-5 action brought by a tippee against a tipper. 472 U.S. at 319. The Court noted that while tippees are deterred by means other than the *in pari delicto* defense, the threat of private, civil actions frequently serves as the greatest deterrent to illegal conduct by insiders. *Id.* at 316. The Court concluded that “the public interest will most frequently be advanced if defrauded tippees are permitted to . . . expose illegal practices by corporate insiders.” *Id.* at 319; *Rothberg*, 808 F.2d at 255, 258; *Peltz v. SHB Commodities*, 115 F.3d 1082, 1091 (2d Cir. 1997) (finding second prong of *Bateman* test satisfied, and holding *in pari delicto* defense applicable).

The defense of due diligence, going to the reasonableness of the plaintiff’s reliance, has been held to be available in Rule 10b-5 actions by several circuits. See *Ashland Inc. v. Morgan Stanley & Co., Inc.*, 652 F.3d 333, 338 (2d Cir. 2011) (holding that self-described sophisticated investor was not justified in relying on financial advisor’s alleged misrepresentations when a publicly filed statement “explicitly disclosed the very liquidity risks about which appellants claim to have been misled”); *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003) (finding reliance unreasonable where sophisticated plaintiffs relied on oral representations of a friend rather than demand representations in stock purchase agreement); *Kennedy v. Venrock Assocs.*, 348 F.3d 584, 592 (7th Cir. 2003) (finding reliance unreasonable where plaintiff failed to read or understand 20 pages in proxy statement outlining differences between Maryland and Delaware law); *Jackvony v. RIHT Fin. Corp.*, 873 F.2d 411, 416-17 (1st Cir. 1989); *Hirsch v. Du Pont*, 553 F.2d 750, 762-63 (2d Cir. 1977); *Rochez Bros. v. Rhoades*, 491 F.2d 402, 409-10 (3d Cir. 1973), *aff’d following remand*,

527 F.2d 880 (3d Cir. 1975); *Stephenson v. Paine Webber Jackson & Curtis, Inc.*, 839 F.2d 1095, 1098-99 (5th Cir. 1988) (rejecting argument that *Bateman Eichler* eliminated due diligence defense and holding that plaintiff's failure to investigate must rise to level of recklessness to bar claim); *Aschinger v. Columbus Showcase Co.*, 934 F.2d 1402, 1408 (6th Cir. 1991); *Molecular Tech. Corp. v. Valentine*, 925 F.2d 910, 918 (6th Cir. 1991); *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516-17, 1519 (10th Cir. 1983) (stating that plaintiff's reliance must be "justifiable" and holding that recovery was precluded by recklessness); *Ross v. Bank South, N.A.*, 885 F.2d 723, 738-39 (11th Cir. 1989); *cf. Hamilton v. Harrington*, 807 F.2d 102, 107 (7th Cir. 1986) (holding that a son could not ground a fraud claim on allegations that he was misled about the sale of his family's business, when he was fully aware that his father wanted to sell the firm after his retirement). Some courts hold that the exercise of due diligence by the plaintiff does not have to be pleaded in order to state a claim under 10b-5, at least in a fraud on the market case, while others require plaintiffs to plead reasonable reliance. *Compare Peil v. Speiser*, 806 F.2d 1154, 1160 (3d Cir. 1986) (not requiring allegations of due diligence in fraud on the market case), *Maverick Fund, L.D.C. v. Comverse Tech., Inc.*, 801 F. Supp. 2d 41, 57-58 (E.D.N.Y. 2011) (finding that sophisticated investor plaintiff could invoke fraud on the market presumption because it had no duty to seek out information beyond what was publicly available and because presumption remained available to "program traders" relying on securities' relative prices), *and Kline v. Henrie*, 679 F. Supp. 464, 470 (M.D. Pa. 1988) (not requiring allegations of due diligence in fraud on the market case), *with One-O-One Enters., Inc. v. Caruso*, 848 F.2d 1283, 1286 (D.C. Cir. 1988) ("To state a claim of fraud or securities fraud upon which relief can be granted, plaintiffs' allegations must indicate that their reliance on the allegedly fraudulent representations was reasonable.").

On the subject of the plaintiff's reliance, four circuits have held that a non-reliance clause in a written agreement accompanying a stock purchase or sale bars a plaintiff from asserting a claim for damages based on prior oral statements. *See Rissman v. Rissman*, 213 F.3d 381, 384 (7th Cir. 2000); *Jackovny*, 873 F.2d at 416-17; *One-O-One Enters., Inc. v. Caruso*, 848 F.2d 1283, 1286-87 (D.C. Cir. 1988); *McDonald's Corp. v. Barnes*, No. 92-36552, 1993 U.S. App. LEXIS 23513, at *8-9 (9th Cir. Sept. 14, 1993); *see also Heartland Fin. USA, Inc. v. Fin. Insts. Capital Appreciation Ptnrs. I, L.P.*, No. 02 CV 3982, 2002 U.S. Dist. LEXIS 24052, at *15-19 (N.D. Ill. Dec. 12, 2002) (following *Rissman*); *but see AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 183-84 (3d Cir. 2003) (treating non-reliance clause as one of the circumstances to be taken into account in determining whether plaintiff's reliance was reasonable).

In a criminal securities fraud prosecution under Section 10b-5, a defendant may be able to claim, despite a guilty plea, that the “no-knowledge” provision of 15 U.S.C. § 78ff(a) (“no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he has no knowledge of such rule or regulation”) exempts him from imprisonment where he had no knowledge of the rule or regulation that was violated. *See United States v. Behrens*, 644 F.3d 754, 756-57 (8th Cir. 2011).

11. Insider Trading

Since the decision of the SEC in *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961), insider trading—trading on the basis of material nonpublic information—by both corporate insiders and their tippees has been viewed by the SEC and the courts as a violation of Rule 10b-5. This does not mean that there is a duty on corporate insiders to disclose all material information to the public. Rather, the duty is to disclose or to abstain from trading until disclosure takes place. *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *aff’d in part, rev’d in part*, 446 F.2d 1301 (2d Cir. 1971).

The decisions in *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. SEC*, 463 U.S. 646 (1983), did not affect the liability for insider trading of true corporate insiders, or of certain kinds of tippees, but did restrict the scope of liability for insider trading somewhat. In *Chiarella*, an employee of a financial printer was able to guess, without being told, the names of certain takeover targets from documents being prepared at the printer. He was convicted of a criminal violation of Rule 10b-5 for having traded in the target company stocks prior to announcements of the takeovers, apparently on the theory that anyone in possession of material nonpublic information is prohibited from trading on it. 445 U.S. at 231. The Supreme Court, however, rejected this theory and overturned the conviction, ruling that only those who violate some specific duty by trading on nonpublic information can be liable under Rule 10b-5. *Id.* at 232. In dictum, the Court noted that corporate insiders violate a fiduciary duty to shareholders when they trade on the basis of nonpublic information, and that tippees of corporate insiders may be liable if they participate in an insider’s breach of duty. *Id.* at 230 n.12. The Court expressly reserved the issue of whether misappropriation of information for purposes of insider trading in breach of a duty to an employer or the corporation providing it could suffice for insider trading liability under Rule 10b-5. *Id.* at 236-37.

Chiarella itself did not involve a tippee. But after *Chiarella* it appeared that tippee liability under Rule 10b-5 could be grounded only on either the tippee’s participation in a violation of a fiduciary duty by a corporate insider in making the

tip, or on the misappropriation theory reserved by the *Chiarella* Court. It appeared that absent misappropriation or a violation of a duty by a tipping corporate insider, there would be no liability for insider trading by the tippee.

Dirks v. SEC, 463 U.S. 646 (1983), confirmed this. There, a securities analyst was informed by corporate insiders of a major financial scandal in a publicly traded corporation. The analyst, while making attempts to bring this information to the attention of the SEC and the press, informed certain of his clients, who were able to sell the relevant securities before the scandal became public. The analyst was censured by the SEC. The censure was overturned by the Supreme Court, however, because the analyst received the nonpublic information about the company from corporate insiders who were attempting to expose a scandal rather than violating fiduciary duties to shareholders. *Id.* at 665-67; *see also Bateman Eichler*, 472 U.S. at 311 n.21 (noting that a tippee's liability for insider trading generally arises when the tippee knew, or should have known, that the insider source breached such insider's fiduciary duties).

The SEC sought to enhance its power to combat insider trading by issuing Rule 14e-3 under § 14 of the Exchange Act. Rule 14e-3 governs insider trading in the context of tender offers and effectively overrules the specific result in *Chiarella*. Rule 14e-3 may apply before a tender offer is officially announced, if anyone has taken "a substantial step or steps" to commence the offer. 17 C.F.R. § 240.14e-3(a). In *SEC v. Ginsburg*, 362 F.3d 1292, 1302-04 (11th Cir. 2004), for example, the court held that the appointment of a due diligence team and execution of a confidentiality agreement was sufficient to trigger application of the rule. *See also SEC v. Mayhew*, 121 F.3d 44 (2d Cir. 1997) (finding retention of consulting firm, execution of consulting agreements, and meetings between top officials constituted "substantial steps" toward tender offer); *SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995) (finding meeting between officers of target and acquiring companies, after the target had solicited an offer from the acquiring company, constituted "substantial steps" toward tender offer).

The question unanswered by *Dirks* and expressly reserved by the Supreme Court in *Chiarella*—whether the misappropriation of information in order to trade in securities in violation of a duty of confidentiality to an employer or corporation can provide the basis for insider trading liability—came before the Court in *Carpenter v. United States*, 484 U.S. 19 (1987). R. Foster Winans, a reporter for *The Wall Street Journal*, was co-author of the "Heard on the Street" column, which reviewed selected stocks or groups of stocks on a daily basis. Winans gave advance information on the subjects of upcoming columns to others, who traded on this information and split the profits with Winans. With one justice recusing himself, the Supreme Court split 4-4, which had the effect of affirming the

Second Circuit's decision in *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), which held that Winans had knowingly breached a duty of confidentiality by misappropriating pre-publication information that was the property of the *Journal*, his employer. 484 U.S. at 23-24; *see also FMC Corp. v. Boesky*, 852 F.2d 981, 990 (7th Cir. 1988) (applying *Carpenter* and holding that information that corporation was to undergo a recapitalization was "corporate property," and misappropriation of that information violated Rule 10b-5).

Because the *Carpenter* Court was evenly divided and *Chiarella* and *Dirks* failed to address the issue, a wide hole existed in Rule 10b-5's prohibition of insider trading for persons who came into possession of inside information legitimately, such as accountants, lawyers and investment bankers, but then used the information to trade. Some circuit courts, including the Second Circuit, filled this hole by recognizing the "misappropriation theory." *See, e.g., United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981), *aff'd following remand*, 722 F.3d 729 (2d Cir. 1983); *Rothberg v. Rosenbloom*, 771 F.2d 818, 825 (3d Cir. 1985) (Higginbotham, J., concurring), *rev'd on other grounds after remand*, 808 F.2d 252 (3d Cir. 1986); *SEC v. Cherif*, 933 F.2d 403, 408 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990). But the Fourth and Eighth Circuits rejected this basis for insider trading liability. *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995); *United States v. ReBrook*, 58 F.3d 961, 964-65 (4th Cir. 1995); *United States v. O'Hagan*, 92 F.3d 612, 617 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997). This conflict among the circuits was finally resolved, and the gap in the law filled, by the Supreme Court's decision in *United States v. O'Hagan*, 521 U.S. 642 (1997).

O'Hagan involved the trades of a lawyer who had received information that one of his law firm's (though not his own) clients, Grand Metropolitan PLC, was planning a tender offer for Pillsbury Company. On the basis of this information, O'Hagan purchased Pillsbury options and common stock. When Grand Met announced its tender offer, O'Hagan sold the options and stock at a \$4.3 million profit.

The Eighth Circuit reversed all of O'Hagan's criminal securities law convictions on the grounds that (1) O'Hagan was not guilty of securities fraud because trading on the basis of misappropriated nonpublic information in securities of a company to which O'Hagan owed no fiduciary duty did not violate § 10(b) or Rule 10b-5; and (2) O'Hagan could not be guilty of violating Rule 14e-3, which prohibits trading on nonpublic information relating to a tender offer, without regard to whether fraud was committed, because the SEC had exceeded its authority when promulgating this rule. *See United States v. O'Hagan*, 92 F.3d 612, 622, 627-28 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

The Supreme Court reversed the Eighth Circuit on both grounds. The Court held that criminal liability under § 10(b) could be predicated on the misappropriation theory. It explained that trading on misappropriated confidential information is deceptive under § 10(b) because the fiduciary-turned-trader deceives those who entrust him with access to confidential information and defrauds them of exclusive use of the information. The Court did concede that “[b]ecause the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation.” *United States v. O’Hagan*, 521 U.S. 642, 655 (1997). However, in this case, O’Hagan had made no such disclosure upon receipt of the confidential information, and he breached his duty of loyalty to his law firm and its client when he traded on the basis of the confidential information.

Likewise, the Court explained that this deception had occurred “in connection with” the purchase or sale of securities as required by §10(b) “because the fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities.” *Id.* at 656. In other words, the deceived/defrauded individual need not be a party to the offensive trade in order for the deception to be “in connection with” the trade; rather, the information only must be used as a basis for the trade. *Id.* Accordingly, the Court acknowledged, using confidential information for reasons other than purchasing or selling stock would fall outside of the scope of § 10(b). *Id.*

The Supreme Court also held that, as applied in this case, Rule 14e-3 did not exceed the SEC’s rulemaking authority. Rule 14e-3 prohibits trading on the basis of any material nonpublic information which relates to a tender offer and imposes a duty on individuals with such information to disclose it or refrain from trading. Under the Rule, this duty is imposed even if the trader owes the information’s source *no* fiduciary duty of loyalty or confidentiality. The Eighth Circuit had noted that pursuant to § 14(e) the SEC can regulate only “fraudulent . . . acts . . . in connection with any tender offer.” Additionally, under § 10(b)—the section that the Eighth Circuit felt guided its interpretation of § 14(e)—nondisclosure of information is fraudulent only when a fiduciary relationship imposes on one a duty to speak. *O’Hagan*, 92 F.3d at 625-26. According to the Eighth Circuit, Rule 14e-3 went beyond the SEC’s power to regulate fraudulent acts because the rule punished nondisclosure of information in a nonfiduciary setting. *Id.* at 627. The Supreme Court disagreed with the Eighth Circuit’s reasoning and found that the application of Rule 14e-3 in this case fell within the SEC’s statutory authority. *O’Hagan*, 521 U.S. at 667. The court did not decide whether the SEC’s authority to define fraud under § 14(e) exceeded its fraud-defining power under § 10(b).

Rather, it recognized that § 14(e) did not only prohibit fraud in connection with tender offers but also expressly authorized the SEC to promulgate prophylactic rules designed to prevent fraudulent trading, and held that in this case the Rule constituted a proper exercise of the SEC's prophylactic authority. *Id.* at 672-73.

Prior to *O'Hagan*, the Second Circuit had extended the ambit of the misappropriation theory by holding that liability under the theory would adhere whenever a defendant engaged in a securities transaction based on information acquired in "breach of a fiduciary duty or similar relationship of trust and confidence." *United States v. Mylett*, 97 F.3d 663, 667 (2d Cir. 1996) (quoting *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991) (en banc)). In doing so the court tacitly approved of some previous cases extending the misappropriation theory outside the employer and advisor context. *See, e.g., SEC v. Lenfest*, 949 F. Supp. 341, 345-46 (E.D. Pa. 1996) (husband and wife); *United States v. Willis*, 737 F. Supp. 269, 273-74 (S.D.N.Y. 1990) (psychiatrist and patient); *United States v. Reed*, 601 F. Supp. 685, 717-18 (S.D.N.Y. 1985) (father and son), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985). *O'Hagan* appears to support this extension of the misappropriation theory. *See O'Hagan*, 521 U.S. at 650 n.3 (citing *Chestman* with approval). Moreover, lower courts after *O'Hagan* have grounded liability on special relationships beyond those of employer or advisor. *See, e.g., SEC v. Yun*, 130 F. Supp. 2d 1348, 1354-56 (M.D. Fla. 2001) (upholding jury verdict in which misappropriation theory was based on husband-wife relationship, despite the fact that defendant did not owe her husband a formal fiduciary duty under Florida law), *aff'd in part and vacated in part on other grounds*, 327 F.3d 1263 (11th Cir. 2003); *SEC v. Sargent*, 229 F.3d 68, 76 (1st Cir. 2000) (holding that sole stockholders in closely-held business corporation owed fiduciary relationship sufficient to support misappropriation theory, even when misappropriated information did not relate to the corporation itself); *see also Alexandra Global Master Fund, Ltd. v. Ikon Office Solutions, Inc.*, 2007 WL 2077153, at *9 (S.D.N.Y. July 20, 2007) (corporation owes no fiduciary or similar duty of trust and confidence to holders of the corporation's convertible debt and therefore cannot be liable to them under Rule 10b-5 for not disclosing material nonpublic information when buying back the debt).

Courts have continued to grapple with situations where individuals are charged with insider trading on the basis of allegedly misappropriated information from parties with whom the defendants did not have a fiduciary relationship. In *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated and remanded on other grounds*, 650 F.3d 551 (2010), the district court held that absent a fiduciary relationship between the parties, a confidentiality agreement may be the basis for a misappropriation theory claim, but only if the agreement explicitly or implicitly imposes both a duty not to disclose material nonpublic information and a duty not

to trade on or otherwise use that information. *Id.* at *10 (dismissing SEC's insider trading claim even though the company had given the shareholder defendant private information in reliance on the defendant's promise to keep the information confidential). In *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009), the Second Circuit held that the SEC did not need to demonstrate a breach of fiduciary duty when the defendant affirmatively misrepresented himself in obtaining the material nonpublic information. *Id.* at 49-51 (overturning a lower court decision that dismissed an insider trading action against a defendant who hacked into a website to steal a company's earnings information).

In August 2000, the SEC promulgated new Rule 10b5-2 in an attempt to clarify when "certain non-business relationships, such as family and personal relationships, may provide the duty of trust or confidence required under the misappropriation theory." Selective Disclosure and Insider Trading, Exchange Act Release No. 43154, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, at 83,695 (Aug. 15, 2000) [hereinafter Selective Disclosure and Insider Trading Release]. The new Rule provides first that a duty of trust or confidence exists whenever a person agrees to maintain information in confidence. 17 C.F.R. § 240.10b5-2(b)(1) (2002). It then provides that "a duty of trust or confidence exists when two people have a history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality." Selective Disclosure and Insider Trading Release, at 83,696; *see also* 17 C.F.R. § 240.10b5-2(b)(2). This prong requires a "facts and circumstances" test based on the expectation of the parties in light of the overall relationship." Selective Disclosure and Insider Trading Release, at 83,696. Third and finally, new Rule 10b5-2 adopts a bright-line test, stating that a duty of trust or confidence exists when a person receives or obtains material nonpublic information from certain enumerated close family members: spouses, parents, children, and siblings. 17 C.F.R. § 240.10b5-2(b)(3). The person receiving the information has an affirmative defense, however, if that person can demonstrate that no duty of trust or confidence existed with respect to the information. *Id.* To enjoy this affirmative defense, the recipient must establish that "he or she neither knew nor reasonably should have known that the person who was the source of the information expected [the information to be kept confidential], because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information." *Id.* While domestic partners, step-parents, and step-children are not covered by this last bright-line rule, exchanges of information among parties of this type may still be

covered by the first two provisions of Rule 10b5-2. *See* Selective Disclosure and Insider Trading Release, at 83,697.

To date, relatively few courts have discussed Rule 10b5-2. One court determined that allegations that the defendant agreed to safeguard confidential information obtained from executives, and thereafter received documents marked “confidential,” brought the case within Rule 10b5-2(b)(1). *SEC v. Kornman*, 391 F. Supp. 2d 477, 489-90 (N.D. Tex. 2005). However, another court held that the SEC cannot rely on Rule 10b5-2(b)(1) to establish liability based on an agreement that lacks the necessary component of an obligation not to trade on or otherwise use confidential information for personal benefit. *Cuban*, 634 F. Supp. 2d at 720. Two courts have cited the rule in dicta to support a duty of loyalty and confidentiality between spouses, in the context of trades that occurred prior to the enactment of the rule. *See SEC v. Yun*, 327 F.3d 1263, 1273 n.23 (11th Cir. 2003); *SEC v. Goodson*, 2001 WL 819431, *3 n.1 (N.D. Ga. 2001). *See also SEC v. Rocklage*, 470 F.3d 1, 7 & n.5 (1st Cir. 2006) (no dispute among parties, for purposes of motion to dismiss, that spousal relationship gave rise to a “duty of trust or confidence”; citing Rule 10b5-2). Another court, in a case arising in the business context, declined to apply Rule 10b5-2 even for purposes of guidance, stating that “Rule 10b5-2 was not intended to apply to business relationships.” *SEC v. Talbot*, 430 F. Supp. 2d 1029, 1061 n.91 (C.D. Cal. 2006), *rev’d on other grounds*, 530 F.3d 1085 (9th Cir. 2008). In *United States v. Kim*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002), the court discussed Rule 10b5-2’s potentially broader applications, also in the context of a trade that occurred before the enactment of the rule. In *Kim*, the government prosecuted a member of a club for young business executives who had used information revealed at the club to trade in advance of a takeover. 184 F. Supp. 2d at 1008-09. The club required each member to sign a confidentiality agreement, and the question before the district court was whether membership in the club created a duty of trust and confidence among members sufficient to sustain the misappropriation theory of insider trading. The court answered the question in the negative, holding that the relationship among business executives in the private club did not exhibit qualities similar enough to those inherent in a fiduciary relationship to sustain the theory. *Id.* at 1012. The court relied upon *Chestman* and other cases decided before the promulgation of Rule 10b5-2 because the facts of the case occurred before the Rule became effective. However, the court did address Rule 10b5-2 in dictum, concluding that if the Rule had applied, the court might have reached the opposite result. *Id.* at 1014. The court said that private business club membership and a confidentiality agreement among members satisfies both 10b5-2(b)(1)—agreeing to maintain information in confidence—and 10b5-2(b)(2)—a history, pattern, or practice of sharing confidences. *Id.* That a formal confidentiality

agreement constitutes “an agree[ment] to maintain information in confidence” appears uncontroversial. *Id.*; 17 C.F.R. § 240.10b5-2(1). The court left unexplained, however, what facts allowed it to conclude that there existed “a history, pattern, or practice of sharing confidences.” *Kim*, 184 F. Supp. 2d at 1014; 17 C.F.R. § 240.10b5-2(2). Future courts are left to explore what may be the scope of that provision of the Rule.

Another controversial question in the insider trading context is what constitutes trading “on the basis of” material nonpublic information for purposes of § 10 and Rule 10b-5. Few courts have specifically addressed whether these provisions require a causal connection between the material nonpublic information and the insider’s trading, or whether knowing possession of that information, while trading, is sufficient for liability. Courts in the Second Circuit have held “knowing possession” of material nonpublic information to be sufficient. *See, e.g., United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993); *SEC v. Thrasher*, 152 F. Supp. 2d 291, 302 (S.D.N.Y. 2001). In contrast, the Eleventh Circuit has ruled that the Supreme Court’s language in *Chiarella*, *Dirks* and *O’Hagan* suggests that there is no securities violation in the absence of a stronger causal connection. *SEC v. Adler*, 137 F.3d 1325, 1337-38 (11th Cir. 1998). Accordingly, the court held that insider trading while in knowing possession of material nonpublic information is not a per se violation. Rather, such activity raises a strong inference that the insider intended to use the information in trading, an inference that the insider can attempt to rebut. *See Adler*, 137 F.3d at 1333-38. Following the Eleventh Circuit, the Ninth Circuit has also rejected the knowing possession standard in favor of a use standard, noting that “[i]t is the insider’s use, not his possession, that gives rise to an informational advantage and the requisite intent to defraud.” *United States v. Smith*, 155 F.3d 1051, 1068 (9th Cir. 1998); *see also id.* at 1069 (refusing to create the *Adler* presumption).

In August of 2000, the SEC promulgated new Rule 10b5-1 in an attempt to end the use/possession debate. Under the new rule, “a purchase or sale of a security of an issuer is ‘on the basis of’ material nonpublic information about that security or issuer if the person making the purchase or sale was *aware* of the material nonpublic information when the person made the purchase or sale.” 17 C.F.R. § 240.10b5-1(b) (emphasis added). *See also United States v. Mooney*, 401 F.3d 940, 945 (8th Cir. 2005) (stating the test and rejecting a defense that it was uncertain the stock price would rise upon release of the material non-public information; “[t]he legal test is not whether the price would certainly rise, however, but whether the inside information used was material”), *modified in part by* 2005 U.S. App. LEXIS 7404 (8th Cir. Apr. 28, 2005), *aff’d on reh’g.*, 425 F.3d 1093 (8th Cir. 2005) (en banc). The SEC thus came down in favor of a standard similar to the “knowing possession” test, mitigated by “carefully enumerated

affirmative defenses.” Selective Disclosure and Insider Trading Release, at 83,692. The most important affirmative defense, available to both individuals and entities, provides exclusions for certain situations in which a trade resulted from a pre-existing plan, contract or instruction that was made in good faith. *See* 17 C.F.R. § 240.10b5-1(c)(1)(i)-(iii); *SEC v. Lyon*, 605 F. Supp. 2d 531, 548 (S.D.N.Y. 2009) (“To plead the affirmative defense, Rule 10b5-1 requires defendants to assert the existence of a *written* plan for trading adopted before defendants became aware of the material nonpublic information.”) (emphasis in original). This defense covers “situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision,” which potentially includes situations such as issuers operating repurchase programs, employees adopting plans for exercising stock options, and employees acquiring “company stock through payroll deductions under an employee stock purchase plan or a Section 401(k) plan.” Selective Disclosure and Insider Trading Release, at 83,694. An additional affirmative defense is available to entities alone. An entity can avoid liability if it can demonstrate that the person making investment decisions for the entity was not aware of the information, and that the entity had implemented reasonable policies and procedures to prevent insider trading. *See* 17 C.F.R. § 240.10b5-1(c)(2). *See also In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F. Supp. 2d 576, 592-93 (S.D. Tex. 2003) (describing and adopting Rule 10b5-1).

The existence of a Rule 10b5-1 plan may not, however, necessarily insulate someone from insider trading liability where the decision to establish the Rule 10b5-1 plan was made while in possession of material non-public information. *See* Complaint for Violations of the Federal Securities Laws, *SEC v. Mozilo*, No. CV 09-3994-JFW, 2009 WL 1549287 (C.D. Cal. June 4, 2009).

At the SEC’s behest, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), which added § 20A and § 21A to the Exchange Act, authorizing the SEC to seek, and federal courts to impose, a civil penalty of three times the illicit profit for insider trading that violates any provision of the securities laws or rules thereunder. *See Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, No. 02-C-4356, 2008 WL 2178150 (N.D. Ill. May 22, 2008) (holding that § 20A liability must be based upon a violation that involves insider trading). Despite the ambiguous position of the Supreme Court on the precise contours of insider trading, Congress, in enacting ITSFEA, did not adopt a definition of insider trading, and has not done so thereafter. In *SEC v. Rosenthal*, the Second Circuit held that civil monetary penalties for insider trading are only available under ITSFEA, and not under the Exchange Act’s general civil penalty provision, section 21(d)(3), which applies “to securities law violations ‘other than’ insider trading.” 650 F.3d 156, 162 (2d Cir. 2011).

In the civil context, the role of Rule 10b-5 in insider trading cases was once a little uncertain. In *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), the Second Circuit rejected the misappropriation theory in the context of a private civil action under Rule 10b-5, *id.* at 15-16, ruling that a plaintiff cannot “piggyback” his claim on a duty owed by a defendant to others. *Id.* at 13. *Moss* was based on the same facts as *Newman*, where the Second Circuit had *upheld* the defendants’ criminal convictions based on the misappropriation theory. Congress, however, seems to have overturned the result in *Moss* in § 4 of the ITSFEA, which added § 20A to the Exchange Act. Section 20A(a) states:

Any person who violates any provision of this title . . . by purchasing or selling a security while in possession of material, nonpublic information shall be liable . . . to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class.

15 U.S.C.A. § 78t-1(a). By extending the liability of insider traders to losses incurred by contemporaneous traders, regardless of whether the insider trader violated a duty to the contemporaneous trader, Congress has both eliminated the privity requirement in insider trading cases and expanded the scope of the definition of insider trading. *See SEC v. Clark*, 915 F.2d 439, 452 & n.23 (9th Cir. 1990) (quoting the House Committee Report, including its discussion of *Moss*); *see also Fujisawa Pharm. Co. v. Kapoor*, 932 F. Supp. 208, 210 (N.D. Ill. 1996) (holding that § 20A(a) does not cover face-to-face transactions), *aff’d in part and rev’d in part on other grounds*, 115 F.3d 1332 (7th Cir. 1997).

After *O’Hagan* and the passage of ITSFEA, courts may be willing to apply the misappropriation theory in private civil actions as well as in criminal and SEC injunctive actions. *See Clark*, 915 F.2d at 452-53. Certainly, the rulings of *Chiarella* and *Moss* are not applicable to defendants who trade on the basis of inside information received directly from true corporate insiders, rather than from printers, investment bankers, or others in a contractual relationship with a corporation. *See O’Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 600 F. Supp. 702, 703-05 (S.D.N.Y. 1985). The *O’Connor* court, moreover, refused to dismiss a complaint filed by options traders despite holding that corporate insiders and their tippees have no state law fiduciary duty to options traders, and held that such defendants, unlike those in *Chiarella* and *Moss*, have a duty to the marketplace at large not to trade on inside information. *Id.* at 703. The Ninth Circuit has held that the contemporaneousness requirement of ITSFEA also

applies to private claims under 14e-3 relating to misleading tender offers. *Brody v. Transitional Hosps. Corp.*, 280 F.3d 997, 1005 (9th Cir. 2002).

12. Section 10(a)

The Congress that passed the Exchange Act was not able to come to a conclusion about whether short sales are good or bad. *See* S. Rep. No. 1455, at 50-55 (1934), *reprinted in* Fed. Bar Ass'n, *Federal Securities Laws: Legislative History 1933-1982*, at 1257, 1313-18 (1983). Thus § 10(a) under the Exchange Act does nothing other than to place short sales under SEC rule-making power.

The rules issued by the SEC under § 10(a), first adopted in 1938, reflected the view that there is a danger that short sales, especially if not marked as such, can cause a declining market to decline more rapidly. Until recently, Rule 10a-1(c) required short sales on national exchanges to be marked as such. And Rule 10a-1(b) prohibited short selling at a price lower than the last reported price for regular trades in the relevant security, and stated that short sales could not be made even at that price unless it was above the next preceding different price. The effect was to make short sales difficult, if not impossible, in a declining market.

Over the years, the SEC added exceptions to Rule 10a-1 and granted numerous written requests for relief from the rule's restrictions. In addition, the advent of decimal pricing reduced the difficulty of short-selling on an "uptick." In 2004, in an effort to modernize the short sale rules, the SEC enacted Rule 202T of Regulation SHO, which established a one-year pilot program temporarily suspending the provisions of the Commission's short sale price test for certain securities. *See* SEC Release No. 34-50103, 69 Fed. Reg. 48,008 (Aug. 6, 2004). In 2007, based on a review of the pilot program's results, the SEC adopted amendments deleting Rule 10a-1 and adding Rule 201 of Regulation SHO to provide that no price test, including any price test by any self-regulatory organization (SRO), shall apply to short selling in any security, and that no SRO may have a price test. *See* 17 C.F.R. § 242.201; SEC Release No. 34-55970, 72 Fed. Reg. 36,348 (July 3, 2007). Regulation SHO also includes provisions intended to deter abusive "naked short sales." In March 2009, two senators introduced a bill ordering the SEC to reinstate the repealed Rule 10a-1, the uptick rule. S. 605, 111th Cong. (2009).

Effective September 2008, the SEC adopted Rule 10b-21 which expressly targets fraudulent short selling transactions. The new rule covers short sellers who deceive broker-dealers or any other market participant and makes clear that those who lie about their intention or ability to deliver securities in time for settlement

are violating the law when they fail to deliver. In July 2009, the SEC made permanent Rule 204, which seeks to prevent “naked” short selling by requiring broker-dealers to promptly purchase or borrow securities to deliver on a short sale.

B. Selective Disclosure

In recent years, the SEC has taken steps to eliminate the practice of “selective disclosure.” Selective disclosure occurs when corporate insiders divulge nonpublic information to a select class of recipients, usually analysts or institutional investors, before disclosing this information to the public at large. Selective Disclosure and Insider Trading Release, at 83,677. Troubled by instances of selective disclosure reported in the media and by recent studies regarding the impact of selective disclosure on market integrity, the SEC released proposed Regulation FD for comment in December of 1999. *See* Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, at 72,591-92 (proposed Dec. 28, 1999). After extending the comment period and receiving almost 6,000 comments, the SEC adopted Regulation FD by a three-to-one vote on August 10, 2000. *See* J. Scott Colesanti, *Bouncing the Tightrope: The SEC Attacks Selective Disclosure, But Provides Little Stability for Analysts*, 25 S. Ill. U. L.J. 1, 3-4 (2000).

The basic rule of Regulation FD is found in new Rule 100, which provides that whenever an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated market professionals or stockholders likely to trade on the basis of the information, the issuer must make public disclosure of that same information. *See* 17 C.F.R. § 243.100; Selective Disclosure and Insider Trading Release, at 83,680-81. The issuer must make this disclosure simultaneously for intentional selective disclosures, or promptly for non-intentional selective disclosures. *See id.*

As evidenced by the volume of comments received prior to adoption of Regulation FD, the Regulation and the SEC’s authority for promulgating it was, and remains, quite controversial. *See* Peter Talosig III, *Regulation FD—Fairly Disruptive? An Increase in Capital Market Efficiency*, 9 Fordham J. Corp. & Fin. L. 637 (2004). For example, the SEC filed a civil action against Siebel Systems, Inc. for allegedly violating Regulation FD. *SEC v. Siebel Sys., Inc.*, No. 04-CV-5130 (GBD) (S.D.N.Y. filed June 29, 2004). The Chamber of Commerce filed an amicus brief challenging the constitutionality of Regulation FD, contending that the SEC greatly exceeded its authority when passing the regulation and that the regulation offends basic First Amendment rights. Brief of Amicus Curiae Chamber of Commerce of the United States, *SEC v. Siebel*, No. 04-CV-5130

(GBD) (S.D.N.Y. filed June 29, 2004). The court granted the defendants' motion to dismiss the SEC's claims and declined to address the constitutional questions. *SEC v. Siebel Sys., Inc.*, 384 F. Supp. 2d 694, 709 n.16 (S.D.N.Y. 2005).

1. Basis of Liability and Enforcement

Although selective disclosure raises many of the same concerns as insider trading, the SEC has made clear that Regulation FD is not an antifraud provision based on § 10(b) of the Exchange Act. *See id.* at 83,691. Rather, it is “an issuer disclosure rule that is designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act and Section 30 of the Investment Company Act.” *Id.* Accordingly, if an issuer violates the requirements of Regulation FD, the SEC may bring an enforcement action alleging violations of § 13(a) or § 15(d) and seeking “a cease-and-desist order, or . . . an injunction and/or civil money penalties.” *Id.* Individuals responsible for violations may also be liable under § 21C or the Exchange Act or as an aider and abetter in an injunctive action. *See id.* at 83,691-92.

Regulation FD does *not* create new duties under the antifraud provisions of the securities laws. *See id.* at 83,691. In fact, Rule 102 specifically states that “[n]o failure to make a public disclosure required solely by [Rule 100] shall be deemed to be a violation of Rule 10b-5.” 17 C.F.R. § 243.102. However, because Regulation FD does not affect any of the existing grounds for liability under Rule 10b-5, selective disclosure may still subject an issuer to fraud liability under certain circumstances:

[L]iability for “tipping” and insider trading under Rule 10b-5 may still exist if a selective disclosure is made in circumstances that meet the Dirks “personal benefit” test. In addition, an issuer’s failure to make a public disclosure may give rise to liability under a “duty to correct” or “duty to update” theory in certain circumstances. And an issuer’s contacts with analysts may lead to liability under the “entanglement” or “adoption” theories. In addition, if an issuer’s report or public disclosure made under Regulation FD contained false or misleading information, Rule 102 would not provide protection from Rule 10b-5 liability.

Selective Disclosure and Insider Trading Release, at 83,691.

2. Covered Communication

Regulation FD applies to all issuers with securities registered under § 12 of the Exchange Act, and to all issuers required to file reports under § 15(d) of the Exchange Act. 17 C.F.R. § 243.101(b). Regulation FD also covers closed-end investment companies, but does not reach other investment companies, foreign governments or foreign private issuers. *See id.*

Besides statements by an issuer itself, Regulation FD applies to disclosures “by any person acting on [the issuer’s] behalf.” *Id.* § 243.100(a). Two classes of persons fit this characterization. In the first class are “senior official[s],” meaning “any director, executive officer . . . investor relations or public relations officer, or other person with similar functions.” *Id.* § 243.101(f). The second class consists of any other officers, employees or agents of the issuer who regularly communicate with any of the enumerated market professionals or with stockholders. *See id.* § 243.101(c). Regulation FD does not apply to disclosures by officers, employees or agents made in violation of a duty of trust or confidence to the corporation because Rule 101(c) states that these persons do not act “on behalf” of the corporation.

The general rule against selective disclosure only applies to disclosures made to four enumerated categories of persons. *See id.* § 243.100(b). “The first three categories are securities market professionals—(1) broker-dealers and their associated persons, (2) investment advisers, certain institutional investment managers and their associated persons, and (3) investment companies, hedge funds, and affiliated persons.” Selective Disclosure and Insider Trading Release, at 83,681. “These categories will include sell-side analysts, many buy-side analysts, large institutional investment managers, and other market professionals who may be likely to trade on the basis of selectively disclosed information.” *Id.* at 83,681-82. The fourth category consists of holders of a corporation’s securities who are reasonably likely to trade on the basis of selectively disclosed information. 17 C.F.R. § 243.100(b)(1)(iv).

However, even if an issuer discloses material nonpublic information to one of these enumerated parties, the disclosure requirement is not triggered if one of four exclusions apply. First, no public disclosure is required if the person to whom information is disclosed owes a duty of trust or confidence to the issuer. *See id.* § 243.100(b)(2)(i). Thus, disclosure to “temporary insiders” such as attorneys, accountants or investment bankers will not trigger the requirements of Regulation FD. Second, no public disclosure is required if the person to whom information is disclosed expressly agrees to maintain the information in confidence. *See id.* § 243.100(b)(2)(ii). Accordingly, “issuers [can] share material nonpublic

information with other parties to a business combination transaction or with a purchaser in a private placement without having to make public disclosure if the party receiving the information agrees to hold the information in confidence.” 64 Fed. Reg. 72,590, at 72,595. Third, the requirements of Regulation FD do not apply when disclosure is to an entity whose primary business is the issuance of credit ratings, provided that the information is disclosed solely for the purpose of developing a credit rating and the entity’s ratings are publicly available. 17 C.F.R. § 243.100(b)(2)(iii). Finally, “with limited exceptions, Regulation FD as adopted does not apply to disclosures made in connection with a securities offering registered under the Securities Act.” Selective Disclosure and Insider Trading Release, at 83,689; *see also* 17 C.F.R. § 243.100(b)(2)(iv).

3. Material Nonpublic Information

Regulation FD only applies to selective disclosure of “material nonpublic” information. The Regulation does not define these terms, but rather draws their definition from pre-existing case law. Adopting the standard found in *Texas Gulf Sulphur*, the SEC indicated that “[i]nformation is nonpublic if it has not been disseminated in a manner making it available to investors generally.” Selective Disclosure and Insider Trading Release, at 83,683 & n.40. For materiality, the SEC adopted the *TSC Industries* “total mix” standard. *See id.* at 83,683 & nn.38-39.

Recognizing the amorphous quality of the materiality inquiry, the SEC provided a nonexclusive list of subjects that are likely to trigger the duty to make public disclosure:

- (1) [e]arnings information;
- (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets;
- (3) new products or discoveries, or developments regarding customers or suppliers (*e.g.*, the acquisition or loss of a contract);
- (4) changes in control or in management;
- (5) changes in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report;
- (6) events regarding the issuer’s securities—*e.g.*, defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and
- (7) bankruptcies or receiverships.

Id. at 83,684. *But see Vladimir v. Bioenvision, Inc.*, 374 F. App’x 141, 143 (2d Cir. 2010) (holding that, while there is a duty to disclose merger *agreements*, there is no duty to disclose merger *negotiations*).

The SEC also indicated that when an officer gives direct or indirect “guidance” to an analyst regarding earnings forecasts, “he or she takes on a high degree of risk under Regulation FD.” *Id.* However, because the *TSC Industries* test is keyed to the “reasonable investor” and not the professional analyst, selective disclosure of some information that analysts find useful, even regarding one of the above-flagged topics, may not trigger a violation of Regulation FD. As the SEC recognized, “[a]nalysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions.” *Id.* See also *In re Centerline Holding Co. Sec. Litig.*, 380 F. App’x 91, 93-94 (2d Cir. 2010) (investment trust had no duty to disclose to analysts its plans to change its business model “from one focused on the generation of distributable tax-exempt income to that of an asset manager focused on growth”).

4. Timing of Public Disclosure

The timing of the required public disclosure under Regulation FD depends upon whether selective disclosure is intentional or unintentional. If selective disclosure is intentional, then the issuer must make public disclosure simultaneously with the selective disclosure. 17 C.F.R. § 243.100(a)(1). “[T]his requirement for simultaneous disclosure means that issuers cannot engage in an intentional selective disclosure consistent with the terms of Regulation FD.” *Selective Disclosure and Insider Trading*, 64 Fed. Reg. 72,590, at 72,595. According to the SEC, the disclosure is “intentional” if the disclosing party either knows or is reckless in not knowing, prior to disclosure, that the information he or she is communicating is *both* material and nonpublic. 17 C.F.R. § 243.101(a); see also *Selective Disclosure and Insider Trading Release*, at 83,685. “Thus, in the case of a selective disclosure attributable to a mistaken determination of materiality, liability will arise only if no reasonable person under the circumstances would have made the same determination.” *Id.* at 83,685-86.

If selective disclosure is unintentional, then public disclosure of the same information must be made promptly after the selective disclosure. 17 C.F.R. § 243.100(a)(2). “‘Promptly’ means as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day’s trading on the New York Stock Exchange) after a senior official of the issuer . . . learns that there has been a non-intentional disclosure. . . .” *Id.* § 243.101(d). Moreover, a senior official does not “learn” of the disclosure until he or she knows or is reckless in not knowing that the selectively disclosed information is *both* material and nonpublic. *Selective Disclosure and Insider Trading Release*, at 83,686.

5. Form of Public Disclosure

Rule 101(e) provides two options to the issuer who must make public disclosure under Regulation FD. First, the issuer can file a Form 8-K with the SEC disclosing the selectively disclosed information. 17 C.F.R. § 243.101(e)(1). Second, the issuer may disseminate the information through another method or combination of methods reasonably designed to provide “broad, non-exclusionary distribution of the information to the public.” *Id.* § 243.101(e)(2).

In its Final Release, the SEC emphasized the flexibility of the latter option, indicating that Regulation FD does not require use of a particular method or a “one size fits all” standard for disclosure. Selective Disclosure and Insider Trading Release, at 83,687. Possible methods include “press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or conference calls that interested members of the public may attend or listen to either in person, by telephonic transmission, or by other electronic transmission (including use of the Internet).” *Id.* Additionally, the SEC suggests that if a conference call or webcast will be used, the content of the presentation should be available for some time afterwards so as to ensure that those who missed the presentation may have access to it at a later point. *Id.* at n.73. While in the Proposing Release the SEC indicated that posting of new information on a company’s website would not by itself be sufficient, the SEC took a somewhat more optimistic view of internet technology in the Final Release. First, the SEC suggested that in the future, as technology evolves and more investors have access to the internet, companies might be able to rely on this method alone. *Id.* at 83,686. More immediately, the SEC indicated that currently a company may be able to demonstrate that disclosure made on its website constitutes part of a *combination of methods* “reasonably designed to provide broad, non-exclusionary distribution” of information to the public. *Id.*

C. Section 18

Section 18(a) creates an express private right of action for any person who, in reliance on a false or misleading statement or omission made in a document required by the Exchange Act or rules thereunder to be filed with the SEC, purchases or sells a security at a price affected by such statement. Misleading statements contained in sections of forms, such as Part I of Form 10-Q, which are deemed as a matter of law *not* to be filed with the SEC, are not actionable under § 18(a). *See In re Digi Int’l Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1103 (D. Minn. 1998), *aff’d*, 14 F. App’x 714 (8th Cir. 2001); *Cohen v. Stevanovich*, 722 F. Supp. 416 (S.D.N.Y. 2010) (dismissing § 18 claim that failed to identify any SEC filings, much less allege that a document filed with the SEC contained a material

misstatement or omission). *In re Stone & Webster, Inc., Sec. Litig.*, 253 F. Supp. 2d 102 (D. Mass. 2003) (dismissing § 18(a) claims that referred to portions of 10-Q not filed as a matter of law with SEC, and that failed to meet Fed. R. Civ. P. 9(b) particularity requirements), *aff'd*, 414 F.3d 187 (1st Cir. 2005). Also, § 18(a) claims will not lie where the complaint merely alleges a failure to file a required form rather than inclusion of a misleading statement in a filing. *See Dewitt v. Am. Stock Transfer Co.*, 433 F. Supp. 994, 1005 (S.D.N.Y. 1977).

A majority of the courts considering the issue have concluded that § 18 does not provide the exclusive remedy for misstatements and omissions in statements required to be filed under the Exchange Act, and that Rule 10b-5 provides another remedy if the elements of a Rule 10b-5 cause of action can be made out. *See, e.g., Huddleston v. Herman & MacLean*, 640 F.2d 534, 543 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983); *Wachovia Bank and Trust Co. v. Nat'l Student Mktg. Corp.*, 650 F.2d 342, 359 (D.C. Cir. 1980); *Ross v. A. H. Robins Co.*, 607 F.2d 545, 555 (2d Cir. 1979); *cf. In re Ames Dep't Stores, Inc. Stock Litig.*, 991 F.2d 953, 965-66 (2d Cir. 1993) (citing *Ross* to support broad construction of the "in connection with" requirement). *See also Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.*, 315 F. Supp. 2d 666, 685 (E.D. Pa. 2004) (in dismissing § 18(a) to the same extent as it dismissed § 10(b) claims, the court held that the loss and reliance requirements of § 18(a) and § 10(b) are "coterminous"). However, a very few district courts have ruled that § 18 is exclusive, and that an action under Rule 10b-5 will not lie for false or misleading statements in documents filed with the SEC under the Exchange Act. *See, e.g., Issen v. GSC Enters., Inc.*, 522 F. Supp. 390, 397 (N.D. Ill. 1981); *McKee v. Federal's, Inc.*, No. 76-70695, 1979 U.S. Dist. LEXIS 10517, at *12-13 (E.D. Mich. Aug. 8, 1979). *See also Levie v. Sears Roebuck & Co.*, No. 04 C 7643, 2006 WL 756063, at *3-4 (N.D. Ill. Mar. 22, 2006) (noting that although some courts had concluded that § 18(a) provides the exclusive remedy for violations of § 13(d), claim that defendants failed to file required schedules was outside § 18(a) and could be brought pursuant to Rule 10b-5).

The fact that in most courts remedies under Rule 10b-5 are available to supplement those under § 18, the stringent reliance requirement, the short statute of limitations, and the availability of a good faith defense under § 18 have made for a paucity of § 18 cases. Despite the fact that few cases construe § 18, the outlines of a § 18 action are reasonably clear from the statute itself.

1. Standing

It is clear from the statute that the plaintiff must have bought or sold securities to bring a § 18 action. The few courts that have interpreted the purchaser-seller

requirement of § 18 have ruled that it is to be construed in the same broad manner as that under Rule 10b-5. *Phillips v. TPC Commc'ns, Inc.*, 532 F. Supp. 696, 698 (W.D. Pa. 1982); *Weisman v. Darneille*, No. 77 Civ. 2110 (LFM), 1978 U.S. Dist. LEXIS 20308, at *7 (S.D.N.Y. Jan. 6, 1978). Thus, for example, forced sellers have been allowed to sue under § 18. *Id.*

2. Persons Liable

Section 18 liability extends to anyone who “shall make or cause to be made” any false or misleading statement in a covered document. Under this provision, directors and officers, as well as accountants, can be sued for false or misleading statements. *See Kramer v. Scientific Control Corp.*, 452 F. Supp. 812, 817 (E.D. Pa. 1978) (directors); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 n.31 (1976) (accountants); *Fischer v. Kletz*, 266 F. Supp. 180, 189 (S.D.N.Y. 1967) (same). No privity between plaintiff and defendant is required under § 18.

3. Scienter and Good Faith

A § 18 plaintiff need not prove scienter, or even negligence, to establish a case. *Ross*, 607 F.2d at 556. However, the statute provides an affirmative defense, on which a defendant bears the burden of proof, of good faith and lack of knowledge. *Magna Inv. Corp. v. John Does One Through Two Hundred*, 931 F.2d 38 (11th Cir. 1991). In light of this, the standard for liability under § 18 is closer to scienter than negligence. *See Hochfelder*, 425 U.S. 211 at n.31. To the same extent required under Rule 10b-5, new Section 21E(c) of the Exchange Act created by the Reform Act requires actual knowledge of the false or misleading statements to maintain a § 18 private action premised on certain “forward-looking statements.”

4. Reliance and Causation

Section 18 contains a very strict reliance requirement. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 257 (1988) (White, J., dissenting). The terms of the statute require plaintiff to show that he bought or sold “in reliance” on a false or misleading statement in an appropriate document. This has been interpreted to mean that a plaintiff must plead and prove that he actually read a copy of the document filed with the SEC. *See, e.g., Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968). It is not enough that the plaintiff relied on information ultimately derived from such a document if he himself did not read the document. This “eyeball” reliance requirement is the reef on which most § 18 cases founder. *See, e.g., Cohen v. Stevanovich*, 722 F. Supp. 2d 416 (S.D.N.Y. 2010); *Cyber Media Group v. Island Mortg. Network, Inc.*, 183 F. Supp. 2d 559, 577-78 (E.D.N.Y.

2002); *Kennedy v. Nicastro*, 503 F. Supp. 1116, 1118 (N.D. Ill. 1980); *Ross v. Warner*, 480 F. Supp. 268, 272-273 (S.D.N.Y. 1979); *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518, 525 (S.D.N.Y. 1977); *Gross v. Diversified Mortg. Investors*, 431 F. Supp. 1080, 1093 (S.D.N.Y. 1977), *aff'd mem.*, 636 F.2d 1201 (2d Cir. 1980). Given the strictures of this requirement, the new Section 21D(b)(4) of the Exchange Act, which places on the plaintiff the burden of proving loss causation in a private right of action under the Exchange Act, does not change the elements of a § 18 cause of action. In addition to showing reliance, a plaintiff must show that the statements complained of affected the price of the securities he bought or sold. *See Jacobson*, 445 F. Supp. at 525.

5. Remedies and Measure of Damages

Remedies under § 18 are limited to damages by the terms of the statute. *Sta-Rite Indus., Inc. v. Nortek, Inc.*, 494 F. Supp. 358, 362 n.1 (E.D. Wis. 1980). But § 18 does not specify how damages are to be measured, and cases on the subject are rare. One case, *Harris v. Am. Inv. Co.*, 523 F.2d 220, 224 n.3 (8th Cir. 1975), has applied the measure of damages under Rule 10b-5 to § 18.

Just as in the case of private actions under Rule 10b-5, new Section 21D(e) of the Exchange Act adopts a cap on damages in an attempt to account for a “bounce-back” in a security’s price after full or corrective disclosure is made. Under this provision, if following the corrective disclosure of unfavorable information the security recovers all or a portion of the initial price decrease, damages will be capped by the difference between the plaintiff’s purchase or sale price and the mean trading price of the security over the 90-day period beginning on the date of the corrective disclosure. 15 U.S.C.A. § 78u-4(e)(1). When the plaintiff sells or repurchases the security before expiration of the 90-day period, the plaintiff may recover no more than the difference between the purchase or sale price and the appropriate mean trading price. 15 U.S.C.A. § 78u-4(e)(2).

Under § 18(a), costs and attorneys’ fees are available to a prevailing litigant.

6. Statute of Limitations

Section 18(c) provides the statute of limitations for actions brought under § 18(a). Actions must be brought within one year of discovery of the false or misleading character of the statements complained of, and in any case within three years from the time the action accrues. *See Rahr v. Grant Thornton LLP*, 142 F. Supp. 2d 793, 796 (N.D. Tex. 2000). An action accrues under § 18 when a plaintiff makes the purchases or sales complained of, rather than when the allegedly false or misleading documents are filed with the SEC. *Lindner Dividend Fund, Inc. v.*

Ernst & Young, 880 F. Supp. 49, 53 (D. Mass. 1995); *Jacobson*, 445 F. Supp. at 527.

7. Contribution

Section 18(b) specifically creates a right of action for contribution for persons found liable under § 18. Contribution is *pro rata* as in contract, rather than by fault as in tort. *But see* Section IV.E, *infra*.

IV

Secondary Liability, Contribution and Indemnification

A defendant can be held secondarily liable for primary violations of the securities laws under § 15 of the Securities Act or § 20 of the Exchange Act, as well as by application of the common law doctrines of respondeat superior, aiding and abetting, or conspiracy.

A. Controlling Person Liability under § 15 of the Securities Act and § 20 of the Exchange Act

Despite differences in wording, § 15 of the Securities Act and § 20 of the Exchange Act have always been interpreted as parallel statutes. *Pharo v. Smith*, 621 F.2d 656, 673 (5th Cir. 1980); *Durham v. Kelly*, 810 F.2d 1500, 1503 (9th Cir. 1987). Section 15 imposes secondary liability on controlling persons for primary liabilities of controlled persons under §§ 11 and 12, though not § 17, of the Securities Act. Section 20 imposes secondary liability on controlling persons for primary liabilities of controlled persons under any provision of the Exchange Act. Since § 15 and § 20 are secondary liability provisions, it is necessary that a primary violation be established before liability under § 15 or § 20 arises. *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 84 (1st Cir. 2002). However, it is not necessary that the controlled person held primarily liable be joined in an action under § 15 or § 20. *See SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1170 n.47 (D.C. Cir. 1978); *Kemmerer v. Weaver*, 445 F.2d 76, 78-79 (7th Cir. 1971) (holding that action may continue against controlling persons when suit against controlled persons dismissed on procedural, rather than substantive, grounds); *Keys v. Wolfe*, 540 F. Supp. 1054, 1060-61 (N.D. Tex. 1982), *rev'd on other grounds*, 709 F.2d 413 (5th Cir. 1983); *Primavera Familienstiftung v. Askin*, No. 95 CIV. 8905, 1996 WL 580917, *2 (S.D.N.Y. Oct. 9, 1996); *McCarthy v. Barnett Bank*, 750 F. Supp. 1119, 1126 (M.D. Fla. 1990); *see also In re Stone & Webster, Inc. Sec. Litig.*, 424 F.3d 24, 27 (1st Cir. 2005) (holding that the dismissal of Rule 10b-5 direct claims against individual defendants “is in no way incompatible” with a plaintiff’s right to establish their secondary liability under § 20(a) as controlling persons of a liable corporation). The question of whether the primary violation must be actionable has been considered only once, and was answered in the negative. *Johnson v. Aljian*, 490 F.3d 778, 781-82 (9th Cir. 2007) (affirming a finding of § 20 liability even when the statute of limitations period had expired on the primary violation).

1. “Control”

“Control” is defined as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise,” 17 C.F.R. § 230.405, but exactly who meets this standard has never been completely clear. It has been held that a broker is “controlled” by his brokerage company. *See Martin v. Shearson Lehman Hutton, Inc.*, 986 F.2d 242, 244 (8th Cir. 1993); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1573 (9th Cir. 1990) (en banc). More generally, a principal is a controlling person of his agent; indeed, the term extends to many non-agency relationships. *Metge v. Baehler*, 577 F. Supp. 810, 817-18 (S.D. Iowa 1984), *aff’d in part and rev’d in part on other grounds*, 762 F.2d 621 (8th Cir. 1985). Thus, controlling shareholders, directors and even lenders can be controlling persons, where they have the power or potential power to influence the activities of the controlled person. *See, e.g., Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1162-63 (9th Cir. 1996) (discussing standards for finding lenders and directors to be “controlling persons”); *Arthur Children’s Trust v. Keim*, 994 F.2d 1390, 1396-97 (9th Cir. 1993); *In re Gaming Lottery Sec. Litig.*, No. 96 Civ. 5567 (RPP), 1998 U.S. Dist. LEXIS 7926, at *25-26 (S.D.N.Y. May 27, 1998) (officers), *vacated on other grounds sub nom. Pecarsky v. Galaxiworld.com Ltd.*, 249 F.3d 167 (2d Cir. 2001); *Stern v. Am. Bankshares Corp.*, 429 F. Supp. 818, 824 (E.D. Wis. 1977) (directors); *Klapmeier v. Telecheck Int’l, Inc.*, 315 F. Supp. 1360, 1361 (D. Minn. 1970) (controlling shareholder). The Second Circuit has held that ratings agencies are not control persons of banks issuing securities that they rated. *In re Lehman Bros. Mortg.-Backed Sec. Litig.*, 650 F.3d 167, 187 (2d Cir. 2011) (“[P]roviding advice that the banks chose to follow does not suggest control.”).

The Ninth Circuit reversed a district court’s dismissal of allegations that the Texas Pacific Group and Continental Airlines, Inc. were controlling persons of America West Airlines. *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 945-46 (9th Cir. 2003). Applying *Paracor*, the court found “indicia of control” sufficient to state a claim under 20(a): first, TPG and Continental had been shareholders of America West since 1994; second, they were the largest shareholders, together owning 57.4% of the company; third, they had the power to elect a majority of America West’s Board of Directors; and fourth, some of their own officers served on the America West Board. *Id.*

The circuits remain split as to whether a plaintiff must establish that the defendant was a “culpable participant” in the alleged violation in order to qualify as a “controlling person” for purposes of § 15 and § 20. The Second and Third Circuit Courts of Appeals adhere to the “culpable participant” test, at least with respect to

§ 20, which requires the plaintiff to show not only that the controlling and controlled persons stood in a relationship whereby the former had direct or indirect influence over the decision-making process of the latter, but also that the defendant actually participated in the alleged violation. *See, e.g., ATSI Comm., Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 108 (2d Cir. 2007); *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890 (3d Cir. 1975); *In re Equimed, Inc. Sec. Litig.*, No. 98-CV-5374 (NS), 2000 U.S. Dist. LEXIS 6209, at *27-28 (E.D. Pa. May 9, 2000). Such participation can be either direct or indirect involvement; defendant's inaction will suffice so long as it is apparent that the inaction "intentionally furthered the fraud or prevented its discovery." *Rhoades*, 527 F.2d at 890. District courts within the Second Circuit had been divided over whether culpable participation is an element that must be adequately pled in the complaint. *See, e.g., Baxter v. A.R. Baron & Co.*, No. 94 Civ. 3913, 1996 U.S. Dist. LEXIS 15098, at *16 (S.D.N.Y. Sept. 30, 1996) (holding that at the *pleading stage* a plaintiff need not establish culpable participation; rather, establishing control is sufficient); *Edison Fund v. Cogent Inv. Strategies Fund, Ltd.*, 551 F. Supp. 2d 210, 231 (S.D.N.Y. 2008) (to withstand motion to dismiss, plaintiff must allege culpable participation). More recently, in *Poptech, L.P. v. Stewardship Credit Arbitrage Fund, LLC*, 792 F. Supp. 2d 328, 332-34 (D. Conn. 2011), the District Court held that culpable participation is part of a plaintiff's *prima facie* case under Section 20.

The standard in the Second Circuit was not clear prior to the adoption of a culpable participation standard in *First Jersey*, 101 F.3d at 1472 (requiring control person to be "in some meaningful sense [a] culpable participant[] in the fraud perpetrated by [the] controlled person[]") (modifications in original). *See Dietrich v. Bauer*, 126 F. Supp. 2d 759, 764 n.3 (S.D.N.Y. 2001) (noting uncertainty prior to *First Jersey*); *Harrison v. Enventure Capital Group, Inc.*, 666 F. Supp. 473, 478 (W.D.N.Y. 1987) (applying "culpable participant" standard); *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980) (holding control relationship alone sufficient for pleading a *prima facie* case, but that lack of culpability is available as an affirmative defense). Even after *First Jersey*, district courts in the Second Circuit have adopted a variety of approaches as to what satisfies the "culpable participant" standard. *See, e.g., Cyber Media Group, Inc. v. Island Mortg. Network, Inc.*, 183 F. Supp. 2d 559, 576 (E.D.N.Y. 2002) (applying "willful blindness standard"); *Steed Fin. LDC v. Nomura Sec. Int'l, Inc.*, No. 00 Civ. 8058, 2001 WL 1111508, at *10 (S.D.N.Y. Sept. 20, 2001) (requiring pleading of either "conscious misbehavior or recklessness"); *Mishkin v. Ageloff*, No. 97 Civ. 2690, 1998 WL 651065, at *25 (S.D.N.Y. Sept. 23, 1998) (requiring pleading of "particularized facts of the controlling person's conscious

misbehavior as a culpable participant in the fraud”). Moreover, district courts have divided after *First Jersey* as to whether the “culpable participant” element applies only to claims under § 20(a) of the Exchange Act and not to claims under § 15 of the Securities Act. *See, e.g., In re Vivendi Universal, S.A.*, 381 F. Supp. 2d 158, 187-88 (S.D.N.Y. 2003) (culpable participation is not an element required to establish a prima facie case of control person liability pursuant to section 15); *In re Deutsche Telekom AG Sec. Litig.*, No. 00 Civ. 9475 (SHS), 2002 U.S. Dist. LEXIS 2627, at *16-20 (S.D.N.Y. Feb. 20, 2002) (same); *In re Indep. Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d 741, 769-70 (S.D.N.Y. 2001) (same) (collecting cases), *abrogated on other grounds by In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 393-97; *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 207-08 (E.D.N.Y. 2000) (concluding that because “claims under Sections 11 and 12 of the Securities Act sound in strict liability . . . the concept of culpability would not apply” to claims under § 15). *See In re Lehman Bros. Mortg.-Backed Sec. Litig.*, 2011 WL 1778726 (2d Cir. 2011) (declining to decide if § 15 requires culpable participation).

Although the Sixth Circuit has not adopted the “culpable participant” standard, district courts in the circuit have uniformly required it. *See, e.g., Sanders Confectionery Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 486 (6th Cir. 1992) (declining to state whether “culpabl[e] participat[ion]” is required); *In re FirstEnergy Corp. Sec. Litig.*, 316 F. Supp. 2d 581, 600 (N.D. Ohio 2004) (requiring “culpable participation” and finding it satisfied); *D.E. & J. Ltd. P’ship v. Conaway*, 284 F. Supp. 2d 719, 750 (E.D. Mich. 2003) (requiring “culpable participation” but dismissing § 20(a) allegations for lack of primary violation), *aff’d*, 133 F. App’x 994 (6th Cir. 2005); *In re Telxon Corp. Sec. Litig.*, 133 F. Supp. 2d 1010, 1032 (N.D. Ohio 2000); *Yadlosky v. Grant Thornton, L.L.P.*, 120 F. Supp. 2d 622, 631 (E.D. Mich. 2000); *Ballan v. Upjohn Co.*, 814 F. Supp. 1375, 1389 (W.D. Mich. 1992).

In contrast to the above courts, the Fifth, Seventh, Eighth, and Tenth Circuits reject the “culpable participant” test, and merely require the plaintiff to show that the defendant “‘actually participated in (*i.e., exercised* control over) the operations of the corporation in general . . . [and] that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this latter power was exercised.’” *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (quoting *Metge*, 577 F. Supp. at 817-18); *see also Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305, 1306 n.8 (10th Cir. 1998) (rejecting “culpable participant” standard, but recognizing and declining to address circuit split on whether actual control over general affairs or potential control is required to make out *prima facie* case);

Harrison v. Dean Witter Reynolds, Inc., 79 F.3d 609, 614 (7th Cir. 1996); *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 619-20 (5th Cir. 1993).

In the Ninth Circuit there seems to be an intra-circuit split regarding the controlling person test and the need to prove culpable participation. In *Howard v. Everex Sys., Inc.*, 228 F.3d 1057 (9th Cir. 2000), the Ninth Circuit stated a “plaintiff need not show that the defendant was a culpable participant in the violation” 228 F.3d at 1065. The *Howard* court established that a controlling person may prove lack of scienter as a good faith defense, but the plaintiff need not prove culpable participation to make out a *prima facie* case for liability. See also *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1575 (9th Cir. 1990) (en banc) (rejecting the culpable participant requirement in the “context of the broker-dealer/registered representative relationship” only but leaving open the possibility for other cases). More recently, in *In re Daou Sys. Sec. Litig.*, 397 F.3d 704, amended by 411 F.3d 1006 (9th Cir. 2005), the Ninth Circuit stated, “To state a claim under [§ 15(a) or § 20(a)], a plaintiff must allege that the individual defendants had power or influence over the company and that the individual defendants were culpable participants in the company’s alleged illegal activity.” 397 F.3d at 725 (citing *Durham v. Kelly*, 810 F.2d 1500 (9th Cir. 1987)). On denial of rehearing, however, the Ninth Circuit issued an amended opinion and struck these words from its opinion without explanation. *Daou*, 411 F.3d at 1027. See also *Knollenberg v. Harmonic, Inc.*, 152 F. App’x 674, 685 (9th Cir. 2005) (adopting the “culpable participant” standard). More recently, the Central District of California has held that the fact that an audit committee member wrote and signed a letter on behalf of the audit committee terminating the company’s auditor “leads to the inference that his responsibilities were greater than that of a mere committee member” so as to state a claim for control person liability against him, and that the chairperson of the Audit Committee was also subject to § 20(a) claim by virtue of that position. *In re China Educ. Alliance, Inc. Sec. Litig.*, 2012 WL 1155860, at *5, *7 (C.D. Cal. Apr. 6, 2012).

The Fourth and Eleventh Circuits’ test for “controlling person” differs only slightly from the *Metge* test. The relevant inquiry is whether a defendant “had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws . . . [and] had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability.” *Brown v. Enstar Group, Inc.*, 84 F.3d 393, 396-97 (11th Cir. 1996) (adopting the test articulated by the district court in *Brown v. Mendel*, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994)); see also *In re Valujet Sec. Litig.*, 984 F. Supp. 1472, 1480 (N.D. Ga. 1997) (applying the test set out in *Brown v. Enstar*). The Fourth Circuit used a “culpable participant” test in the past, see *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979); *In re*

Criimi Mae, Inc., Sec. Litig., 94 F. Supp. 2d 652, 657 (D. Md. 2000) (dicta); *In re Cryomedical Scis., Inc. Sec. Litig.*, 884 F. Supp. 1001, 1012 (D. Md. 1995), but it has adopted the test in *Brown* in more recent cases. See *In re Mutual Funds Inv. Litig.*, 566 F.3d 111, 130 (4th Cir. 2009) (applying the test in *Brown v. Enstar*), *rev'd on other grounds, Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011); *cf. In re Microstrategy, Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 659-60 & n.76 (E.D. Va. 2000) (rejecting culpable participant standard and interpreting *Carpenter v. Harris, Upham & Co, Inc.* as requiring defendant to carry burden of proving good faith).

The First and District of Columbia Circuits have not settled whether the plaintiff is required to allege culpable participation to state a claim under § 20(a). See *Aldridge*, 284 F.3d at 85 (recognizing split but declining to adopt or reject “culpable participant” standard, instead affirming dismissal of controlling person liability due to lack of allegations showing actual exercise of control); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1170 n.49 (noting, but not resolving, the “variety of interpretations” regarding the plaintiff’s burden under § 20(a)). The Court of Appeals for the First Circuit has noted repeatedly that “[c]ontrol is a question of fact that ‘will not ordinarily be resolved summarily at the pleading stage.’” *Miss. Pub. Employees’ Ret. Sys. v. Boston Scientific Corp.*, 523 F.3d 75, 93 (1st Cir. 2008) (quoting *In re Cabletron Sys., Inc.*, 311 F.3d 11, 41 (1st Cir. 2002)). With only this vague appellate court guidance, district courts in the First Circuit have reached a variety of results. See, e.g., *In re Stone & Webster, Inc., Sec. Litig.*, 253 F. Supp. 2d 102, 135 (D. Mass. 2003) (expressing uncertainty as to whether “culpable participant” standard is required but finding it met in the case at hand); *Neely v. Bar Harbor Bankshares*, 270 F. Supp. 2d 50, 53-54 (D. Me. 2003) (refusing to apply “culpable participant” standard); *In re Lernout & Hauspie Sec. Litig.*, 208 F. Supp. 2d 74, 90-91 (D. Mass. 2002) (finding possession and exercise of control sufficient). The latest relevant case in the District of Columbia Circuit suggests that a lower standard than culpable participation suffices. See *In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 24 (D.D.C. 2000) (finding ability to control sufficient, even if actual exercise of control not shown).

Some courts have suggested that a plaintiff may not simultaneously assert both Section 10(b) and Rule 10b-5 claims and Section 20(a) claims against the same defendant. See, e.g., *Lemmer v. Nu-Kote Holding, Inc.*, 2001 WL 1112577, at *12 (N.D. Tex. 2001), *aff'd*, 71 F. App’x 356 (5th Cir. 2003); *Kalnit v. Eichler*, 85 F. Supp. 2d 232, 246 (S.D.N.Y. 1999); *In re Capstead Mortg. Corp. Sec. Litig.*, 258 F. Supp. 2d 533, 566 (N.D. Tex. 2003); 183 A.L.R. Fed. 141 § 2[b] (2003) (“It is a frequent practice to plead in the alternative that a defendant is both a primary violator and a controlling person of primary violators, although, as

some courts have noted, one cannot simultaneously be both.”). The Sixth Circuit Court of Appeals noted this line of authority in *PR Diamonds, Inc. v. Chandler*, but declined to settle the question. 364 F.3d 671, 697 n.4 (6th Cir. 2004), *abrogated on other grounds by Frank v. Dana Corp.*, 646 F.3d 954 (6th Cir. 2011).

2. **Scienter and Defenses**

Neither § 15 nor § 20 by its terms contains any scienter, or even negligence, requirement. But § 15 states that the controlling person is not liable if he had no knowledge or reason to know the facts that establish the liability of the controlled person. And § 20 states that the controlling person is not liable if he acted in good faith and did not induce the acts on which the liability of the controlled person is founded. The courts have uniformly held that these are affirmative defenses, to be pleaded and proved by defendants. *See, e.g., Kaplan v. Rose*, 49 F.3d 1363, 1382-83 (9th Cir. 1994); *Marbury Mgmt., Inc.*, 629 F.2d at 716; *Gould v. Am.-Hawaiian S.S. Co.*, 535 F.2d 761, 779 (3d Cir. 1976). As discussed above, however, courts adopting the “culpable participant” standard will also require a plaintiff to prove some culpability as part of his *prima facie* case, before the burden of proving good faith shifts to the defendant. *See, e.g., Rochez Bros.*, 527 F.2d at 890.

In cases involving *brokers*, courts routinely impose a strict duty to supervise and find liability under § 15 or § 20 if supervision is negligent. *See, e.g., Carpenter*, 594 F.2d at 394; *Henricksen v. Henricksen*, 640 F.2d 880, 888 (7th Cir. 1981). In other contexts, however, no duty to supervise is imposed and something like a scienter standard reigns. *See, e.g., Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981); *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1134-35 (9th Cir. 1975). *But see Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 886 (S.D.N.Y. 1986) (construing *Marbury* to hold that the standard for controlling person liability is “mere negligence”).

3. **Statute of Limitations**

The statute of limitations governing a claim against a controlling person under § 15 or § 20 is the same as that which governs the underlying claim against the controlled person. *Klock v. Lehman Bros. Kuhn Loeb, Inc.*, 584 F. Supp. 210, 216 (S.D.N.Y. 1984); *Hill v. Equitable Trust Co.*, 562 F. Supp. 1324, 1341 (D. Del. 1983).

4. Remedies and Damages

A controlling person found liable under § 15 or § 20 is jointly and severally liable for any damages for which the controlled person is liable. Although § 21(D)(f) of the PSLRA generally imposes proportionate liability instead of joint and several liability when the defendant did not knowingly violate the securities laws, 15 U.S.C. § 78u-4(f)(2) (West 2007), the only appellate court so far to consider the interplay between the two sections determined that the PSLRA does not restrict or amend the joint and several liability provision of § 20(a). *LaPerriere v. Vesta Ins. Group, Inc.*, 526 F.3d 715, 726 (11th Cir. 2008). If the controlled person is not joined, the controlling person is liable for any damages for which the controlled person would be liable if joined. *See Keys v. Wolfe*, 540 F. Supp. 1054, 1061-62 (N.D. Tex. 1982), *rev'd on other grounds*, 709 F.2d 413 (5th Cir. 1983). Thus, the measure of damages that can be assessed against a controlling person under §§ 15 and 20 varies with the underlying claims or possible claims against the controlled person.

Sections 15 and 20 have been held to have no application to injunctive actions. *SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974). However, the Second Circuit has recognized that § 20(a) is available as an enforcement mechanism to the SEC in other contexts. *First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996).

B. Respondeat Superior

Application of the common law doctrine of respondeat superior to hold an employer secondarily liable for wrongful acts of his employee committed within the scope of employment is, of course, well accepted. Most circuits have explicitly declared this doctrine applicable under the federal securities laws, and no circuit currently regards the securities laws as supplanting liability under the doctrine. *See, e.g., In re Atl. Fin. Mgmt., Inc. Sec. Litig.*, 784 F.2d 29, 35 (1st Cir. 1986); *Marbury Mgmt.*, 629 F.2d at 716; *Paul F. Newton & Co. v. Tex. Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980); *Holloway v. Howerdd*, 536 F.2d 690, 694-5 (6th Cir. 1976); *Henricksen*, 640 F.2d at 887; *Commerford v. Olson*, 794 F.2d 1319, 1323 (8th Cir. 1986) (en banc); *Hollinger*, 914 F.2d 1564, 1576-77 (en banc).

The Third Circuit has held that the doctrine of respondeat superior is applicable in certain securities cases, such as broker-dealer fraud. *Rochez Bros., Inc.*, 527 F.2d at 884; *Sharp*, 649 F.2d at 181-83 (vicarious liability is applicable in broker-dealer cases or other cases where the principal owes a high duty of care to supervise an agent's conduct). The positions of the Fourth and Tenth Circuits are

somewhat unclear. The Fourth Circuit appeared to accept the doctrine in *Carras v. Burns*, 516 F.2d 251, 260-61 (4th Cir. 1975), but its later decision in *Carpenter*, 594 F.2d 388, which discussed controlling person liability under the Securities Acts without referring to agency principles of liability, cast its earlier decision in doubt. District courts in the Fourth Circuit have disagreed over the status of its law. Compare *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303, 1311-12 (E.D. Va. 1981) (holding that *Carpenter* overruled *Carras* and that remedies under the securities laws are not concurrent with principles of agency liability), with *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 740-42 (W.D. Va. 1982) (rejecting *Haynes* and finding remedies concurrent), and *Baker v. Wheat First Sec.*, 643 F. Supp. 1420, 1425-27 (S.D. W. Va. 1986) (same). The Tenth Circuit, in *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 741 (10th Cir. 1974), held that a corporation could be found vicariously liable for its president's securities fraud, but did not address the issue of concurrent liability under the securities and common laws. Most courts have interpreted *Kerbs* as permitting respondeat superior liability under the securities laws. See, e.g., *Atl. Fin. Mgmt., Inc.*, 784 F.2d at 30 (citing *Kerbs* in support of vicarious liability); *Seolas v. Bilzerian*, 951 F. Supp. 978, 983 (D. Utah 1997) (respondeat superior is viable theory of liability under § 10(b)); *Castleglen, Inc. v. Commonwealth Sav. Ass'n*, 689 F. Supp. 1069, 1071-72 (D. Utah 1988) (noting differing interpretations of *Kerbs* and holding securities laws do not preempt common law remedies), *aff'd sub nom. Castleglen, Inc. v. Resolution Trust Corp.*, 984 F.2d 1571 (10th Cir. 1993); cf. *Haynes*, 508 F. Supp. at 1309 (stating that *Kerbs* does not definitively resolve the issue). The Eleventh Circuit has not addressed the issue directly, but under the rule of *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981), it is bound by the Fifth Circuit's decision in *Paul F. Newton & Co.*, 630 F.2d 1111, rendered before the division between the two Circuits. See *In re Villa*, 261 F.3d 1148, 1152 (11th Cir. 2001) (citing *Newton* and noting that § 20(a) and respondeat superior liability are distinct). No courts in the District of Columbia have directly addressed the issue. See *SEC v. Nat'l Student Mktg. Corp.*, 457 F. Supp. 682, 701 n.42 (D.D.C. 1978) (the court ruled in favor of the SEC's vicarious liability claims; though the SEC did not state possible grounds for the liability, the court suggested that respondeat superior could be one of them).

The precedential force of these cases, to the extent they involve a claim based on secondary liability under Rule 10b-5, is questionable after the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). *Central Bank*, discussed below, rejected the availability of aiding and abetting liability under § 10(b). However, the impact of *Central Bank* on agency theories of liability is still unclear. Some courts have held that respondeat superior liability under § 10(b) remains in spite of *Central Bank*. See,

e.g., *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d Cir. 2001) (holding that *Central Bank* did not shield business entities from being held liable for misstatements of their agents); *AT & T Co. v. Winback & Conserve Program, Inc.*, 42 F.3d 1421, 1430-31 (3d Cir. 1994) (concluding, based on detailed comparison of aiding and abetting liability and agency liability, that *Central Bank* did not preclude the latter); *In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 172 (D. Mass. 2002) (“[A]gent liability remains a viable theory of liability after *Central Bank*. . . .”); *Gabriel Capital, L.P. v. NatWest Fin., Inc.*, 122 F. Supp. 2d 407, 430-31 (S.D.N.Y. 2000) (concluding that agency liability survived *Central Bank*, but holding that “a principal can be liable under § 10(b) for the misrepresentations of its agent only if the person to whom the misrepresentations were made knows that the agent is acting under the actual or apparent authority of the principal”); *cf. Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353 (5th Cir. 2004) (sustaining a respondeat superior liability claim without ever referring to *Central Bank*). Some courts have held the opposite. *See, e.g., In re Fidelity/Micron Sec. Litig.*, 964 F. Supp. 539, 543-44 (D. Mass. 1997); *Converse, Inc. v. Norwood Venture Corp.*, No. 96 Civ. 3745, 1997 U.S. Dist. LEXIS 19106, at *7-11 (S.D.N.Y. Nov. 26, 1997); *ESI Montgomery Cty., Inc. v. Montenay Int’l Corp.*, No. 94 Civ. 0119 (RLC), 1996 U.S. Dist. LEXIS 592, at *7-8 (S.D.N.Y. 1996).

C. Aiding and Abetting versus Direct Participation

Prior to the Supreme Court’s ruling in *Central Bank of Denver*, 511 U.S. at 164, discussed below, a majority of the circuit courts of appeal had held that civil liability could be imposed on those who aided and abetted primary violations of the securities laws. *See, e.g., Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1126-28 (5th Cir. 1988); *Orloff v. Allman*, 819 F.2d 904, 907 (9th Cir. 1987); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *Armstrong v. McAlpin*, 699 F.2d 79, 91 (2d Cir. 1983). The major disagreement among these courts concerned the conditions under which inaction could be viewed as actionable assistance. Several courts had ruled that inaction could lead to liability only when there was an independent duty to act. *See, e.g., SEC v. Rogers*, 790 F.2d 1450, 1459 (9th Cir. 1986); *Kerbs*, 502 F.2d at 740; *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973). Others had ruled that inaction can be the basis of aiding and abetting liability where there was a specific intent to further the primary violation of the securities laws. *See, e.g., Nat’l Union Fire Ins. Co. v. Turtur*, 892 F.2d 199, 206-07 (2d Cir. 1989); *Abell*, 858 F.2d at 1127; *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 36 (D.C. Cir. 1987); *Armstrong*, 699 F.2d at 91; *IIT v. Cornfeld*, 619 F.2d 909, 927 (2d Cir. 1980), *abrogated by Morrison v. Nat’l Austl. Bank, Ltd.*, 130 S. Ct. 2869 (2010); *Rochez Bros.*, 527 F.2d at 889.

Although most of these cases arose under § 10(b), courts had also approved aiding and abetting theories in § 11 and § 12 cases. *See, e.g., In re Caesars Palace Sec. Litig.*, 360 F. Supp. 366, 378 (S.D.N.Y. 1973). *But see Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126-27 (2d Cir. 1989) (rejecting aiding and abetting liability under § 12(2) based on *Pinter*); *Drexel Burnham Lambert, Inc. v. Am. Bankers Ins. Co.*, No. 88-146-CIV-5, 1989 U.S. Dist. LEXIS 16402, at *3-4 (E.D.N.C. Nov. 8, 1989) (same).

The Supreme Court swept away all of these precedents in *Central Bank of Denver*, 511 U.S. 164 (1994). There, the Court held that § 10(b) would not support a cause of action for aiding and abetting. *Cent. Bank of Denver*, 511 U.S. at 191. Moreover, the Court suggested in dictum that no aiding and abetting liability would lie under any of the liability provisions of the Acts. *Id.* In particular, the Court noted that had Congress intended the securities laws to encompass aiding and abetting behavior, Congress would have expressly so provided. The Court held that in the absence of any mention of such behavior, courts should not infer a cause of action. *Id.* at 183-84.

Following *Central Bank*, courts grappled with whether parties, such as accountants and lawyers, traditionally subject to liability under an aiding and abetting theory may be made subject to primary liability for their role in preparing misleading information. In some circuits, notably the Ninth, this liability attached even if the misstatement was made by another party. *See, e.g., Ponce v. SEC*, 345 F.3d 722, 737 (9th Cir. 2003); *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000); *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628 & n.3 (9th Cir. 1994); *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 314-16 (S.D.N.Y. 1996) (holding an underwriter primarily liable for material misstatements in a prospectus), *aff'd mem.*, 108 F.3d 1370 (2d Cir. 1997); *Walco Invs., Inc. v. Thenen*, 881 F. Supp. 1576, 1582 (S.D. Fla. 1995) (holding that a law firm may be liable for drafting misleading solicitation documents); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (finding accounting firm to be “intricately involved” in the creation of false documents, and holding its “resulting deception” to be a primary violation of § 10(b)); *In re MTC Elec. Techs. S’holders Litig.*, 898 F. Supp. 974, 986 (E.D.N.Y. 1995), *vacated in part*, 993 F. Supp. 160 (E.D.N.Y. 1997). *But see Tricontinental Indus., Ltd. v. Anixter*, 256 F. Supp. 2d 806, 807 (N.D. Ill. 2003) (denying motion for reconsideration and holding that auditor that did no more than endorse corporation’s allegedly fraudulent documents could not be held primarily liable for securities fraud), *rev’d in part on other grounds* by 313 F. Supp. 2d 785 (N.D. Ill. 2004).

The Second, Fourth, Tenth and Eleventh Circuits, and district courts in the First and Third Circuits, have restricted this “preparatory liability.” These courts have

held that it is not sufficient merely to participate in the preparation of the misrepresentation; rather, the party must actually *make* a false or misleading statement to be liable after *Central Bank*. These courts used what was referred to as the “bright line test”: for example, *In re Mutual Funds Inv. Litig.*, 566 F.3d 111, 121 (4th Cir. 2009), *reversed by Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), required that allegations that a defendant “participat[ed] in the writing and dissemination” of a prospectus sufficiently identify that defendant as the “maker” of supposed misstatements in the prospectus. *See also Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 369-70 (4th Cir. 2004) (instructing district court on remand to examine whether accounting firm made a public misrepresentation for which it may be found primarily liable); *Ziamba v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205, 1207 (11th Cir. 2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 n.10 (10th Cir. 1996); *SEC v. Lucent Techs., Inc.*, 363 F. Supp. 2d 708 (D.N.J. 2005) (discussing the evolution of the “bright line” test and, in the absence of Third Circuit guidance, adopting it as the proper one to determine if a claim for aiding and abetting liability will lie); *In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1256 (S.D.N.Y. 1996), *vacated in part, rev’d in part on other grounds*, 206 F.3d 302 (3d Cir. 2000); *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26, 28 (D. Mass. 1994) (accountant’s “review and approval” of financial statements and prospectuses insufficient); *Vosgerichian v. Commodore Int’l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) (allegations that accountant “advised” and “guid[ed]” client in making allegedly fraudulent misrepresentations insufficient). At least one court adopted an intermediate position advocated by the SEC. *See In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002) (holding that when secondary actor writes misrepresentation for inclusion in a document on which investor-plaintiff relies, such defendant “makes” material misstatement and can be liable as primary violator under § 10(b), even if defendant’s identity is not disclosed to investors, and even if defendant did not “initiate” such misrepresentations). However, the First Circuit, sitting en banc, held that a person using or disseminating a third party’s statement without regard to its authorship has not “made” a statement as the term is used in Rule 10b-5. *SEC v. Tambone*, 597 F.3d 436 (1st Cir. 2010) (en banc).

In the Second Circuit, a defendant did not have to make a false or misleading statement directly to the plaintiff in order to be liable; it was enough that the defendant “knows or should know that the misrepresentation will be communicated to the plaintiff.” *Gabriel Capital, L.P. v. Natwest Fin., Inc.*, 94 F. Supp. 2d 491, 508 (S.D.N.Y. 2000); *accord Enron*, 235 F. Supp. 2d at 588. However, a defendant would not be liable for a misleading statement

communicated via a third party unless that third party attributed the statement to the defendant at the time of its dissemination. *Pacific Inv. Mgmt. Co. v. Mayer Brown, LLP*, 603 F.3d 144 (2d Cir. 2010) (holding that a law firm which drafted securities documents containing false statements is not liable as a primary violator under § 10(b) if the false statements were not attributed to the firm or its attorneys at the time of dissemination by the client); *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998); *see also Gabriel Capital, L.P. v. Natwest Fin., Inc.*, 122 F. Supp. 2d 407, 420-21 (S.D.N.Y. 2000) (holding that plaintiffs cured defects in prior complaint when they specifically alleged that representatives attributed false statements to defendant when made).

Similarly, a defendant in the Fourth Circuit did not have to make a false or misleading statement directly to the plaintiff in order to be liable. Rather, “a plaintiff seeking to rely on the fraud-on-the-market presumption must ultimately prove that interested investors (and therefore the market at large) would attribute the allegedly misleading statement to the defendant.” *In re Mutual Funds Inv. Litig.*, 566 F.3d at 124. A defendant may be liable if “interested investors would attribute to the defendant a substantial role in preparing or approving the allegedly misleading statement.” *Id.*

The Sixth Circuit held that attorneys may also be subject to primary liability under Rule 10b-5, if the attorney failed to provide “complete and non-misleading information with respect to subjects on which he undertakes to speak.” *Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263, 268 (6th Cir. 1998). Similarly, the Ninth Circuit followed the approach in *Rubin* and held that “[a]n attorney who undertakes to make representations to prospective purchasers of securities is under an obligation, imposed by Section 10(b), to tell the truth about those securities. That he or she may have an attorney-client relationship with the seller of the securities is irrelevant under Section 10(b).” *Thompson v. Paul*, 547 F.3d 1055, 1063 (9th Cir. 2008). A Third Circuit opinion appeared to combine the “significant involvement” and actual statement tests—holding that lawyers may be liable under 10b-5 when they “significantly participate in the creation of their client’s misrepresentations . . . [such that] they may fairly be deemed authors or co-authors.” *Klein v. Boyd* [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) 90,136, at 90,324 (3d Cir. 1998); *accord Enron*, 235 F. Supp. 2d at 588. That judgment was vacated, however, and rehearing en banc granted. *Klein v. Boyd*, Nos. 97-1143 & 97-1261, 1998 U.S. App. LEXIS 4121 (3d Cir. Mar. 9, 1998). The appeal was subsequently dismissed with prejudice by stipulation of the parties.

The Supreme Court however, has put into question this case law imposing primary 10b-5 liability on parties who would have been considered aiders and

abettors prior to *Central Bank*. In *Janus Capital Grp., Inc. v. First Derivatives Traders*, 131 S. Ct. 2296 (2011), the Court, following *Central Bank*, held that Rule 10b-5 liability may only be imposed on the “maker” of the statement alleged to be materially false or misleading. “For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not ‘make’ a statement in its own right.” *Id.* at 2302. Accordingly, a company that created a mutual fund and acted as its investment adviser and administrator was not the maker of an allegedly false statement in the Fund’s prospectus. *See also, e.g., In re Optimal U.S. Litig.*, No. 10 Civ. 4095, 2011 WL 4908745, at *5 (S.D.N.Y. Oct. 14, 2011) (rejecting conflation of shareholder control with “ultimate authority” and finding that, while investment manager owned all voting shares, statements were “made” by the company, not the manager). However, at least one district court has applied *Janus* to find liability against a firm even where it did not “control” the content of private placement memoranda, where it was involved in drafting and preparing the memoranda and where its name appeared prominently on the document. *In re Nat’l Century Fin. Enters., Inc.*, --- F. Supp. 2d ----, 2012 WL 685495, at *19 (S.D. Ohio Mar. 2, 2012). This was particularly so where the defendant “took these statements and put them into investors’ hands” despite not having authored every word: “It is fraud to knowingly provide false information to another person, regardless of who originally drafted the words.” *Id.* at *20.

In another effort to circumvent *Central Bank*’s limitation on aiding and abetting liability, plaintiffs had advanced a theory that secondary actors, such as investment banks, that have no duty to disclose and do not prepare or participate in preparing a corporation’s financial misstatements could nonetheless be held liable under Rule 10b-5 as participants in a “scheme to defraud.” For example, plaintiffs sought to impose such “scheme” liability on counterparties to dubious transactions that have the effect of permitting a struggling corporation to meet quarterly earnings targets and present a false picture of financial health — *i.e.*, an agreement to purchase assets from a corporation at one price and then sell the assets back to the corporation at a higher price in a later quarter.

The Supreme Court rejected scheme liability theory in private actions in deciding *Stoneridge Inv. Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148 (2008). In that case, Charter, a cable operator, overpaid defendant Scientific Atlanta for the purchase of cable boxes. *Id.* at 154. In exchange, Scientific Atlanta overpaid for advertising that it purchased from Charter. *Id.* As a result, Charter accounted for the advertising revenue as income while capitalizing the equal and offsetting cable box expense, thus boosting its operating cash flow numbers for the year to meet investor expectations. *Id.* at 154-55. Scientific Atlanta also fraudulently

backdated the contracts and fabricated documents to imply that the transactions occurred in the ordinary course of business, thus acting with knowing or reckless disregard of Charter's intent to defraud investors by making it unlikely that its auditors would connect the transactions and recognize the lack of economic substance. *Id.* The Court held that the defendants were not liable because they "had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either, actual or presumed, of [defendants'] deceptive acts during the relevant times." *Id.* at 159. The Court explicitly rejected the argument that "in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect." *Id.* at 160. It reached this conclusion based on (1) a fear that otherwise "the implied cause of action would reach the whole marketplace in which the issuing company does business," *id.*, (2) a common-law torts argument that Charter severed the chain of proximate cause because "nothing [Defendants] did made it necessary or inevitable for Charter to record the transactions as it did," *id.* at 160-61, (3) a fear that private litigation would invade "areas already governed by functioning and effective state-law guarantees," *id.* at 161, (4) an *exclusio unius* argument that Congress foreclosed private actions for secondary liability by amending § 104 of the PSLRA in the wake of *Central Bank* to grant express enforcement power to the SEC for secondary liability but not to private litigants, *id.* at 162-63, and (5) a fear that private actions would raise the costs of doing business and discourage overseas firms from doing business in this country, *id.* at 163-64.

Some commentators believe that it is unclear whether the result in *Stoneridge* would hold for investment banks, accountants, lawyers or other defendants who act "in the investment sphere" because the opinion includes an observation that "[u]nconventional as the arrangement was, it took place in the marketplace for goods and services, *not in the investment sphere.*" *Id.* at 774 (emphasis added). This has led these commentators to wonder whether scheme liability might still attach to actors with financial or legal expertise. *See, e.g.,* Michael L. Rugen, *Stoneridge And Enron -- Are Secondary Actors Free From Liability For Securities Fraud?*, 13 No. 21 Andrews' Bank & Lender Liab. Litig. Rep. 11; Kaye Scholer, *Supreme Court Rejects "Scheme Theory" of Liability and Curbs Investor Suits Against Secondary Actors*, <http://www.kayescholer.com/web.nsf/s/A96A2BEA9CB1DA7B852573D2006C3300>. A certiorari petition in an Enron-related case that was pending while the Supreme Court was considering and deciding *Stoneridge* squarely presented exactly this question, *Regents of the University of California v. Credit Suisse First Boston, Inc.*, 482 F.3d 372 (5th Cir. 2007), *cert. denied*, 128 S. Ct. 1120 *sub nom. Regents of Univ. of Cal. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, and the petition urged the Court hear the

case for that reason. Petition for Writ of Certiorari at 28, *Regents of the Univ. of Cal. v. Merrill Lynch Pierce Fenner & Smith, Inc.*, No. 06-1341, 2007 WL 1059567 (5th Cir. Apr. 5, 2007). Nevertheless, the Court denied the petition following its decision in *Stoneridge*, keeping in place the Fifth Circuit's decision rejecting scheme liability in the circumstances of that case. Three circuits — the Second, Eighth, and Ninth — have held that scheme liability claims “must be based on conduct beyond misrepresentations or omissions actionable under Rule 10b-5(b).” *Public Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 987 (8th Cir. 2012) (citing *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011)), and *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005)).

In response to the SEC's complaint that its enforcement authority was significantly diminished as a result of the *Central Bank* decision, Congress in enacting the Reform Act created new Exchange Act Section 20(e), which expressly allows the SEC to bring actions against those who knowingly aid or abet primary violations for either an injunction or a civil money penalty. 15 U.S.C.A. § 78t(f) (West 1997 & Supp. 2003). The provision does not grant a private right of action for aiding and abetting, and thus the core holding of *Central Bank of Denver* remains intact.

In order for a defendant to be liable as an aider and abettor in a civil enforcement action, the SEC must prove: “(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) ‘knowledge’ of this violation on the part of the aider and abettor; and (3) ‘substantial assistance’ by the aider and abettor in the achievement of the primary violation.” *SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009) (quoting *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 62 (2d Cir. 1985)). In *SEC v. Apuzzo*, --- F.3d ----, 2012 WL 3194303 (2d Cir. Aug. 8, 2012), the Second Circuit, quoting Judge Learned Hand's formulation in *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938), for establishing a criminal defendant's liability as an aider and abettor, held that to establish the “substantial assistance” element as to a defendant in an SEC enforcement action, the SEC “must . . . prove ‘that he in some sort associate[d] himself with the venture, that [the defendant] participate[d] in it as in something that he wishe[d] to bring about, [and] that he [sought] by his action to make it succeed.’” *Apuzzo*, 2012 WL 3194303, at *6 (quoting *Peoni*, 100 F.2d at 402). In reversing the district court's dismissal of the SEC's complaint, the Second Circuit held that to establish the “substantial assistance” element, “the SEC is not required to plead or prove that an aider and abettor proximately caused the primary securities law violation.” *Id.* at *7.

In *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004), the D.C. Circuit discussed the level of scienter the SEC must establish for an aiding and abetting violation and held it sufficient if the SEC proved that the aider and abettor acted with “extreme recklessness.” 376 F.3d 1136, at 1142-43 (citing *Investors Research Corp. v. SEC*, 628 F.2d 168 (D.C. Cir. 1980)). In her concurrence, Judge Henderson described the majority opinion’s acceptance of an extreme recklessness standard as a “new . . . scienter level.” *Id.* at 1150-51 (Henderson, J., concurring).

In 2010, the Dodd-Frank Act amended Section 20(e) of the Exchange Act to make clear that the SEC’s authority to bring enforcement actions against aiders and abettors of Exchange Act violations encompassed “reckless” as well as “knowing” conduct. § 929O. Dodd-Frank also added Section 15(b) to the Securities Act to empower the SEC to pursue actions premised on knowingly or recklessly aiding or abetting violations of that Act (and added similar provisions to the Investment Company Act of 1940 and the Investment Advisors Act of 1940). §§ 929M, 929N. Dodd-Frank requires the Comptroller General to conduct a study analyzing the impact of authorizing a private right of action for aiding and abetting violations of the federal securities laws, but does not overturn Supreme Court authority denying such actions. § 929Z.

D. Conspiracy

A few courts have invoked conspiracy theories to hold peripheral defendants liable in civil suits under the securities laws for the primary violations of others. *See Herpich v. Wilder*, 430 F.2d 818, 819 (5th Cir. 1970); *Shell v. Hensley*, 430 F.2d 819, 827 n.13 (5th Cir. 1970); *Dasho v. Susquehanna Corp.*, 380 F.2d 262, 267 n.2 (7th Cir. 1967); *Tex. Cont’l Life Ins. Co. v. Dunne*, 307 F.2d 242, 249 (6th Cir. 1962); *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946). All of these cases arise under § 10(b) of the Exchange Act, and none discusses the conspiracy theory in detail. The leading case appears to be *Dasho*, in which the court said that a defendant may be found liable for having joined a conspiracy to violate the securities laws and taken steps to further it. 380 F.2d at 267 n.2. This standard was followed in *Hensley*, 430 F.2d at 827 n.13.

In light of the Supreme Court’s holding in *Central Bank*, the availability of conspiracy as a theory of liability is in doubt. *See Central Bank*, 511 U.S. at 200 n.12 (Stevens, J., dissenting) (“The Court’s rationale would sweep away the decisions recognizing that a defendant may be found liable in a private action for *conspiring* to violate § 10(b) and Rule 10b-5.”) (emphasis in original). Numerous courts have held that the *Central Bank* rationale forecloses conspiracy liability. *See, e.g., In re Glenfed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) (citing *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1098 (N.D. Cal. 1994)); *Epstein v.*

MCA, Inc., 50 F.3d 644, 648-49 n.7 (9th Cir. 1995) (“We reject [plaintiff’s] attempt to avoid *Central Bank*’s restrictions on private aiding and abetting actions by using the label ‘conspiracy.’”) (Rules 14d-10 and 10b-13), *rev’d on other grounds sub nom. Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367 (1996); *In re Faleck & Margolies, Ltd.*, Nos. 89 Civ. 8548 (SWK), 90 Civ. 1356 (SWK), 1995 U.S. Dist. LEXIS 970, at *34-37 (S.D.N.Y. Jan. 27, 1995); *Otto v. Variable Annuity Life Ins. Co.*, No. 82 C 4762, 1995 U.S. Dist. LEXIS 3352, at *3 (N.D. Ill. Mar. 16, 1995); *In re Cypress Semiconductor Sec. Litig.*, 891 F. Supp. 1369, 1381 (N.D. Cal. 1995), *aff’d mem. sub nom. Eisenstadt v. Allen*, 113 F.3d 1240 (9th Cir. 1997); *Upton v. McKerrow*, 887 F. Supp. 1573, 1580 (N.D. Ga. 1995). The Second Circuit has held that *Central Bank* precludes not only aiding and abetting claims under 10b-5, but conspiracy claims as well. *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 842 (2d Cir. 1998); *accord Farey-Jones v. Buckingham*, 132 F. Supp. 2d 92, 102-03 (E.D.N.Y. 2001). However, a few courts have found that conspiracy liability does survive *Central Bank*. *See, e.g., Wenneman v. Brown*, 49 F. Supp. 2d 1283, 1289-90 & n.3 (D. Utah 1999); *Trafton v. Deacon Barclays de Zoete Wedd Ltd.*, No. C 93 2758-FMS, 1994 U.S. Dist. LEXIS 20971, at *71 (N.D. Cal. Oct. 19, 1994) (holding that *Central Bank* does not extend to conspiracy claims).

E. Contribution

As noted, § 11 of the Securities Act and § 18 of the Exchange Act expressly provide a right to contribution. The Supreme Court has held that there is a right to pro rata contribution for liability imposed under the § 10(b) implied private cause of action. *Musick, Peeler & Garrett v. Emp’rs Ins. of Wausau*, 508 U.S. 286, 298 (1993); *see also Asdar Grp. v. Pillsbury, Madison & Sutro*, 99 F.3d 289, 295-96 (9th Cir. 1996) (holding that for contribution actions the then one-year/three-year statute of limitation is measured from the time the party seeking contribution pays a judgment in an amount that exceeds its liability).

Even prior to the Supreme Court’s ruling, the clear trend among lower courts was toward finding a right of contribution under all the liability provisions of the securities laws, particularly § 10(b). *See, e.g., In re Jiffy Lube Sec. Litig.*, 927 F.2d 155, 160 (4th Cir. 1991); *Smith v. Mulvaney*, 827 F.2d 558, 560 (9th Cir. 1987); *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 578 (2d Cir. 1982); *Tucker v. Arthur Andersen & Co.*, 646 F.2d 721, 727 n.7 (2d Cir. 1981); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 557-59 (5th Cir. 1981), *aff’d in part, rev’d in part on other grounds*, 459 U.S. 375 (1983); *Heizer Corp. v. Ross*, 601 F.2d 330, 334 (7th Cir. 1979); *Baker v. BP Am., Inc.*, 749 F. Supp. 840, 842-43 (N.D. Ohio 1990). *But see Chutich v. Touche Ross & Co.*, 960 F.2d 721, 724 (8th Cir. 1992);

Robin v. Doctors Offcenters Corp., 730 F. Supp. 122, 125 (N.D. Ill. 1989); *In re Prof'l Fin. Mgmt., Ltd.*, 683 F. Supp. 1283, 1285-87 (D. Minn. 1988).

Some courts also have held that there is no right of contribution under § 12(2) of the Securities Act. See *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1104-06 (4th Cir. 1989) (en banc); *In re Prof'l Fin. Mgmt., Ltd.*, 683 F. Supp. at 1285-86. In light of *Musick, Peeler*, these cases will likely be overruled by the courts that decided them.

The Reform Act, through subsection 21D(f) of the Exchange Act, instituted proportionate rather than joint and several liability for any violation that is not “knowingly committed” by a “covered person,” defined as one liable under either the Exchange Act or, in the case of defendant outside directors, under § 11 of the Securities Act. It also creates an explicit right of contribution—“covered persons” have an explicit right to contribution from (1) other “covered persons” held proportionately or jointly and severally liable, or (2) any other person responsible for the violation. The provision states that for purposes of this provision only, “reckless” conduct is not “knowingly committed.” A defendant is liable for an uncollectible share in proportion to his share, up to 50 percent of the dollar amount of the defendant’s original proportionate share. If an individual plaintiff has a net worth of \$200,000 or less and the judgment is equal to more than 10 percent of her net worth, all defendants are jointly and severally liable for the uncollectible share.

F. Indemnification and Insurance

Indemnification is not available for infractions of the federal securities laws committed *with knowledge*. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969); *cf. Stamford Bd. of Educ. v. Stamford Educ. Ass’n*, 697 F.2d 70, 74 (2d Cir. 1982) (citing *Globus* and denying indemnification in a case brought under the Civil Rights Act and Fair Labor Standards Act). For liability not based on knowing misrepresentation, indemnification is not prohibited, but it is penalized in effect for companies making public offerings. Item 512(i) of Regulation S-K denies acceleration of effectiveness for a registration statement if provisions for such indemnification by the issuer exist, unless the registration statement states that in the SEC’s view such provisions are contrary to public policy and unenforceable. As a general matter, indemnification is not expressly provided for in the federal securities laws, and, therefore, will be available only in limited instances where such a right can be implied under the relevant statute or rule or is available as a matter of federal common law. See, e.g., *Tex. Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 638 (1981); *In re Cont'l Airlines*, 203 F.3d 203, 215-16 (3d Cir. 2000) (expressing disfavor for indemnification of

securities law violations); *Eichenholtz v. Brennan*, 52 F.3d 478, 483 (3d Cir. 1995) (no express or implied right to indemnification under the federal securities laws); *In re U.S. Oil & Gas Litig.*, 967 F.2d 489, 495 (11th Cir. 1992) (same); *First Golden Bancorporation v. Weiszmann*, 942 F.2d 726, 728-29 (10th Cir. 1991) (no indemnity for § 16(b) violation); *Riverhead Sav. Bank v. Nat'l Mortg. Equity Corp.*, 893 F.2d 1109, 1116 (9th Cir. 1990) (no indemnification under federal securities laws); *Baker, Watts & Co.*, 876 F.2d at 1106 (no right to indemnification under § 12(2)); *King v. Gibbs*, 876 F.2d 1275, 1280 (7th Cir. 1989) (no implied right to indemnification under § 10(b) or Rule 10b-5); *Arden Way Assocs. v. Boesky*, 664 F. Supp. 863, 865 (S.D.N.Y. 1987) (finding indemnification available if liability is vicarious or imputed); *Thomas v. Duralite Co.*, 386 F. Supp. 698, 727-28 (D.N.J. 1974) (permitting indemnification action by employer against violating employee), *aff'd in part, vacated in part on other grounds*, 524 F.2d 577 (3d Cir. 1975); *deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809, 816 (D. Colo. 1968) (same), *aff'd in part, vacated in part on other grounds*, 435 F.2d 1223 (10th Cir. 1970).

No similar prohibitions or penalties attach to the use of insurance for liabilities under the securities laws, and nothing prevents repayment of the expenses of a successful defense of a suit under the securities laws.