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# Caselaw Developments 2015

William O. Fisher
*University of Richmond*, bfisher@richmond.edu



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## Overview[1]

*Supreme Court*. The Supreme Court held that an opinion can be false, for securities law purposes, if the speaker or writer disbelieves the opinion when delivering it, if the opinion includes embedded facts that are false, or if, in context, a reasonable investor would be misled by the omission of material facts relating to the opinion, such as the analysis or investigation on which it is based.[2]

*SEC rulemaking*. The D.C. Circuit held invalid, as violating the First Amendment, the portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and implementing regulation that required public companies to include in their conflict minerals disclosures statements that certain products were not "DRC conflict free."[3]

*SEC enforcement actions*. The Eleventh Circuit affirmed a judgment that a public relations firm aided and abetted a client's Rule 10b-5 violation and that the public relations firm had violated the registration requirement by selling stock with which the client paid for services.[4] Both the D.C. Circuit and the Seventh Circuit rejected attempts by respondents in administrative enforcement proceedings before the Securities and Exchange Commission ("SEC" or "Commission") to enjoin those proceedings on constitutional grounds by lawsuits that the respondents filed in federal district courts.[5]

*Proxy solicitation*. The Third Circuit ruled that the "ordinary business operations" exception to Rule 14a-8 permitted Wal-Mart to exclude from its proxy materials a shareholder resolution designed to discourage the retailer from selling firearms with ten-round magazines.[6]

*Forward-looking statements*. The D.C. Circuit ruled that warning language accompanying statements about inventory were not "meaningful" so as to invoke the statutory protections for forward-looking statements where the warnings did not disclose that the issuer was holding large amounts of obsolete product

1. The caselaw developments section covers opinions decided during the calendar year 2015. Where this portion of the annual review expresses opinions, they are those of the author of the caselaw developments, William O. Fisher, and not necessarily the opinions of other authors contributing to the annual review, or of members of the subcommittee producing the review, or of the American Bar Association.

2. *See infra* notes 29–65 and accompanying text.

3. *See infra* notes 66–79 and accompanying text.

4. *See infra* notes 82–129 and accompanying text.

5. *See infra* notes 130–62 and accompanying text.

6. *See infra* notes 163–96 and accompanying text.

that it could not sell without heavy discounts.[7] The Eighth Circuit found an issuer's statements that a federal regulator would protect the exclusivity of a product to be "forward-looking" and that the issuer's cautions were "meaningful," in a case where the agency later declined to enforce the exclusivity.[8]

*Insider trading*. Reacting to the 2014 *Newman* decision by the Second Circuit, the Ninth Circuit held that the intangible benefit one family member derives from making a gift to another family member suffices for the personal benefit the original tipper must receive, and of which the tippee must know, in order for the tippee to be liable under the traditional theory of insider trading.[9]

*Materiality*. The D.C. Circuit held that a representation of "very strong sales" was material, rejecting the issuer's argument that the statement constituted mere puffery, where the issuer was accumulating obsolete inventory of the product to which the statement referred.[10] The Second Circuit ruled that statements about an acquisition—including that "[t]here are a lot of areas where [the acquired company] just goes ching, ching, ching"—were puffery, and also held (although the panel divided on this ruling) that, where the market knew a bank needed to raise capital in the face of deteriorating conditions during the credit crisis, the difference between whether a regulator "required" the bank to raise capital versus "encouraged" the bank to do so was immaterial.[11] The First Circuit held that a thin showing of materiality argued against a finding of scienter,[12] and both the First and the Second Circuits suggested that a defendant, in at least some contexts, can challenge the materiality of misrepresentations in transactions between professionals in the financial industry even if professionals in that industry—who were involved in the transactions at issue—testify that the misrepresentations were important to them.[13]

*Duty to disclose*. Disagreeing with a Ninth Circuit decision published in 2014, the Second Circuit held that Regulation S-K Item 303(a)(3)(ii) defines a duty to disclose, the violation of which can support a Rule 10b-5 claim, provided that the omitted facts are material and the other elements of a Rule 10b-5 case are proved.[14]

*Scienter and scienter pleading*. Courts of Appeals addressed scienter in cases where plaintiffs asserted Rule 10b-5 claims criticizing (i) accounting, (ii) other financial disclosures, and (iii) statements by issuers in the drug and medical device industry. The Ninth and Second Circuits addressed (iv) more general scienter questions.

Four notable decisions addressed scienter in cases involving alleged accounting wrongdoing. The Eleventh Circuit held that plaintiffs failed to adequately plead scienter where they asserted that the issuer reported $100 million in

7. *See infra* notes 204–29 and accompanying text.
8. *See infra* notes 230–50 and accompanying text.
9. *See infra* notes 251–66 and accompanying text.
10. *See infra* notes 273–76 and accompanying text.
11. *See infra* notes 277–95 and accompanying text.
12. *See infra* notes 296–311 and accompanying text.
13. *See infra* notes 296–331 and accompanying text.
14. *See infra* notes 332–56 and accompanying text.

cash but defaulted on a $3.5 million debt.[15] The Second Circuit found insufficient allegations that an auditor of a China-based company acted with severe recklessness in failing to compare the financial results that the company submitted to a Chinese regulator with the results in the statements that the auditor audited for submission to the SEC.[16] The Tenth Circuit found wanting scienter allegations against a company that delayed disclosing a billing dispute with a major customer until information about the dispute, which occurred in a foreign country, escalated to the company's U.S. headquarters, management conducted an investigation, and the company resolved the billing with the customer.[17] The Fifth Circuit rejected scienter allegations as inadequate in a case based significantly on asserted misvaluation of mortgage-backed securities, with the court emphasizing that such valuations required subjective judgments.[18]

In an additional case where plaintiffs alleged financial fraud, the Tenth Circuit ruled that plaintiffs adequately pled severe recklessness when a chief executive officer ("CEO") allegedly mischaracterized the reason a strategic investor declined to complete the purchase of an interest in the issuer's assets, with the court rejecting the CEO's argument that he was acting on behalf of the company and its shareholders by couching his disclosure in terms calculated to preserve the issuer's opportunity to sell the interest to some other party at a high price.[19]

Two decisions considered scienter allegations against issuers in the drug and medical device industry. The First Circuit found no adequate scienter pleading where a company said—during a long-running interaction with the Food and Drug Administration ("FDA") over off-label promotion—that the company had a policy against off-label marketing and that it was cooperating with the FDA.[20] The Fourth Circuit found scienter properly pled where the defendants specifically described a meeting with the FDA and an FDA briefing document but, in each case, left out information that showed a decreased chance that the agency would approve the issuer's drug.[21]

Finally, two cases addressed more general scienter issues. The Ninth Circuit considered when the scienter of an officer can be imputed to his or her corporation. The court held that the "adverse interest" exception to such imputation does not apply where the officer communicates with investors with apparent authority created by the company.[22] The Second Circuit decided that scienter does not require an intent to harm.[23]

*Primary violation of Rule 10b-5(b)*. The Seventh Circuit held that *Janus* applies to determine which corporate officers "made" statements for purposes of Rule 10b-5(b), and considered how the *Janus* test—of actual control over

15. *See infra* notes 370–82 and accompanying text.
16. *See infra* notes 383–406 and accompanying text.
17. *See infra* notes 407–24 and accompanying text.
18. *See infra* notes 425–55 and accompanying text.
19. *See infra* notes 456–68 and accompanying text.
20. *See infra* notes 469–500 and accompanying text.
21. *See infra* notes 501–29 and accompanying text.
22. *See infra* notes 530–39 and accompanying text.
23. *See infra* notes 540–43 and accompanying text.

content and dissemination—identifies appropriate officer defendants in private lawsuits based on press releases and other corporate disclosures.[24]

*Loss causation and reliance in open market cases*. The Seventh Circuit set out a protocol of shifting burdens of proof to account for non-fraud, firm-specific information in econometric models used for loss causation and damages.[25] In the same case, the appellate court affirmed the manner in which a trial court—in a second phase of a trial, following a first phase directed to class-wide issues—provided the defense with an opportunity to challenge individual class member reliance on the integrity of the market.[26] The Fifth Circuit found no abuse of discretion in trial court certification of one class in the BP oil spill securities litigation, where differences over whether certain disclosures were "corrective" raised common questions, and no abuse of discretion in the denial of a second class, where plaintiffs' theory required a class-member-by-class-member determination of whether the investor would have bought BP securities at all if the investor had known that the company had no effective plan to deal with a catastrophic blowout.[27]

*Securities Litigation Uniform Standards Act ("SLUSA")*. The Second Circuit set out an elaborate taxonomy of instances in which state-law claims might include an allegation that someone—whether a defendant or another actor—violated the anti-falsity provisions of the federal securities laws with respect to the purchase or sale of "covered securities," as SLUSA defines that term, and, for each category, stated whether SLUSA precluded the allegation or not.[28]

## Supreme Court Addresses Opinions

In *Virginia Bankshares, Inc. v. Sandberg*, the Supreme Court held directors' opinions, that a cash-out merger of minority stockholders for $42 per share provided a "high" value and a "fair" price, were actionable as "facts" under section 14(a) and Rule 14a-9 of the Securities Exchange Act of 1934 ("Exchange Act").[29] The Court reached that conclusion because those opinions were, in "a commercial context[,] . . . reasonably understood to rest on a factual basis that justifie[d] them as accurate, the absence of which render[ed] them misleading."[30] Thus, "whether $42 was 'high,' and the proposal 'fair' to the minority shareholders, depended on whether provable facts about the [issuer's] assets, and about actual

24. *See infra* notes 544–64 and accompanying text.

25. *See infra* notes 575–90 and accompanying text (discussing loss causation and burden shifting); *see also infra* notes 571–604 and accompanying text (discussing the case generally).

26. *See infra* notes 591–604 and accompanying text (discussing rebuttal of presumption of reliance); *see also infra* notes 571–604 and accompanying text (discussing the case generally).

27. *See infra* notes 605–28 and accompanying text.

28. *See infra* notes 629–60 and accompanying text.

29. 501 U.S. 1083, 1088, 1091–95 (1991). Exchange Act section 14(a) makes it unlawful to use the mails or interstate commerce to solicit a proxy to vote a security registered under section 12 of that act if the solicitation violates rules prescribed by the SEC. 15 U.S.C. § 78n(a)(1) (2012). Rule 14a-9 prohibits solicitations "containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material *fact*." 17 C.F.R. § 240.14a-9 (2015) (emphasis added).

30. *Virginia Bankshares*, 501 U.S. at 1093.

and potential levels of operation, substantiated a value that was above, below, or more or less at the $42 figure, when assessed in accordance with recognized methods of valuation."[31]

The Court considered "whether disbelief, or undisclosed belief or motivation, standing alone, should be a sufficient basis to sustain an action under § 14(a), absent proof by . . . objective evidence . . . that the statement also expressly or impliedly asserted something false or misleading about its subject matter."[32] *Virginia Bankshares* held that "proof of mere disbelief or belief undisclosed should *not* suffice for liability under § 14(a)," but added that "it would be rare to find a case with evidence solely of disbelief or undisclosed motivation without further proof that the statement was defective as to its subject matter."[33] The *Virginia Bankshares* opinion generated considerable controversy over whether an opinion, in order to be actionable under the securities laws, must be both subjectively false in the sense that the speaker or author disbelieves the opinion and objectively false in the sense that the underlying facts the opinion implies are untrue. This question is particularly important in (i) cases where plaintiffs sue under Rule 10b-5, because a claim under that rule includes a scienter element[34] that, by itself, seems to encompass subjective falsity when the case rests on defendants' stated opinions, and (ii) cases where plaintiffs make a claim under section 11 of the Securities Act of 1933 ("Securities Act"), which does not require scienter,[35] and where therefore requiring subjective falsity appears to import a mental state that the cause of action does not include.[36]

In 2015, the Court revisited opinions in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*.[37] The plaintiffs brought a section 11 claim against the issuer for including in a registration statement (i) its "belie[f that] our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state laws[,]" and (ii) its "belie[f that] our contracts with pharmaceutical manufacturers are legally and economically valid arrangements."[38] The plaintiffs alleged that, in fact, Omnicare's contracts violated anti-kickback laws.[39] In reversing a district court dismissal, the Sixth Circuit held that the plaintiffs "had to allege

31. *Id.* at 1094.
32. *Id.* at 1095–96.
33. *Id.* at 1096 (emphasis added).
34. *See infra* note 357 and accompanying text.
35. *See In re* Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 359 (2d Cir. 2010).
36. *See In re* Omnicare, Inc. Sec. Litig., 769 F.3d 455, 470–71 (6th Cir. 2014) (holding, in a Rule 10b-5 action, that objective falsity sufficed to prove that an opinion was false, with any required subjective falsity wrapped into the scienter analysis). *Compare* Rubke v. Capitol Bancorp Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009) (holding opinions actionable, in a section 11 claim, "only if the complaint alleges . . . that the statements were both objectively and subjectively false or misleading").
37. 135 S. Ct. 1318 (2015).
38. *Id.* at 1323.
39. *Id.* at 1324.

only that the stated belief was 'objectively false'; they did not need to contend that anyone at Omnicare 'disbelieved [the opinion] at the time it was expressed.'"[40]

The Supreme Court vacated and remanded for further consideration in light of its extended analysis.[41] The majority opinion focused on the language of section 11, which provides a cause of action where a registration statement, at the time it became effective, "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[42] Justice Kagan interpreted that section to impose liability in two instances—(i) where the opinion constituted a false fact,[43] and (ii) where the opinion misled because it omitted material facts.[44] Because a statement of belief—such as a CEO's belief that his or her company's contracts comply with the law—"explicitly affirms one fact: that the speaker actually holds the stated belief," the stated belief "would subject the issuer to liability (assuming the misrepresentation were material)" if it "falsely describe[d the CEO's] state of mind."[45] The complaint in *Omnicare* did not allege falsity in this first way because "the Funds d[id] not contest that Omnicare's opinion was honestly held" and could therefore not prevail simply by showing "that Omnicare's belief turned out to be wrong—that whatever the company thought, it was in fact violating anti-kickback laws."[46] As Justice Kagan put it, "a sincere statement of pure opinion is not an 'untrue statement of material fact,' regardless whether an investor can ultimately prove the belief wrong."[47] The majority acknowledged that a stated belief might also be false if it "contain[ed] embedded statements of fact" (as where a CEO said "I believe our TVs have the highest resolution available because we use a patented technology to which our competitors do not have access") and the "supporting fact" was false (*e.g.*, that the issuer did not use a patented technology).[48] But Omnicare's statements were "pure . . . opinion[s]" that did not recite supporting facts.[49]

The majority, however, concluded that the plaintiffs might prevail on the alternative theory that the issuer's statements of belief in its legal compliance were misleading because those statements omitted facts.[50] The Court held that "a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker's basis for holding that view."[51] If that were

40. *Id.* (quoting Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc., 719 F.3d 498, 506 (6th Cir. 2013) (quoting Fait v. Regions Fin. Corp., 655 F.3d 105, 110 (2d Cir. 2011))).
41. *Id.* at 1333.
42. 15 U.S.C. § 77k(a) (2012).
43. *Omnicare*, 135 S. Ct. at 1326–27.
44. *Id.* at 1327–32.
45. *Id.* at 1326.
46. *Id.* at 1327.
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.* at 1327–33.
51. *Id.* at 1328.

the case, then, drawing on the *Restatement (Second) of Torts*, "liability may result from omission of facts—for example, the fact that the speaker failed to conduct any investigation—that rebut the recipient's predictable inference."[52] Whether an expressed belief would lead a reasonable investor to understand some underlying basis for the speaker's opinion and, if so, what the reasonable investor would understand that basis to be will depend, the majority said, on context.[53] Thus, an investor will assume that more careful analysis underlies an expressed belief in a "formal document[]" like a registration statement than in "off-the-cuff judgments," and an investor will also understand the analysis underlying an expressed opinion "in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information" and "customs and practices of the relevant industry."[54] Moreover, whether a particular fact that cuts against an opinion renders the opinion misleading because that fact is not disclosed depends on the omitted fact. Thus, if "in stating an opinion about legal compliance, the issuer did not disclose that a single junior attorney expressed doubts about a practice's legality, when six of his more senior colleagues gave a stamp of approval[,] . . . [t]hat omission would not make the statement of opinion misleading, even if the minority position ultimately proved correct."[55] That is because a "reasonable investor does not expect that *every* fact known to an issuer supports its opinion statement."[56] The majority emphasized that, in order to assert this second basis for liability for an opinion, an "investor must identify particular (and material) facts going to the basis for the issuer's opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."[57]

The plaintiffs alleged in *Omnicare* "that an attorney had warned [the company] that a particular contract 'carrie[d] a heightened risk' of legal exposure under anti-kickback laws."[58] Thus, on remand, the lower court should "determine whether [the complaint] adequately alleged that Omnicare had omitted that (purported) fact, or any other like it, from the registration statement," taking into "consideration of such matters [(i)] as the attorney's status and expertise and other legal information available to Omnicare at the time . . . [, (ii)] whatever facts Omnicare *did* provide about legal compliance, as well as [(iii)] any other hedges, disclaimers, or qualifications it included in its registration statement."[59]

52. *Id.* at 1330 (citing RESTATEMENT (SECOND) OF TORTS § 539 cmt. a (AM. LAW INST. 1976)).
53. *Id.*
54. *Id.*
55. *Id.* at 1329.
56. *Id.*
57. *Id.* at 1332.
58. *Id.* at 1333 (quoting plaintiffs' complaint).
59. *Id.* (with the last including, "for example, the information Omnicare offered that States had initiated enforcement actions against drug manufacturers for giving rebates to pharmacies, that the Federal Government had expressed concerns about the practice, and that the relevant laws 'could be interpreted in the future in a manner' that would harm Omnicare's business" (quoting registration statement)).

*Significance and analysis.* The most disturbing aspect of *Omnicare* is that the majority did not attempt to integrate its analysis with *Virginia Bankshares*. This is important in two respects. First, *Virginia Bankshares* held that an opinion cannot be a "fact" at all—for securities law prohibitions against making untrue statements of "fact"—unless the opinion is one that a reasonable investor would understand, in the relevant commercial context, to rest on proveable, underlying objective facts.[60] *Omnicare* does not address this holding and, presumably leaves it in place. Nevertheless, it is disturbing that the majority failed to expressly tie the *Virginia Bankshares* analysis into the *Omnicare* analysis in this obvious way.

Second, *Virginia Bankshares* held expressly that subjective falsity is not enough to impose liability for an opinion.[61] The *Omnicare* majority held that an opinion is actionable if it is material and the author did not believe the opinion when he or she professed.[62] Seeking to reconcile this view with *Virginia Bankshares*, the majority characterized the earlier decision as dealing with "the rare hypothetical case . . . in which a speaker expresses an opinion that she does not actually hold, but that turns out to be right."[63] The *Omnicare* majority then conceded that *Virginia Bankshares* "qualifies" the *Omnicare* holding so that no violation occurs where the defendant, in stating a belief, thought "he was lying while actually (i.e., accidentally) telling the truth about the matter addressed in his opinion."[64] This suggests that, in order to prevail on the theory that an opinion is false because the speaker or writer did not believe it, the plaintiff must plead and prove both that the defendant did not believe the opinion and that the opinion was objectively false.[65] On the other hand, where the plaintiff proceeds on the theory that the opinion is false because "embedded facts" are false, the plaintiff will not need to prove any subjective disbelief but only falsity of the embedded facts. Similarly, if the plaintiff proceeds on the theory that, in context, the opinion misleads by omission, the plaintiff does not need to prove the speaker or writer disbelieved his or her opinion, but only that the omitted fact was material and rendered the opinion misleading. *Omnicare* does not address the relationship between falsity and scienter in a Rule 10b-5 action.

## SEC Rulemaking

The Dodd-Frank Act required the SEC to adopt a regulation directing public companies to disclose information about conflict minerals necessary to the function or production of their products.[66] The SEC issued an elaborate implement-

60. *See supra* notes 29–31 and accompanying text.
61. *See supra* note 33 and accompanying text.
62. *Omnicare*, 135 S. Ct. at 1326–27.
63. *Id.* at 1329 n.7.
64. *Id.* at 1326 n.2.
65. Perhaps, the majority meant that the objective truth is an affirmative defense.
66. Pub. L. No. 111-203, § 1502, 124 Stat. 1376, 2213 (2010) (codified at 15 U.S.C. § 78m(p) (2012)).

ing regulation.[67] In 2014, the D.C. Circuit rejected a challenge to that regulation, with one exception.[68] The exception held unconstitutional a requirement, in the statute and in the implementing regulation, that public companies identify certain products as not "DRC [Democratic Republic of the Congo] conflict free" in reports that the companies had to file with the SEC and post on their websites.[69] After a subsequent decision in the same circuit upheld a requirement that meat product labels include country-of-origin,[70] the panel that had published the 2014 opinion on the conflict minerals regulation reheard the constitutional challenge to that rule.[71] In 2015, the panel (two to one) adhered to its 2014 view and struck down—as violating the First Amendment—the part of the statute and the part of the regulation demanding that issuers publicly identify products as not "DRC conflict free," a requirement that, in the majority's view, forced companies to publicly shoulder moral responsibility for atrocities in the Congo.[72]

The D.C. Circuit considered the challenged requirement under two different tests: (i) the test applicable to commercial speech, which can be compelled provided that (a) the government seeks to advance a substantial interest, and (b) the required speech directly advances that interest in a manner that could not be accomplished as well by a narrower intrusion on free expression; and (ii) the test applicable to factual and uncontroversial information about products and services, which can be compelled if the required speech is reasonably related to the government's interest in protecting consumers from deceptive advertising.[73] As to the first part of the first test, the D.C. Circuit majority found that the government interest behind the requirement that public companies identify certain products as not "DRC conflict free" was to "ameliorat[e] the humanitarian crisis in the DRC."[74] The majority treated this as "a sufficient interest of the United States."[75] The requirement, however, could not pass the second part of the first test because the notion that the reporting requirement would reduce atrocities in the Congo rested on "speculation or conjecture."[76]

67. Conflict Minerals, 77 Fed. Reg. 56274 (Sept. 12, 2012) (to be codified at 17 C.F.R. pts. 240 & 249b).

68. Nat'l Ass'n of Mfrs. v. SEC, 748 F.3d 359, 373 (D.C. Cir. 2014) [hereinafter *Nat'l Ass'n of Mfrs. I*], *overruled in part by* Am. Meat Inst. v. U.S. Dep't of Agric., 760 F.3d 18, 22–23 (D.C. Cir. 2014) (en banc); *see Caselaw Developments 2014*, 70 Bus. Law. 903, 911–16 (2015) [hereinafter *2014 Caselaw Developments*] (discussing *Nat'l Ass'n of Mfrs. I*).

69. *Nat'l Ass'n of Mfrs. I*, 748 F.3d at 370–73.

70. *Am. Meat Inst.*, 760 F.3d at 20; *id.* at 22–23 (repudiating *Nat'l Ass'n of Mfrs. I*, 748 F.3d at 370–73).

71. Nat'l Ass'n of Mfrs. v. SEC, 800 F.3d 518, 519–20 (D.C. Cir. 2015) [hereinafter *Nat'l Ass'n of Mfrs. II*].

72. *Id.* at 530.

73. *Id.* at 519–30. The test for commercial speech derives from *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York*, 447 U.S. 557, 564 (1980). The test for disclosures designed to prevent deception of consumers derives from *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626, 651 (1985).

74. *Nat'l Ass'n of Mfrs. II*, 800 F.3d at 524 (quoting SEC brief).

75. *Id.*

76. *Id.* at 524–27 (quoting Edenfield v. Fane, 507 U.S. 761, 770 (1993)).

The D.C. Circuit majority held that the second test did not apply because the required disclosure was not related to advertising or protection of consumers.[77] Moreover, even if the test did apply, the disclosure that particular products were not "DRC conflict free" was not limited to factual and uncontroversial information.[78] Instead, it required companies to accept moral responsibility for wrongdoing, even though that responsibility was a matter of significant disagreement.[79]

## SEC Enforcement Actions

The Eleventh Circuit held last year that a public relations firm was liable for aiding and abetting its client's fraud on brokers and investors and also that the firm violated the registration requirement by taking stock from the client in payment of fees and then reselling the stock to raise cash needed for operations.[80] Both the D.C. Circuit and the Seventh Circuit affirmed dismissals of actions brought in federal court to enjoin, at their outset, SEC administrative enforcement proceedings on the grounds that the proceedings allegedly violated constitutional rights.[81]

*Public relations company exposure for helping issuer increase investor interest. SEC v. Big Apple Consulting USA, Inc.* demonstrates the dangers of providing public relations services to an issuer for the purpose of stimulating trading in the issuer's stock.[82] Big Apple Consulting USA, Inc. ("Big Apple") and its subsidiaries sold public relations and investor relations services to small companies.[83] As part of its work, Big Apple "operated a telephone call room that contacted registered securities brokers and dealers to disseminate public information in order to create interest in client companies and their stock."[84] One Big Apple subsidiary contracted to provide services to CyberKey Solutions, Inc. ("CyberKey"), with the Big Apple subsidiary specifically committing to "diligently market and promote [CyberKey] to brokers . . . and [ ] introduce [CyberKey] and its principals to [the Big Apple subsidiary's] current and future network of brokerage firms and market makers."[85] CyberKey paid the Big Apple subsidiary with CyberKey stock, and the subsidiary purchased options on additional CyberKey shares.[86] This arrangement was typical for Big Apple, as ninety-five percent of its clients paid with stock.[87]

77. *Id.* at 524 ("[W]e therefore hold that *Zauderer* has no application to this case.").
78. *Id.* at 527–30; *see id.* at 524 ("Even if . . . *Zauderer* governed the analysis, we still believe that the statute and the regulations violate the First Amendment.").
79. *Id.* at 530.
80. *See infra* notes 82–129 and accompanying text.
81. *See infra* notes 130–62 and accompanying text.
82. 783 F.3d 786 (11th Cir. 2015).
83. *Id.* at 790.
84. *Id.* at 791.
85. *Id.* (quoting contract). Although CyberKey contracted with one Big Apple subsidiary, the parties understood that Big Apple and its subsidiaries would provide the services. *Id.*
86. *Id.*
87. *Id.*

CyberKey falsely told Big Apple that CyberKey had valuable contracts with U.S. government agencies, including the Department of Homeland Security ("DHS").[88] In late 2005, the CyberKey CEO gave a contract to Big Apple principals, claiming that it documented the transaction with DHS.[89] While the Big Apple principals did not look at the contract closely, the contract showed obvious signs of fraud—with the counterparty identified in several places as the State of Connecticut, rather than DHS, and with the contract award date specified differently on different pages of the document.[90] Nevertheless, Big Apple and a subsidiary publicized the supposed DHS contract through press releases, some of which announced that CyberKey had shipped product to DHS and received two $4.2 million payments from that government agency.[91]

In January 2006, CyberKey provided a financial statement to one of the Big Apple principals showing only $6,000 in cash, despite CyberKey having supposedly received the first payment of $4.2 million from DHS, and CyberKey subsequently failed to engage an outside auditor to review its financials, despite urging from the Big Apple principal to do so.[92] In the summer of 2006, a vice president of a Big Apple subsidiary prepared a memorandum that listed various "broken promises" by CyberKey.[93] In August 2006, a DHS official contacted a Big Apple subsidiary to say that he could not locate the purchase order referred to in a CyberKey press release.[94] The SEC eventually sued the CyberKey CEO, who was also indicted and convicted of securities fraud.[95]

Over the course of its relationship with CyberKey, Big Apple and one of its subsidiaries sold some 720 million shares of CyberKey stock for about $7.8 million.[96] The Big Apple companies never disclosed to investors or brokers that Big Apple was being paid in CyberKey stock.[97]

The SEC sued Big Apple, two subsidiaries, and individuals associated with the Big Apple companies.[98] The district court granted summary judgment to the SEC on claims that (i) Big Apple, a subsidiary, and an individual defendant violated section 5 of the Securities Act; (ii) Big Apple and a subsidiary violated section 15(a) of the Exchange Act, which requires that brokers and dealers register with the SEC; and (iii) two individual defendants aided and abetted the violations of section 15(a).[99] A jury then found that Big Apple, both subsidiary defendants, and the related individuals had violated section 17(a) of the Securities Act and found that they also aided and abetted CyberKey's violations of Rule 10b-5.[100]

88. *Id.* at 792.
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.* at 793.
93. *Id.*
94. *Id.*
95. *Id.* at 794.
96. *Id.* at 793–94.
97. *Id.* at 792–93.
98. *Id.* at 790, 794.
99. *Id.* at 794.
100. *Id.*

In affirming the resulting judgment,[101] the Eleventh Circuit provided four holdings worth noting here. First, the court rejected the defendants' argument that they "did not have ultimate authority over the content of CyberKey's press releases," so that, under *Janus*, "they could not be considered 'makers' of any material misstatements and thus could not be liable under the provisions of § 17(a), which they assert[ed] are 'largely coextensive in scope' to those of Rule 10b-5."[102] The court observed that section 17(a)(2) "renders it 'unlawful for any person in the offer or sale of any securities . . . to obtain money or property *by means of* any untrue statement of a material fact or any omission to state a material fact,'" which, to the court, "'suggest[ed] . . . it is irrelevant for purposes of liability whether the seller uses his own false statement or one made by another individual.'"[103] Thus, the *Janus* ruling[104] on who "makes" a statement for purpose of Rule 10b-5(b)—which prohibits the "mak[ing]" of untrue statements in connection with securities transactions—does not apply to section 17(a)(2).[105] Further, subsections (a)(1) and (a)(3) of section 17 do not contain the word "make" and "are in no way directly or indirectly affected by the *Janus* decision."[106]

In its second noteworthy holding, the Eleventh Circuit addressed aiding and abetting. At the time of the violations, Exchange Act section 20(e) permitted the SEC to bring aiding and abetting claims against "any person who 'knowingly provides substantial assistance' to a primary violator of the Exchange Act."[107] The Dodd-Frank Act amended the provision so that it now permits the SEC to bring such claims against "any person that knowingly *or recklessly* provides substantial assistance" to such a violator.[108] The defendants argued that, because their conduct took place before the amendment, the SEC had to prove that the defendants charged with aiding and abetting had "'actual knowledge' of CyberKey's and [its CEO's] violations of § 10(b) and Rule 10b-5."[109] The Eleventh Circuit reviewed the history of section 20(e) and concluded that—before the Dodd-Frank Act—the Eleventh Circuit and "[e]very other circuit to consider the issue . . . acknowledged that severe recklessness could suffice" for aiding and abetting liabil-

101. *Id.* at 814.

102. *Id.* at 795. *Compare* 15 U.S.C. § 77q(a)(2) (2012) ("obtain money or property by means of any untrue statement"), *with* 17 C.F.R. § 240.10b-5(b) (2015) (" . . . make any untrue statement . . ."). In *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011), the Court held that, "[f]or purposes of Rule 10b–5[(b)], 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."

103. *Big Apple*, 783 F.3d at 796–97 (first quoting 15 U.S.C. § 77q(a)(2) (2012) (emphasis added by the court); and then quoting SEC v. Tambone, 550 F.3d 106, 127 (1st Cir. 2008)). In the *Tambone* case, the First Circuit granted *en banc* review of the panel opinion and withdrew that opinion. *See* SEC v. Tambone, 573 F.3d 54 (1st Cir. 2009). Thereafter, the First Circuit, sitting *en banc*, reinstated the panel's analysis of section 17(a)(2) of the Securities Act. *See* SEC v. Tambone, 597 F.3d 436, 450 (1st Cir. 2010) (en banc).

104. *See supra* note 102.

105. *Big Apple*, 783 F.3d at 797.

106. *Id.* at 796; *see id.* at 797–98 (quotation from 798).

107. *Id.* at 798 (quoting 15 U.S.C. § 78t(e) (2000)).

108. Pub. L. No. 111-203, § 929O, 124 Stat. 1376, 1862 (2010) (codified at 15 U.S.C. § 78t(e) (2012)) (emphasis added to show amendment).

109. *Big Apple*, 783 F.3d at 798.

ity.[110] Congress amended the statute to add the words "or recklessly" to codify those judicial holdings and to correct lower court decisions that held otherwise.[111] Because recklessness therefore sufficed, the Eleventh Circuit affirmed the district court's summary judgment against individual defendants for aiding and abetting Big Apple's failure to register as a broker/dealer, as the lower court had found that those defendants "were at least severely reckless in providing substantial assistance to Big Apple's and [its subsidiary's] § 15(a) violations."[112] The court of appeals similarly held that the lower court properly instructed the jury "that it could find that the defendants acted 'knowingly' for purposes of § 20(e) if the defendants 'knew or were *severely reckless* in not knowing that [CyberKey's CEO] and CyberKey . . . were fraudulently disseminating false statements that CyberKey had obtained a $25 million DHS contract.'"[113]

The Eleventh Circuit's third significant holding approved a "deliberate ignorance" instruction that informed the jurors that they "may infer knowledge of the existence of a fact if a [d]efendant was aware of a high probability of the existence of that fact and purposely contrived to avoid learning [it]."[114] The instruction added that, "[i]f you find by a preponderance of the evidence that a [d]efendant intentionally avoided knowledge or enlightenment, you may find that [d]efendant acted knowingly or recklessly."[115] After noting that the Supreme Court has approved use of "deliberate ignorance" instructions in civil cases,[116] the court of appeals rejected a defense argument that the instruction improperly deviated from the Eleventh Circuit pattern instruction by failing to tell the jury that it could not find that a defendant was deliberately ignorant of a fact if the defendant "actually believed" that the fact did not exist.[117] The appellate court reasoned that the instruction's focus on intentionally avoiding knowledge was sufficient because "a defendant who did not actually believe there was fraud would not be 'intentionally avoid[ing] knowledge or enlightenment' because he would have nothing to believe he was avoiding."[118]

Fourth and finally, the *Big Apple* decision affirmed the summary judgment against Big Apple, a subsidiary, and an individual for violating section 5 of the Securities Act, which prohibits the interstate sale of securities unless the sale occurs pursuant to an effective registration statement or unless the sale is exempt from registration.[119] Conceding that the SEC proved its prima facie case by showing that Big Apple sold millions of shares of CyberKey stock in unregistered

110. *Id.* at 800 (collecting cases).

111. *Id.* at 799–801.

112. *Id.* at 798 (quoting district court).

113. *Id.* (quoting jury instruction) (emphasis added by appellate court). Moreover, the jury had expressly found that the defendants "acted both with actual knowledge and with severe recklessness." *Id.* at 801.

114. *Id.* at 803 (quoting jury instruction) (first alteration by appellate court).

115. *Id.* at 803–04 (quoting jury instruction) (second and third alterations by appellate court).

116. *Id.* at 802–03 (citing Global-Tech Appliances, Inc. v. SEB S.A., 131 S. Ct. 2060, 2069 (2011)).

117. *Id.* at 804–05 (quoting pattern jury instruction).

118. *Id.*

119. *Id.* at 806–10.

transactions, the defendants claimed that they had proved the sales fell within section 4(a)(1) of the Securities Act, which exempts "transactions by any person other than an issuer, underwriter, or dealer."[120] The Eleventh Circuit held that this exemption did not apply because the district court properly determined that the defendants were "underwriters" and that Big Apple and its subsidiary were "dealers."[121]

The Securities Act defines "underwriter" to include "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security."[122] The definition focuses on "investment intent at the time of acquisition," with a rule of thumb "that a two-year holding period is sufficient to negate the inference that the security holder did not acquire the securities with a 'view to distribute.'"[123] While the defendants claimed they had held CyberKey stock for six months and "maybe even longer," that holding period fell short of the two years that would negate an inference of purchase for distribution.[124] Moreover, evidence presented by the SEC showed acquisitions and sales very close in time.[125] While the defendants argued that they took CyberKey stock in payment for services, the court found that fact to reinforce the conclusion that they were underwriters, as it was "difficult to fathom how Big Apple could operate by receiving stock *not* with a 'view toward' distribution in order to maintain its own operating costs."[126]

The Securities Act defines a "dealer" to include "any person who engages either for all or part of his time, directly or indirectly, . . . in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."[127] Big Apple and its subsidiaries fell comfortably into this definition as their "*entire* business model was predicated on the . . . sale of securities" received from clients in exchange for services provided by Big Apple.[128]

*Significance and analysis*. Beyond showing how tricky it is to stay on the right side of the law when providing public relations services to companies for the purpose of raising their profile with investors and brokers, *Big Apple* provides a rare decision on the statutory exemption provided by section 4(a)(1) of the Securities Act. In doing so, the opinion demonstrates the continuing vitality of the

120. *Id.* at 807 (quoting 15 U.S.C. § 77d(a)(1) (2012)).

121. *Id.* at 807–10.

122. 15 U.S.C. § 77b(a)(11) (2012).

123. *Big Apple*, 783 F.3d at 807 (citations omitted).

124. *Id.* (quoting defendants).

125. *Id.* at 808 (citing the acquisition—and, within one month, the sale—of 300 million shares and the acquisition—and, on the same day, the sale—of 6 million shares).

126. *Id.* The defendants pointed to the six-month holding period in Rule 144. *Id.* at 809 (citing 17 C.F.R. § 230.144(d) (2015)). The court, however, declined to read that holding period into the statutory exemption provided by section 4(a)(1), as the defendants did not otherwise qualify for Rule 144 protection. *Id.*

127. 15 U.S.C. § 77b(a)(12) (2012).

128. *Big Apple*, 783 F.3d at 809.

two-year holding period rule of thumb.[129] The decision also illustrates the problems facing any services provider—whether a public relations firm or law firm or other—that takes stock as compensation, where the sale of the stock is consistently necessary to satisfy the service provider's cash flow needs.

*Timing of challenges to SEC choice to proceed by administrative enforcement.* The SEC may bring an enforcement action either in federal district court or in an administrative proceeding before one of the SEC's administrative law judges ("ALJs").[130] Two circuit courts held, in 2015, that respondents in administrative proceedings could not challenge the SEC's decisions to proceed in that forum by suing in federal court before the administrative proceedings ran their course.

In the first case, the Commission filed an administrative proceeding against George Jarkesy, Jr. and the investment advisory firm he headed, also naming as respondents a broker-dealer and another individual defendant—alleging violations of the Exchange Act, the Securities Act, the Investment Advisers Act, and the Investment Company Act.[131] After the broker-dealer and the other individual settled and the SEC issued an order that both approved that settlement and included "findings" that were not binding on Mr. Jarkesy or his advisory firm, but implicated them, Mr. Jarkesy and his advisory firm filed an action in federal court seeking an injunction to prevent the SEC from continuing with the administrative proceeding against them.[132] They alleged that the continuation of that proceeding would violate their (i) Fifth Amendment due process rights because the SEC had prejudged them by the findings it made in approving the settlement with the other respondents; (ii) equal protection rights because they were denied a right to a jury trial (which they would have had if the Commission had proceeded in federal court); and (iii) equal protection rights because the SEC pursued them out of animus.[133] They also contended that the SEC administrative proceeding should be stopped because the Commission had (iv) violated the Administrative Procedure Act ("APA") by engaging in ex parte communications with the settling respondents; and (v) failed to provide discovery that the SEC was required by its own rules to produce.[134]

Affirming the district court's dismissal of the case[135] on the ground that the statutory scheme for administrative proceedings "implicitly precluded concurrent district-court jurisdiction over challenges like Jarkesy's,"[136] the D.C. Circuit employed the analysis set out in *Thunder Basin Coal Co. v. Reich*.[137] This analysis required Mr. Jarkesy to "proceed exclusively through [the] statutory scheme of

129. 1 Louis Loss et al., Fundamentals of Securities Regulation 568 (6th ed. 2011) (tracing the two-year presumption back to comments made by SEC Commissioner Manuel F. Cohen in the 1960s).

130. 15 U.S.C. §§ 78u(d), 78u-2, 78u-3 (2012).

131. Jarkesy v. SEC, 803 F.3d 9, 13 (D.C. Cir. 2015).

132. *Id.*

133. *Id.* at 14.

134. *Id.*

135. *Id.* at 12, 30.

136. *Id.* at 12.

137. *Id.* at 15 (citing Thunder Basin Coal Co. v. Reich, 510 U.S. 200, 207 (1994)).

administrative and judicial review when (i) [a congressional] intent [that the respondent do so] is 'fairly discernible in the statutory scheme,' and (ii) the litigant's claims are 'of the type Congress intended to be reviewed within [the] statutory structure.'"[138]

Turning to the first prong of the analysis, the court of appeals found the requisite intent because the securities statutes provided a "comprehensive structure for the adjudication of securities violations in administrative proceedings," including Commission review of ALJ decisions followed by the opportunity to seek review of an adverse Commission decision in a federal court of appeals.[139] By statute, Congress left the choice of forum to the SEC, and the Commission's right to make its choice "could be for naught if respondents like Jarkesy could countermand the Commission's choice by filing a court action."[140]

The appellate court then divided the second prong of the analysis into three factors: (i) whether the judicial review provided by statute to Mr. Jarkesy was "meaningful"; (ii) whether his attack through his federal court action was "wholly collateral" to his administrative proceeding; and (iii) whether his federal court claims were outside the SEC's area of expertise.[141] As to the first factor, the court rejected Mr. Jarkesy's contention that judicial review was not meaningful because the SEC could not adjudicate constitutional challenges to the statutes that permitted the administrative proceeding, reasoning that his "constitutional claims . . . can eventually reach 'an Article III court fully competent to adjudicate' them."[142] Nor was Mr. Jarkesy deprived of a meaningful review because he had to go through a costly administrative proceeding to get to a court of appeals because—unlike a litigant who had to break a law that he or she would not otherwise break in order to generate a controversy to raise a constitutional question—Mr. Jarkesy was "already properly before the Commission by virtue of his alleged violations."[143] Moreover, the review was not without meaning because the ALJ had denied Mr. Jarkesy's requests for discovery to prove some of his claims, as an appeals court could always remand the matter to the SEC for further factual development, if necessary.[144]

As to the second factor, Mr. Jarkesy's claims were not "wholly collateral" to his administrative proceeding because several of them—such as that the Commission had (i) prejudged his case by making non-binding findings against him in the order settling with other respondents, (ii) violated the APA through ex parte communications with the other respondents during settlement with them, and (iii) failed to provide required discovery—were "inextricably intertwined with the conduct of the very enforcement proceeding the statute grants

138. *Id.* (quoting *Thunder Basin*, 510 U.S. at 207, 212) (last alteration by D.C. Circuit).
139. *Id.* at 16–17.
140. *Id.* at 17.
141. *Id.* (quoting *Thunder Basin*, 510 U.S. at 212–13).
142. *Id.* at 19 (quoting Elgin v. Dep't of Treasury, 132 S. Ct. 2126, 2137 (2012)).
143. *Id.* at 20.
144. *Id.* at 22.

the SEC the power to institute and resolve as an initial matter."[145] The D.C. Circuit declined to parse the claims finely in order to create collateral issues because doing so would produce ambiguous analysis that "would encourage respondents in administrative enforcement proceedings to frame their challenges [in ways to conform to any 'collateral' issues a close analysis might conjure] . . . and thereby earn access to another forum in which to advance their arguments."[146]

Turning to the third factor of the second prong of the *Thunder Basin* analysis, the court granted that the SEC might not have special expertise in certain of the constitutional issues Jarkesy raised, but found that the Commission was fully capable of addressing such matters as whether the settlement with the other respondents prejudiced Mr. Jarkesy and his other attacks on the fairness of the proceeding.[147] Moreover, if the administrative proceeding resolved in Mr. Jarkesy's favor, the constitutional claims could be avoided, and even if not, the Commission might interpret the securities laws in such a way that would "answer or shed light on" those claims.[148]

Resolving both prongs of the *Thunder Basin* analysis against him, the D.C. Circuit held "that the securities laws provide an exclusive avenue for judicial review that Jarkesy may not bypass by filing suit in district court."[149]

The Seventh Circuit reached a similar result, albeit with a less rigorous analysis, in *Bebo v. SEC*.[150] The SEC brought an administrative enforcement proceeding against Laurie Bebo, alleging that, while CEO, she had manipulated internal records at her company, lied to auditors, and made false disclosures to the Commission.[151] Before the ALJ entered an initial decision, Ms. Bebo sued in federal court, alleging that the provision of the Dodd-Frank Act that authorized the SEC to initiate administrative actions against persons who are not registered with the SEC in the securities business[152] is unconstitutional "because it provides the SEC 'unguided' authority to choose which respondents will and which will not receive the procedural protections of a federal district court, in violation of equal protection and due process guarantees."[153] She also argued that, because the ALJs presiding in the administrative proceedings are insulated from removal by the president "by multiple layers of for-cause protection," the proceedings "interfere[] with the President's [Article II] obligation to ensure the faithful execution of the laws."[154] As in *Jarkesy*, the district court dismissed the federal court action for lack of subject matter jurisdiction, and the court of appeals affirmed.[155]

145. *Id.* at 23 (quoting Jarkesy v. SEC, 48 F. Supp. 3d 32, 38 (D.D.C. 2014)).
146. *Id.* at 25.
147. *Id.* at 28.
148. *Id.* at 29.
149. *Id.* at 30.
150. 799 F.3d 765 (7th Cir. 2015), *cert. denied*, 84 U.S.L.W. 3438 (U.S. Mar. 28, 2016) (No. 15-997).
151. *Id.* at 767.
152. *See* Pub. L. No. 111-203, § 929P(a), 124 Stat. 1376, 1862–64 (2010) (codified at 15 U.S.C. § 78u-2 (2012)).
153. *Bebo*, 799 F.3d at 768.
154. *Id.*
155. *Id.* at 768, 775.

The Seventh Circuit, however, keyed its analysis to *Free Enterprise Fund v. Public Company Accounting Oversight Board*,[156] which the court found to focus on the three factors in the second prong of the *Thunder Basin* analysis.[157] The court held that the question of whether Ms. Bebo had available "meaningful judicial review" was the "most critical," and that Ms. Bebo had such review because, as she was "already the respondent in a pending enforcement proceeding," she could, "[a]fter the pending enforcement action has run its course, . . . raise her objections in a circuit court of appeals established under Article III."[158] Being already embroiled in an enforcement proceeding involuntarily, she did "not need to risk incurring a sanction voluntarily just to bring her constitutional challenges before a court of competent jurisdiction."[159] With this "most important" factor weighing against her, it did not matter whether her constitutional claims were "wholly collateral" to her administrative proceeding or not,[160] and jurisdiction did "not turn on whether the SEC has authority to hold [the relevant section of the Dodd-Frank Act] unconstitutional, nor [did] it hinge on whether Bebo's constitutional challenges fall outside the agency's expertise."[161]

Echoing the concern voiced by the D.C. Circuit, the Seventh Circuit worried that a contrary holding would mean that "[e]very person hoping to enjoin an ongoing administrative proceeding could make [Ms. Bebo's] argument," and returned, at the end of the opinion to the first *Thunder Basin* prong, saying that it found "no evidence from the statute's text, structure, and purpose that Congress intended for plaintiffs like Bebo who are already subject to ongoing administrative enforcement proceedings to be able to stop those proceedings by challenging the constitutionality of the enabling legislation or the structural authority of the SEC."[162]

## Proxy Solicitation

*Ordinary business exception to shareholder's right to use company proxy for shareholder resolution.* Exchange Act Rule 14a-8 provides that a registered shareholder of a public company—who has continuously held at least $2,000 worth, or at least one percent, of the company's voting securities for at least one year—can submit a proposal to be considered at the company's annual meeting of shareholders and further provides that the "company must include [that] proposal

156. *Id.* at 768–69 (citing Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477 (2010)).

157. *Id.* at 769. The court of appeals also relied on *Elgin v. Department of Treasury*, 132 S. Ct. 2126, 2135–36, 2140 (2012), for the rule that a facial constitutional challenge to an administrative hearing scheme does not automatically entitle a respondent in an administrative proceeding to "seek judicial review in . . . district court," *Bebo*, 799 F.3d at 771, and the rule "that jurisdiction does not turn on whether the SEC has authority to hold § 929P(a) of Dodd-Frank unconstitutional," *id.* at 773.

158. *Bebo*, 799 F.3d at 774.

159. *Id.*

160. *Id.*

161. *Id.* at 772–73 (citing *Elgin*, 132 S. Ct. at 2140).

162. *Id.* at 775. In one other noteworthy decision, the D.C. Circuit agreed with the SEC that the requirement for the Division of Enforcement to file a proceeding within 180 days of serving a Wells notice is not jurisdictional, and therefore the violation of that time limit does not require dismissal of the late-filed proceeding. Montford & Co. v. SEC, 793 F.3d 76, 81–83 (D.C. Cir. 2015).

in its proxy statement and identify the proposal in its form of proxy when the company holds an annual or special meeting of shareholders."[163] The company's proxy statement must also include the shareholder's argument in support of the proposal, but the proposal itself and the supporting argument cannot exceed 500 words.[164]

The company, however, can exclude a proposal from its proxy materials if any of a number of exceptions apply.[165] One exception permits the company to exclude a shareholder's proposal from its proxy materials if "the proposal deals with a matter relating to the company's ordinary business operations"[166] (the "Ordinary Business Operations Exclusion"). Another exception permits the company to exclude a proposal from its proxy materials if the "proposal or supporting statement is contrary to any of the Commission's proxy rules."[167] Proposals can be excluded on this ground when they "are 'so vague and ambiguous that the issuer and security holders would not be able to determine what action the proposal is contemplating'"[168] (the "Vague and Ambiguous Exclusion").

Trinity Wall Street ("Trinity"), an Episcopal parish, submitted a proposal to Wal-Mart Stores, Inc. ("Wal-Mart") for inclusion in Wal-Mart's proxy materials for its 2014 annual shareholder meeting.[169] Trinity's proposal requested that the directors amend the charter of the board's Compensation, Nominating and Governance Committee to add to its duties:

> Providing oversight concerning [and the public reporting of] the formulation and implementation of . . . policies and standards that determine whether or not the Company should sell a product that:
>
> 1) especially endangers public safety and well-being;
> 2) has the substantial potential to impair the reputation of the Company; and/or
> 3) would reasonably be considered by many offensive to the family and community values integral to the Company's promotion of its brand.[170]

Trinity's supporting statement said that the oversight would include "policies and standards that would be applicable to [(i)] determining whether or not the company should sell guns equipped with magazines holding more than ten rounds of ammunition, . . . and [(ii)] balancing the benefits of selling such guns against the risks that these sales pose to the public and to the Company's reputation and brand value."[171]

163. 17 C.F.R. § 240.14a-8 (2015).
164. *Id.* § 240.14a-8(d).
165. *Id.* § 240.14a-8(i) (listing thirteen bases for exclusion).
166. *Id.* § 240.14a-8(i)(7).
167. *Id.* § 240.14a-8(i)(3).
168. Trinity Wall St. v. Wal-Mart Stores, Inc., 792 F.3d 323, 355 (3d Cir. 2015) (Shwartz, J., concurring) (quoting Proposed Amendments to Rule 14a–8, Exchange Act Release No. 19,135, 1982 WL 600869, at *13 (Oct. 14, 1982)).
169. *Id.* at 328 (majority opinion). Judge Ambro authored the opinion of the court, and was joined by Judge Vanaskie. *Id.* at 326.
170. *Id.* at 329–30 (quoting proposal) (alteration by court).
171. *Id.* at 330 (quoting proposal).

In January 2014, Wal-Mart informed Trinity and the SEC's Division of Corporate Finance that Wal-Mart believed that the proposal fell within the Ordinary Business Operations Exclusion.[172] In March 2014, the SEC staff issued a "no-action" letter to Wal-Mart, stating that the staff would not recommend an enforcement action against the company if it excluded Trinity's proposal from its proxy materials.[173] Trinity sued in federal court for a declaration that Wal-Mart's decision to exclude the proposal violated Rule 14a-8, seeking both a preliminary and permanent injunction to prevent Wal-Mart from excluding the proposal.[174] The district court denied the preliminary injunction on the basis that the Ordinary Business Operations Exclusion applied.[175] However, because the district court concluded that the case was not moot after the 2014 shareholder meeting because the complaint reasonably anticipated a 2015 violation,[176] the lower court proceeded with the case and ruled on summary judgment in Trinity's favor, concluding that the Ordinary Business Operations Exclusion did *not* apply.[177]

The Third Circuit reversed the district court,[178] with (i) an opinion of the court, authored by two judges, who concluded—on an elaborate analysis—that the Ordinary Business Operations Exemption applied,[179] and (ii) a concurring opinion by the third judge, who (a) also concluded—but on a more truncated analysis—that the Ordinary Business Operations Exemption applied,[180] and (b) further concluded, joined by a member of the majority, that the Vague and Ambiguous Exclusion applied.[181] The majority found that the "subject matter" of Trinity's proposal was not corporate governance through board oversight of strategic matters, such as community responsibility and reputation, but that "[t]he subject matter of the proposal [was] instead its *ultimate* consequence—here a potential change in the way Wal-Mart decides which products to sell."[182] That subject matter was "at the core of Wal-Mart's business" because "[a] retailer's approach to its product offerings is the bread and butter of its business."[183] Thus, the proposal "relate[d]" to Wal-Mart's ordinary business.[184]

The majority, however, recognized that the SEC staff takes the view that the Ordinary Business Operations Exclusion generally does not apply if "a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate

172. *Id.* at 330–31.
173. *Id.* at 331.
174. *Id.*
175. *Id.* at 332.
176. *Id.*
177. *Id.*
178. *Id.* at 328.
179. *Id.* at 340–51.
180. *Id.* at 351–54 (Shwartz, J., concurring).
181. *Id.* at 355. Judge Vanaskie joined this part of the concurrence. *See id.* at 351, 355.
182. *Id.* at 342 (majority opinion).
183. *Id.* at 344.
184. *Id.*; *see* 17 C.F.R. § 240.14a-8(i)(7) (2015) (stating that shareholder proposal may be excluded if it "deals with a matter *relating* to the company's ordinary business operations" (emphasis added)).

for a shareholder vote."[185] The majority conceded that the Trinity proposal "raise[d] a matter of sufficiently significant policy."[186] The policy, however, did not transcend Wal-Mart's ordinary business operations because "the essence of a retailer's business is deciding what products to put on its shelves—decisions made daily that involve a careful balancing of financial, marketing, reputational, competitive and other factors."[187] Pointing to a series of no-action letters in which the SEC staff concluded that the Ordinary Business Operations Exclusion applied to shareholder proposals designed to force retailers to stop selling or promoting products that "pose a threat to public health," the majority found that Trinity's proposal "targets the same basic business decision: how to weigh safety risks in the merchandising calculus."[188] The majority further found that "Wal-Mart's consideration of the risk that certain products pose to its 'economic success' and 'reputation for good corporate citizenship' is enmeshed with the way it runs its business and the retailer-consumer interaction."[189] In short, "[f]or a policy issue here to transcend Wal-Mart's business operations, it must target something more than the choosing of one among tens of thousands of products it sells," and Trinity's proposal "fail[ed] that test."[190]

The concurring judge (alone) thought that this analysis went too far and "practically gives companies carte blanche to exclude any proposal raising social policy issues that are directly related to core business operations."[191] She concluded, however, that the first component of Trinity's proposal—which was not phrased specifically in terms of high-capacity weapons, but instead referred broadly to "public safety," implicating "thousands of goods"—was not sufficiently focused to raise a "significant social policy."[192] The second and third components of Trinity's proposal—which related to potential harm to Wal-Mart's reputation and whether its products might offend family and community values—could also "cover many products" and, in addition, were matters of concern to the *company* and its shareholders but did "not present a social policy issue."[193]

The concurring judge (joined by one member of the majority) also found that Wal-Mart could exclude Trinity's proposal from its proxy materials because the Vague and Ambiguous Exclusion applied.[194] Focusing on the third set of policies Trinity demanded—regarding "the sale of products that 'would reasonably be considered by many to be offensive to the family and community values in-

185. *Trinity Wall St.*, 792 F.3d at 345 (quoting SEC Staff Legal Bulletin No. 14E, 2009 WL 4363205, at *2 (Oct. 27, 2009)).

186. *Id.* at 346.

187. *Id.* at 348.

188. *Id.* at 348–50.

189. *Id.* at 350. The majority observed that the outcome might have been different if such a proposal had been submitted to a company that manufactured a very narrow range of products, unlike retailers that "typically deal with thousands of products amid many options for each." *Id.* at 349.

190. *Id.* at 351.

191. *Id.* at 353 (Shwartz, J., concurring).

192. *Id.* at 354.

193. *Id.*

194. *Id.* at 355. Judge Vanaskie joined this part of the concurrence. *See id.* at 351, 355.

tegral to' Wal-Mart's brand"—the concurrence found that "th[o]se buzz words fail[ed] to provide any concrete guidance as to what constitutes 'many' or what 'family values' should be considered."[195] Accordingly, the proposal did "not inform the shareholders of the breadth of the subject on which they would be asked to vote nor [did] it make clear what the Company would be required to do if it were adopted."[196]

## Forward-Looking Statements

Federal securities law defines forward-looking statements to include financial projections and forecasts of future economic performance, management's plans and objectives for future operations, and related or underlying assumptions.[197] With important exceptions not relevant to decisions discussed below, both the Securities Act and the Exchange Act provide two protections, from liability in private lawsuits, for forward-looking statements made by issuers filing reports pursuant to Exchange Act sections 13(a) or 15(d), and the officers and other agents of those issuers.[198] First, to establish liability, a plaintiff must prove that a forward-looking statement was made with "actual knowledge . . . that [it] was false or misleading."[199] Second, if an issuer accompanies a forward-looking statement with "meaningful cautionary [language] identifying important factors that could cause actual results to differ materially from those in the forward-looking statement," then neither the issuer nor anyone acting on its behalf can be liable on the statement in a private action at all.[200] Cautionary language accompanies an oral forward-looking statement for this purpose if the oral statement refers to "a readily available written document" that contains the warnings, with SEC filings being "readily available" for this purpose.[201]

Two decisions interpreted these protections in 2015. The D.C. Circuit held that cautions accompanying forward-looking statements about inventory were not meaningful where they did not disclose that the issuer was holding obsolete inventory that would be hard to sell without heavy discounting.[202] The Eighth Circuit held that an issuer's statements regarding government-protected product exclusivity were forward-looking even though phrased in the present tense and that the accompanying cautions were meaningful, in a case where the government ultimately exercised its discretion against enforcing the exclusivity.[203]

195. *Id.* (quoting proposal).

196. *Id.* In another notable section 14(a) case, the Sixth Circuit found that communications by a fired CEO to shareholders that effectively urged shareholders to revoke proxies given to management—but that did not ask shareholders to give proxies to the CEO—were exempt from the SEC rules requiring that proxy solicitations be filed with the SEC and include the content that SEC rules prescribe. Gas Nat. Inc. v. Osborne, 624 F. App'x 944, 952–55 (6th Cir. 2015).

197. 15 U.S.C. §§ 77z-2(i)(1), 78u-5(i)(1) (2012).

198. *Id.* §§ 77z-2(a)–(c), 78u-5(a)–(c).

199. *Id.* §§ 77z-2(c)(1)(B), 78u-5(c)(1)(B).

200. *Id.* §§ 77z-2(c)(1)(A), 78u-5(c)(1)(A).

201. *Id.* §§ 77z-2(c)(2)–(3), 78u-5(c)(2)–(3)(B).

202. *See infra* notes 204–29 and accompanying text.

203. *See infra* notes 230–50 and accompanying text.

*Forward-looking statements, about growth and expansion and planned reduction in product inventory, made without disclosing that the inventory was obsolete*. By the time *In re Harman International Industries, Inc. Securities Litigation* reached the D.C. Circuit, only three statements remained in the Rule 10b-5 action that the plaintiffs brought against the issuer defendant and three officers,[204] with two of those statements treated as "forward-looking statements" for purpose of the appeal.[205] The issuer manufactured a variety of products, including personal navigation devices ("PNDs").[206] The plaintiffs alleged that the defendants committed fraud by making the two forward-looking statements without also telling investors that the company was stuck with a large inventory of obsolete PNDs that could not be sold except at low prices.[207] In the first statement, the CEO, on April 26, 2007, reminded listeners that the company had said three months earlier that "PND inventories in Europe had grown substantially"; noted that the company had, at that time, said that it "planned to reduce [inventory] to normal levels at year-end"; added that this "plan is proceeding"; projected sales of 618,000 PND units by the end of the year; and forecasted reductions of inventory from $75 million at the end of March to $50 million by the end of April, $30 million at the end of May, and $15 million by the end of June.[208] In the second statement, the chief financial officer ("CFO"), on September 27, 2007, predicted "a very strong first quarter [for Fiscal Year ('FY') 2008], . . . reflecting . . . [in part] the PND business, where we continue the growth and expansion of that business primarily in Europe."[209]

Before addressing whether the cautionary language accompanying those statements shielded the defendants from liability, the D.C. Circuit defined "meaningful" cautions—for purposes of the forward-looking statutory protection—to be "'substantive company-specific warnings based on a realistic description of the risks applicable to the particular circumstances'" that are "tailored to the forward-looking statement that it accompanies."[210] The court held that cautions "cannot be 'meaningful' if [they are] 'misleading in light of historical fact[s].'"[211] Although the cautions need not mention the particular risk that later matures and frustrates realization of the forward-looking statement, "Congress required that a company must warn of factors that '[h]av[e] much import or significance' and 'carry[] with [them] great or serious consequences,' and which are 'likely to

204. 791 F.3d 90, 94–96 (D.C. Cir. 2015), *cert. denied*, 84 U.S.L.W. 3307 (U.S. Feb. 29, 2016) (No. 15-694).

205. The plaintiffs asserted on appeal that those statements did not fit within the statutory definition of "forward-looking statements," 15 U.S.C. § 78u-5(i)(1), but the court of appeals ruled the plaintiffs had forfeited that contention. *Harman*, 791 F.3d at 100.

206. *Harman*, 791 F.3d at 95.

207. *Id.* at 97–98.

208. *Id.* at 96–97 (quoting CEO's statements to analysts).

209. *Id.* at 98 (quoting CFO's statements to analysts).

210. *Id.* at 102 (quoting Southland Sec. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 372 (5th Cir. 2004)).

211. *Id.* (quoting Slayton v. Am. Express Co., 604 F.3d 758, 770 (2d Cir. 2010)).

have a profound effect on success.'"[212] "[M]ere boilerplate . . . does not meet the statutory standard because by its nature it is general and ubiquitous, not tailored to the specific circumstances of a business operation,"[213] and language that "remain[s] unchanged despite a significant change in circumstances of material importance to an investor" will not do.[214]

Armed with these principles, the D.C. Circuit reversed the district court's dismissal, which rested on the determination that Harman's cautionary language insulated the two forward-looking statements from a private Rule 10b-5 claim.[215] Turning to the first statement, made in a conference call on April 26, 2007, the defendants argued that cautions in the company's Annual Report on Form 10-K ("10-K") for the fiscal year 2006—to which the moderator of the conference call referred listeners—said that "PND 'inventories . . . had grown substantially,' increasing to approximately $50 million."[216] In addition, the 10-K "stated sales could suffer if the Company failed to 'develop, introduce and achieve market acceptance of new and enhanced products,' that it had to 'maintain and improve existing products, while successfully developing and introducing new products,' and could 'experience difficulties that delay or prevent the development, introduction or market acceptance of new or enhanced products,' as well as that competitors could 'introduce superior designs or business strategies, impairing [the Company's] distinctive image and [its] products' desirability.'"[217] Those warnings, however, were not "meaningful" (at least when reviewed on a motion to dismiss) "because they were misleading in light of historical fact"—i.e., "they did not warn of actual obsolescence that had already manifested itself,"[218] and that would make the amassed inventory hard to sell. The plaintiffs successfully pled that manifestation by alleging that (i) Harman had modified the PND design in early 2007, making its older versions obsolete; (ii) the company had missed its 2006 PND sales target and was storing units in a warehouse; and (iii) the sales team had discussed price reductions in order to remain competitive.[219]

The defendants pointed to the general rule that a company does not need to disclose what investors already know—here that technical devices obsolesce as new, more advanced products arrive on the market.[220] The court brushed this argument aside for the same reason it rejected the cautionary statements included in the 10-K; the general principle did not mean that investors knew, at the time of the first statement, that Harman's PND inventory was already obso-

212. *Id.* at 103 (quoting, in the first and second instances, 7 Oxford English Dictionary 728 (2d ed. 1989); then quoting New Oxford American Dictionary 849 (2d ed. 2005) (citations omitted)).

213. *Id.* at 102.

214. *Id.* at 107.

215. *Id.* at 95, 112.

216. *Id.* at 104 (quoting 10-K). Harman's fiscal year ended on June 30, so the pertinent 10-K was filed in September 2006. *See* Harman Int'l Indus., Inc., 10-K (Sept. 6, 2006), http://www.sec.gov/Archives/edgar/data/800459/000080045906000077/0000800459-06-000077-index.htm.

217. *Harman*, 791 F.3d at 103–04 (quoting 10-K) (alteration by court).

218. *Id.* at 104.

219. *Id.*

220. *Id.*

lete.[221] As to the first statement's reference to a "plan" to reduce inventory by selling 618,000 PND units by the end of the year, that was "not a warning at all, much less of obsolescence."[222]

Moving to the second forward-looking statement, on September 27, 2007, the court reached the same conclusion.[223] The cautionary statements on which defendants relied to protect that statement appeared in the company's "FY 2007 [10-K], which repeated the general warnings in the FY 2006 [10-K]."[224] By September 27, plaintiffs alleged, (i) Harman had agreed in June to sell 100,000 PNDs for $240 per unit, not the ordinary price of $350; (ii) the company had missed its FY 2007 projected PND sales by more than 200,000 units; and (iii), as told by an accounting manager, "had on hand hundreds of millions of dollars worth of obsolete Generation 2 PNDs which were being superseded by newer Generation 3 PNDs in August 2007."[225] In the face of those pled facts, the court found that warnings of "a generalized risk of obsolescence and the general effect that obsolescence could have on sales" were not "meaningful" but instead "misleading in light of historical facts," because, by the time of the second statement, "there was no longer a mere risk and some evidence of obsolescence, but rather an intractable problem of obsolescence was a reality that the Company failed to disclose."[226]

*Significance and analysis. Harman* suggests that, in order to obtain the protection in a case where the cautionary language does not address the particular factor that ultimately causes results to differ materially from those predicted in the forward-looking statement, the cautionary language must warn of "factors that '[h]av[e] much import or significance' and 'carry[] with [them] great or serious consequences,' and which are 'likely to have a profound effect on success.'"[227] Unfortunately, this definition of "meaningful" is so general as to provide virtually no operational guidance. *Harris v. Ivax Corporation*, which *Harman* cites and quotes, offers a more useful formulation, saying that warnings are sufficient, even if they do not mention the particular risk that matured, if the cautions "warned of risks of a significance similar to that actually realized."[228] *Harman* may be best understood as addressing only the particular instance in which cautionary language points to the very risk that frustrates the forward-looking statement but the language is not "meaningful" because, at the time the defendants make the statement, the risk has already materialized and the defendants do not so disclose.[229]

*Forward-looking statements that federal agency would bring enforcement actions to protect exclusivity of drug.* K-V Pharmaceutical Company ("K-V") bought the

221. *Id.* at 105.
222. *Id.*
223. *Id.* at 106–08.
224. *Id.* at 106.
225. *Id.* at 106–07 (quoting complaint).
226. *Id.* at 107.
227. *See supra* note 212 and accompanying text.
228. 182 F.3d 799, 807 (11th Cir. 1999), *quoted in Harman*, 791 F.3d at 103.
229. *Harman*, 791 F.3d at 108.

rights to a drug to reduce pre-term labor in at-risk mothers.[230] K-V sought from the FDA, and obtained, an exclusive right to sell the drug for seven years, under the Orphan Drug Act, which is designed to stimulate the development and production of drugs to treat conditions affecting less than 200,000 persons in the United States.[231] K-V stated in a conference call with investors on February 14, 2011, that (i) the FDA had granted the medication orphan drug status; (ii) K-V planned to charge $1,500 per injection; (iii) insurers would pay for the drug because the cost of pre-term birth ($51,000) exceeded the total price for injections during a pregnancy ($30,000); and (iv) K-V would offer financial assistance to patients with household incomes up to $100,000.[232]

The K-V price marked a 14,900 percent increase from the price of the drug when mixed by compounding pharmacies.[233] As to FDA action to enforce K-V's exclusive right, the company stated during the February 14, 2011, conference call its belief "that the regulations and laws are very clear . . . that compounding pharmacies are not FDA-approved manufacturing facilities and that FDA regulations and state pharmacy laws generally prohibit the distribution of compounded products that are the same or essentially the same as FDA-approved products."[234] The company added its belief "that compounded pharmacies are aware of these laws and regulations, and our expectation is that they will adhere to them."[235]

On February 17, 2011, K-V sent letters to compounding pharmacies advising them that they should not concoct the drug and warning them that that FDA enforcement action could follow if a compounding pharmacy produced the drug in an unlicensed way.[236] On March 30, 2011, however, the FDA issued a statement saying that, "[i]n order to support access to this important drug . . . [the agency did] not intend to take enforcement action against pharmacies that compound [the chemical equivalent of the drug]."[237] In response, K-V announced that it would reduce the price of the drug to $690 per injection.[238]

The price of K-V stock dropped,[239] and the plaintiffs filed a Rule 10b-5 action against K-V and three officers.[240] The Eighth Circuit affirmed a district court judgment dismissing the case.[241] The court of appeals held that the challenged

230. Julianello v. K-V Pharm. Co., 791 F.3d 915, 917 (8th Cir. 2015).

231. *Id.* (citing 21 U.S.C. §§ 360aa–360ee).

232. *Id.* at 918.

233. *Id.* "Compounding" is "a practice in which a licensed pharmacist, a licensed physician, or, in the case of an outsourcing facility, a person under the supervision of a licensed pharmacist, combines, mixes, or alters ingredients of a drug to create a medication tailored to the needs of an individual patient." *Compounding and the FDA: Questions and Answers*, U.S. Food & Drug Admin., http://www.fda.gov/Drugs/GuidanceComplianceRegulatoryInformation/PharmacyCompounding/ucm339764.htm#what (last updated Oct. 6, 2015).

234. *K-V*, 791 F.3d at 918 (quoting company comments during call).

235. *Id.* (quoting company comments during call).

236. *Id.* at 919.

237. *Id.* (quoting FDA's statement).

238. *Id.*

239. *Id.*

240. *Id.* at 916–17, 920 (expressly referring to Rule 10b-5).

241. *Id.* at 917, 920, 922, 923.

representations fell within the portion of the statutory definition of forward-looking statements that provides protection to any "statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer"[242] because the statements "detailed K-V's future launch of [the drug] and the anticipated results."[243] Even though the statements—"that K-V felt the laws and regulations were clear and that they anticipated that the FDA would enforce exclusivity once [the drug] was launched"—were phrased in "the present tense," the use of the present tense did "not undermine [the court's] determination that they were forward-looking" because the statements were "tied to a future event[,] the launch of [the drug]" and "[u]ntil th[at] future event occurred, it could not be determined whether the FDA would vary from its usual practice of enforcing exclusivity."[244] The court thereby applied the principle that a statement in the present tense is forward-looking if its "veracity . . . [can] only be determined after [it is] made."[245]

Having ruled that K-V's statements fell within the statutory definition of "forward looking," the Eighth Circuit went on to hold that the statute precluded a private Rule 10b-5 action on the statements because the company had accompanied them with meaningful cautionary language.[246] The company had commenced the February 14, 2011, conference call by saying that actual results could differ materially from those suggested by forward-looking statements made during the call and that the uncertainties that might work this unhappy result included those that K-V had identified as risk factors in its 10-K.[247] This was sufficient under the Exchange Act to "accompany" the oral forward-looking statements in the call by the cautionary language included in those risk factors.[248] In turn, those risk factors advised that "any product launch may be delayed or unsuccessful, including with respect to Gestiva [the drug that was the subject of the case]"; and warned of "the possibility that any period of exclusivity may not be realized, including with respect to Gestiva, a designated Orphan Drug."[249] The Eighth Circuit found these cautions "meaningful" because, far from being "boilerplate," they "warned [investors] of precisely the risks about which [the plaintiffs] now complain" by "explicitly identif[ying] the risks associated with the FDA's presumed en-

242. 15 U.S.C. § 78u-5(i)(1)(B) (2012). The statute also defines "forward-looking statement" to include "any statement of the assumptions underlying or relating to any statement" of management's plans and objectives. *Id.* § 78u-5(i)(1)(D). The court said that K-V's words "may also fairly be categorized as the underlying assumptions that are recognized as part of the protected forward-looking statements." *K-V*, 791 F.3d at 921.

243. *K-V*, 791 F.3d at 921.

244. *Id.*

245. *Id.*

246. *Id.* at 922.

247. *Id.* at 917–18.

248. *See supra* note 201 and accompanying text.

249. *K-V*, 791 F.3d at 918 (quoting 10-K). The warnings in the 10-K referred to the drug as "Gestiva," but K-V later rebranded the drug as "Makena." *Id.* at 917.

forcement of exclusivity," tying this risk to the orphan-drug status of the very medicine that underlay the lawsuit.[250]

## Insider Trading

In 2014, the Second Circuit held, in *United States v. Newman*, that a tipper violates Rule 10b-5 only if he or she receives a personal benefit from the tip and that benefit is "of some consequence."[251] The Second Circuit added that, while an inference of such benefit might be based on a personal relationship between the tipper and a tippee, "such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[252] The court added that this "standard, although permissive, does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature," and that it would not be enough "that two individuals were alumni of the same school or attended the same church."[253] The Second Circuit held, as well, that a remote tippee—in order to violate Rule 10b-5—must know that the original tipper breached his or her duty in providing the tip which, in turn, means that the remote tippee must know that the original tipper received a personal benefit "of some consequence" from conveying the material nonpublic information.[254]

The Ninth Circuit wrestled with *Newman* last year in *United States v. Salman*.[255] In *Salman*, the defendant traded on inside information that (i) he received from Michael Kara, who became the defendant's brother-in-law, and (ii) Michael Kara, in turn, received from Maher Kara, who was Michael's younger brother, who worked as an investment banker at Citigroup, and who was engaged to, and married, the defendant's sister.[256] On appeal of his conviction for insider trading as a remote tippee under Rule 10b-5,[257] the defendant contended there was insufficient evidence at trial to show either that the original tipper (Maher) received an adequate personal benefit or that, even if so, the defendant knew of such benefit.[258]

250. *Id.* at 922. Another opinion on forward-looking statements, *Pension Fund Group v. Tempur-Pedic International, Inc.*, 614 F. App'x 237, 244 (6th Cir. 2015), held that cautionary language was sufficient to invoke the statutory protections, where the warnings referred to products introduced by competitors but did not include the issuer's internal analysis of the particular competitive threat posed by one of those products.

251. 773 F.3d 438, 452 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015).

252. *Id.*

253. *Id.*

254. *Id.* at 442–43, 447–54.

255. 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 84 U.S.L.W. 3401 (U.S. Jan. 19, 2016) (No. 15-628).

256. *Id.* at 1088–89.

257. *Id.* at 1088, 1090.

258. *Id.* at 1091.

Affirming the conviction,[259] the Ninth Circuit disagreed with *Newman* to the extent that the Second Circuit's holding could be read to require that the benefit to the tipper be "tangible."[260] Harkening back to the Supreme Court's words in *Dirks v. SEC* that "a gift of confidential information to a trading relative or friend" might provide a sufficient benefit[261] and *Newman*'s statement that a personal benefit could include "the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend,"[262] the Ninth Circuit held that the evidence that Maher intended the inside information as a gift to Michael supplied the necessary benefit to Maher and that, "while [the defendant] may not have been aware of all the details of the Kara brothers' relationship, the jury could easily have found that, as a close friend and member (through marriage) of the close-knit Kara clan, [the defendant] must have known that, when Maher gave confidential information to Michael, he did so with the 'intention to benefit' a close relative."[263]

*Significance and analysis*. The critical passage from *Dirks* reads, in full:

> [T]he initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings. There are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[264]

By its reference to "a direct or indirect personal benefit from the disclosure, *such as a pecuniary gain or a reputational benefit that will translate into future earning*,"[265] the passage implies an exchange of value for value. This suggests that psychic satisfaction should not, without more, suffice. Otherwise, virtually any tip would clear the personal benefit hurdle because there must be *some* reason, at least a psychological reason, motivating *any* tipper to tip. If that is so, the personal benefit element is so easily conjured as to constitute no element at all.

The Ninth Circuit did not need to imply that no "tangible" benefit was needed, as evidence in the case supported an inference that Maher was, indeed, effectively exchanging the material nonpublic information for value.[266] Perhaps the

259. *Id.* at 1094.

260. *Id.* at 1093.

261. *Id.* (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).

262. *Id.* at 1093–94 (quoting United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015)).

263. *Id.* at 1094.

264. *Dirks*, 463 U.S. at 663–64 (citation omitted).

265. *Id.* (emphasis added).

266. *Salman*, 792 F.3d at 1089 ("Michael helped pay for Maher's college [and,] on one occasion, [Maher] received a call from Michael asking for a 'favor,' requesting 'information,' and explaining that

Ninth Circuit will revisit this issue and clarify *Salman*, by relying on the evidence of such value and expressly rejecting the notion that emotional satisfaction is enough to provide any needed benefit to an original tipper.

## Materiality

A fact is material if there is a substantial likelihood that a reasonable investor would consider the fact important in deciding whether to buy or sell a security, because the fact significantly alters the total mix of information that is available and relevant to that buy/sell decision.[267] Language that expresses general optimism or a favorable characterization of facts, but that would not be important to a reasonable investor, is immaterial "puffery."[268] The D.C. Circuit applied that principle in 2015.[269] The Second Circuit did as well, while also considering both whether an asserted financial error was material even though it constituted a small percentage of the relevant company-wide number and whether there was a material difference between a bank saying that a regulator had "encouraged" the bank to raise capital instead of saying that the regulator had "required" the bank to do so.[270] The First Circuit related materiality to scienter, finding insufficient evidence of scienter where the materiality of the misrepresentation was marginal.[271] Both that court and the Second Circuit rendered decisions that permitted defense challenges to materiality in the face of testimony by financial industry participants that misrepresentations were important to them.[272]

*Puffery*. *In re Harman International Industries, Inc. Securities Litigation* held, in reversing a district court dismissal of a Rule 10b-5 complaint, that the defendants' statement in an annual report—that "[s]ales of aftermarket products, particularly PNDs, were very strong during fiscal 2007"—was not puffery but instead an actionable statement.[273] Centrally, the plaintiffs alleged the defendants concealed during the class period that Harman had a large and growing inventory of obsolete PNDs that the company could only sell at steep discounts.[274] In discussing the materiality of the "very strong [sales]" statement, the court noted plaintiffs' allegations that (i) PNDs were sold by the company's automotive division, which brought in 70% of Harman's business and the bulk

he 'owe[d] somebody.' After Michael turned down Maher's offer of money, Maher gave him a tip about an upcoming acquisition instead." (quoting trial testimony)).

267. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

268. *See In re* Apple Comput., Inc., 127 F. App'x 296, 304 (9th Cir. 2005) ("We have held the following . . . statements to be non-actionable puffery: 'We're doing well and I think we have a great future'; . . . 'Everything is clicking. . . . New products are coming in a wave, not a trickle. . . . Old products are doing very well'; and 'I am optimistic about [the company's] performance during this decade.'" (citation omitted)).

269. *See infra* notes 273–76 and accompanying text.

270. *See infra* notes 277–95 and accompanying text.

271. *See infra* notes 296–311 and accompanying text.

272. *See infra* notes 296–331 and accompanying text.

273. 791 F.3d 90, 94, 108–11, 112 (D.C. Cir. 2015) (quoting FY 2007 Annual Report), *cert. denied*, 84 U.S.L.W. 3307 (U.S. Feb. 29, 2016) (No. 15-694).

274. *See supra* notes 204–29 and accompanying text (discussing the case).

of its revenue, and (ii) PNDs "had been the focus of recent public statements."[275] The D.C. Circuit found that the "very strong" sales comment was not puffery because the "statement was tied to a product and a time period and it was not too vague to be material."[276]

In *IBEW Local Union No. 58 Pension Trust Fund & Annuity Fund v. Royal Bank of Scotland Group, PLC*, the Second Circuit also addressed puffery, and in addition wrestled with more difficult issues of quantitative and qualitative materiality and statements about the relationship between a bank and its regulator during the credit crisis.[277] Purchasers of American Depository Shares ("ADS") of The Royal Bank of Scotland Group, PLC ("RBS") alleged that RBS and several executives violated Rule 10b-5 during the period between October 17, 2007, and January 20, 2009, by making allegedly fraudulent statements about (i) RBS's acquisition of a Dutch bank named ABN AMRO; (ii) RBS's exposure to the subprime mortgage market; and (iii) a Rights Issue.[278] Ultimately, RBS proved to be an investor disaster, as the British government rescued the bank through a $40 billion bailout in exchange for a ninety-four percent ownership interest, and the price of the ADS declined significantly during the class period.[279]

Second Circuit authority holds that "[s]tatements of corporate optimism may be actionable securities violations if 'they are worded as guarantees or are supported by specific statements of fact, or if the speaker does not genuinely or reasonably believe them.'"[280] The court found the following statements about the acquisition to be "inactionable puffery"[281]—that integration of ABN AMRO into RBS was "off to a promising start," that the deal "has rarely seemed more attractive and relevant than it does at this point," that "the positive view we have of the ABN [AMRO] businesses has been confirmed," that the "[u]nderlying performance of retained ABN AMRO businesses [is] in line with expectations," that "[t]here are a lot of areas where [the ABN AMRO acquisition] just goes ching, ching, ching, ching, ching," that "[w]e are happy we bought what we thought we bought," and that ABN AMRO businesses were "kind of in line with where we thought they would be and probably [are] slightly ahead of the equivalent number last year."[282] Those statements were "not worded as guarantees and there [were] no allegations that defendants did not reasonably believe them."[283]

275. *Harman*, 791 F.3d at 109.

276. *Id. Compare* Pension Fund Grp. v. Tempur-Pedic Int'l, Inc., 614 F. App'x 237, 245 (6th Cir. 2015) (concluding that statement that issuer had "strengthened [its] competitiveness" was "immaterial as a matter of law"); *id.* at 247 (concluding that reference to the issuer's "consumer preferred" product line was puffery).

277. 783 F.3d 383 (2d Cir. 2015).

278. *Id.* at 387.

279. *Id.*

280. *Id.* at 392 (quoting *In re* Int'l Bus. Machs. Sec. Litig., 163 F.3d 102, 107 (2d Cir. 1998) (citations omitted)).

281. *Id.*

282. *Id.* at 388 (quoting, in the first and second instances, an RBS press release dated December 6, 2007; and quoting, in the remaining instances, an RBS conference call on February 28, 2008).

283. *Id.* at 392.

*Quantitative materiality*. As to subprime assets, the plaintiffs alleged that an RBS press release on December 6, 2007, which represented "[t]otal U.S. subprime exposure[ ]" to be $10.3 billion, understated the true exposure by $6.8 billion.[284] The Second Circuit addresses quantitative materiality in a two-step process that it draws from SEC Staff Accounting Bulletin No. 99.[285] In the first step, the court determines whether the misstatement is less than five percent of the relevant company-wide number.[286] If the misstatement falls below that threshold, the court preliminarily considers the misstatement immaterial but proceeds to a second step, which addresses whether the error is nevertheless material for any of a number of qualitative reasons.[287] In *RBS*, the alleged $6.8 billion understatement "constitute[d] less than 4% of RBS's total asset backed securities exposure, and less than 1% of its total assets," and no qualitative consideration applied to make the asserted misstatement material.[288]

*Regulator encouragement versus regulator mandate*. While the rulings on the acquisition and subprime exposure statements were unanimous—in this opinion by which the Second Circuit affirmed dismissal[289]—the ruling on representations related to the rights offering split the panel two-to-one.[290] RBS stated on April 22, 2008, that the determination to raise capital through the rights offering was "purely the Board of RBS['s] decision" and that, while the Financial Services Authority ("FSA," RBS's regulator) was "happy to see [RBS] raising capital and encourage[d RBS] in [its] plans to do so," RBS was "not asked to raise capital by anyone," not even the FSA.[291] The timeline showed that "RBS had already started preparations for the Rights Issue by April 4, 2008—five days before RBS's conversation with the FSA's CEO, when the FSA purportedly 'specifically required' RBS to conduct a Rights Issue."[292] Noting that "RBS was not deemed by the FSA to have violated FSA's minimum capital guidelines," the majority held that the "critical facts were already known to the investing market: RBS needed an infusion of capital; it was taking additional write-downs; the FSA was closely monitoring RBS's situation and encouraging a Rights Issue; and there was generally a steep deterioration in market conditions and credit market outlooks."[293] In light of this context, the majority held that "a reasonable investor would have

284. *Id.* at 391 (quoting press release).

285. *Id.* at 390–91 (citing SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45151–52 (Aug. 19, 1999)).

286. *Id.* at 390.

287. *Id.* at 390–91.

288. *Id.* at 391 ("Plaintiffs do not allege that the amount of exposure could have been calculated precisely, masks a change in earnings, changes a loss into income or vice versa, or involves an unlawful transaction, or that the misstatements resulted in a significant positive market reaction. And, although RBS's asset-backed securitization group was a driving factor in its profitability, this factor alone does not tip the scales in favor of finding the misstatements material.").

289. *Id.* at 387, 394.

290. *Id.* at 394 (Leval, J., concurring in part and dissenting in part).

291. *Id.* at 388, 392–93 (majority opinion) (quoting public statements by RBS that accompanied announcement of Rights Issue).

292. *Id.* (quoting testimony of FSA CEO to Parliament in 2012).

293. *Id.*

deemed the difference between [whether the FSA] 'encouraged' [RBS to raise capital or] 'required' [RBS to raise capital] to be immaterial."[294] The dissenting panel member disagreed on this point, because "[t]he fact that . . . a regulatory agency has required a bank to raise capital implies that the regulatory agency finds the bank's capital reserves to be dangerously low."[295]

*Significance and analysis.* It is difficult to reconcile *Harman* and *RBS* in a manner that provides guidance to issuers and their officers. Similarly, it is difficult to understand the *RBS* majority position that, on a motion to dismiss, the difference between a bank being "encouraged" by a regulator to raise additional capital and "required" to do so would be immaterial. Those cases illustrate that, before a client makes a statement, the counselor may find it hard to advise a client that the content constitutes "inactionable puffery." On the other hand, after the client speaks and is sued, an aggressive approach to arguing that content is immaterial may be in order.

*Proof of materiality and the relationship between materiality and scienter.* In 2015, two public enforcement cases highlighted that federal securities law defines materiality objectively, with one of those cases also holding that the materiality of a misrepresentation is relevant to whether a defendant made it with scienter.

In *Flannery v. SEC*, the First Circuit vacated an SEC order sanctioning a former vice president and head of North American Product Engineering ("Product Engineer") at State Street Bank and Trust Company ("State Street").[296] The Commission had found that the Product Engineer violated Rule 10b-5 and section 17(a)[297] of the Securities Act, when on May 10, 2007, he presented PowerPoint slides to a group of investors that included a client of an institutional consulting firm, whose representative (Mr. Hammerstein) also attended the presentation.[298] The Product Engineer used a standard slide to describe a group of State-Street managed funds collectively known as the Limited Duration Bond Fund ("LDBF").[299] Called the "Typical Portfolio Slide," the slide represented, among other things, that the LDBF's holdings were distributed, by "sector" market value, so:

| | |
|---|---|
| ABS [Asset-Backed Securities]: | 55%; |
| CMBS [Commercial Mortgage-Backed Securities]: | 25%; |
| MBS [Mortgage-Backed Securities]: | 10%; |
| Agency: | 5%; |
| Corporates: | 0%; |
| Cash: | 5%.[300] |

294. *Id.* at 394.
295. *Id.* (Leval, J., concurring in part and dissenting in part).
296. 810 F.3d 1, 3–4 (1st Cir. 2015).
297. 15 U.S.C. § 77q(a) (2012). Like a violation of Rule 10b-5, *see infra* note 357 and accompanying text, a violation of section 17(a)(1) requires proof of scienter, *Flannery*, 810 F.3d at 9.
298. *Flannery*, 810 F.3d at 5–6.
299. *Id.* at 3, 6.
300. *Id.* at 5 (percentages shown in bar graph on slide).

An internal State Street "fact sheet," however, showed that, as of March 31, 2007, the LDBF held 100 percent of its assets in ABS.[301]

Mr. Hammerstein testified before an SEC ALJ that he was surprised when he later learned that the LDBF was fully invested in ABS, and his consulting firm advised its clients to sell their positions in the LDBF because it "felt that State Street did not adequately inform [the audience] of the risks in the portfolio."[302] Specifically, Mr. Hammerstein's firm sent a letter to its clients "recommending that they liquidate their holdings and citing the May 10 meeting where '[t]he LD Bond Fund Portfolio Manager . . . did not disclose the actual sector exposure at the time, instead presenting "typical" portfolio characteristics.'"[303] The First Circuit nevertheless concluded that the Commission's "finding of materiality was marginal."[304] The slide stated that the information it presented was "Typical" rather than up to date, and the fact sheet showing one hundred percent investment in ABS was available six weeks before the May 10 meeting.[305] The information was also available on State Street's website,[306] and an expert for the Product Engineer testified that "a typical investor in an unregistered fund would understand that it could specifically request additional information regarding the fund."[307] The Product Engineer himself also testified that (i) "in his experience, investors did not focus on sector breakdown when making their investment decisions and that LDBF investors did not focus on how much of the LDBF investment was in ABS versus MBS"; (ii) he "did not recall ever discussing the Typical Portfolio Slide or being asked a question about the actual sector breakdown when presenting the slide"; and (iii) "[h]e did not update the Typical Portfolio Slide's sector breakdowns because he did not think the typical sector breakdowns were important to investors."[308] Nothing in the record showed "that the credit risks posed by ABS, CMBS, or MBS were materially different from each other."[309]

Observing that "[q]uestions of materiality and scienter are connected"—in the sense that "[i]f it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact"[310]—the

301. *Id.* at 11.

302. *Id.* at 10 (quoting Hammerstein's testimony before ALJ).

303. *Id.* (quoting letter).

304. *Id.* at 9–10.

305. *Id.* at 10–11.

306. *Id.* at 11 n.8. But the court added that it did "not suggest that the mere availability of accurate information negates an inaccurate statement. Rather, when a slide is labeled 'typical,' and where a reasonable investor would not rely on one slide but instead would conduct due diligence when making an investment decision, the availability of actual and accurate information is relevant." *Id.*

307. *Id.* at 11 (quoting expert).

308. *Id.* at 11–12.

309. *Id.* at 10; *id.* at 10 n.6 ("The Typical Portfolio Slide represented that 85% of the LDBF's investment was in AAA- and AA-rated bonds (45% and 40% respectively), while the March 31, 2007, fact sheet disclosed that 94.46% of its investment was in AAA- and AA-rated bonds (62.2% and 32.26% respectively).").

310. *Id.* at 9 (quoting City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp., 632 F.3d 751, 757 (1st Cir. 2011)) (alteration added).

First Circuit held that the "thin materiality showing" with respect to the Typical Portfolio Slide "cannot support a finding of scienter."[311]

*Materiality of misrepresentations in professional-to-professional communications in the securities industry*. The Second Circuit also published a 2015 opinion that addressed materiality in the context of transactions between professionals in the financial industry. The defendant in *United States v. Litvak*, worked as a trader at Jefferies & Co. ("Jefferies"), a broker-dealer.[312] The defendant sometimes bought and sometimes sold debt securities for Jefferies' customers, and sometimes did so for Jefferies itself.[313] The government charged that the defendant made three types of misrepresentations to counterparties.[314]

First, in some instances, the defendant misrepresented the acquisition costs of residential MBS ("RMBS"), as exemplified by a transaction involving the Alliance-Bernstein Legacy Securities Fund ("ABF"), when he stated that Jefferies had paid $58 (based on a $100 face value) when in fact Jefferies bought the RMBS for $57.50—a difference of 50 cents.[315] The ABF representative who dealt with the defendant in the transaction testified that the difference "would have 'mattered' and been 'important' to him"[316] "[b]ecause we use that information of him buying at 58 to set the price that we would buy it at. If we could have bought it cheaper, that would have been better for my investors."[317] ABF paid $58.00 per $100 face value for a total of about $12 million for the RMBS, but would have paid approximately $60,000 less if the price had been lower by 50 cents per $100.[318]

Second, the government charged that the defendant misrepresented—to sellers of securities—the price at which Jefferies had arranged to resell the securities, as exemplified by a transaction in which the defendant represented to York Capital Management ("York"), a hedge fund selling RMBS to Jefferies, that Jefferies had agreed to resell the RMBS for $61.25 (based on a $100 face value) when, in fact, Jefferies had agreed to resell the RMBS for $62.375.[319] The York representative with whom the defendant negotiated agreed to sell the securities to Jefferies for $61.00 per $100 face value so that Jefferies could make a $.25 profit on the resale, but testified that the "difference [in Jefferies' resale price] would have been 'important' to her"[320] "'[b]ecause that mean[t] that [she] didn't get the best execution and that [the defendant] sold them for a lot higher than what he had

311. *Id.* at 11; *see infra* notes 490–91 and accompanying text (discussing similar analysis by First Circuit). In a portion of the decision not summarized in the text, the First Circuit also vacated the Commission's decision sanctioning a former chief investment officer at State Street. *Flannery*, 810 F.3d at 3–4, 12–15.

312. 808 F.3d 160, 166 (2d Cir. 2015).

313. *Id.* at 167.

314. *Id.* at 167–68.

315. *Id.* at 167.

316. *Id.* (quoting testimony of ABF representative).

317. *Id.* at 167 n.5 (quoting testimony of ABF representative).

318. *Id.* at 167.

319. *Id.* at 167–68.

320. *Id.* at 168 (quoting testimony of York representative).

told [her].'"[321] If York had received $62.125 (to facilitate Jefferies making a $0.25 profit on resale at the price at which Jefferies had *actually* agreed to resell), York would have garnered about $228,500 more in this transaction totalling approximately $20 million.[322]

Third, the government alleged that the defendant represented—to second parties—that Jefferies was negotiating with third parties instead of dealing in its own inventory, as exemplified in a transaction with a hedge fund called Magnetar Capital ("MC"), in which the defendant said that Jefferies was buying RMBS from a third party at $53.00 (on a $100 face value) in order to resell them to MC, when in fact Jefferies already owned the RMBS that the defendant was selling to MC and had bought them for $51.25.[323] MC paid Jefferies $53.25 so that Jefferies could make a $0.25 per $100 face value "commission."[324] The representative of MC testified that, had he known the truth, the difference in the price Jefferies had paid would have "reflected 'a very different situation,'" and that, if he had known that Jefferies was selling from its own inventory, MC would not have paid any "commission" at all.[325] If MC had not paid the "commission," then MC would have paid approximately $14,000 less (on a total cost of about $5.5 million) to acquire the RMBS.[326]

On this record, the Second Circuit held that "a rational jury could have found that [the defendant's] misrepresentations were material" and therefore the trial court had properly sent that issue to the jury.[327] But, in reversing the conviction,[328] the appellate court also held that the trial court exceeded its discretion in excluding the defendant's proffered expert testimony that the RMBS market was not efficient and that professionals set the prices on which they bought and sold by using computer models to determine the securities' value rather than by statements made by counterparties.[329]

*Significance and analysis*. Both *Flannery* and *Litvak* suggest that information might not be material even though financial sector participants in the transactions—in *Flannery*, the consulting firm providing advice to institutional investors and, in *Litvak*, representatives of a mutual fund and two hedge funds—thought that the information was important. The law permits such a conclusion because the law

321. *Id.* at 168 n.6 (quoting testimony of York representative).

322. *Id.* at 168.

323. *Id.*

324. *Id.*

325. *Id.* at 168 & n.7 (quoting testimony of MC representative).

326. *Id.*

327. *Id.* at 175.

328. *Id.* at 174–75, 178–85, 190.

329. *Id.* at 180–84. The Second Circuit also held that the trial judge wrongly excluded expert testimony that the defendant dealt at arms-length with counterparties. *Id.* at 186–88. Proposed testimony regarding the "nature of [the defendant's] relationship with the alleged victims formed the context in which the jury had to consider whether the portfolio managers and traders who testified reflected the views of a reasonable investor . . . [and] would have supported [the defendant's] materiality defense." *Id.* at 187–88. The proffered expert opinion would also have rebutted testimony by one counterparty representative, who stated his understanding that the defendant was acting as the counterparty's agent. *Id.* at 186–88.

judges materiality objectively rather than subjectively—from the viewpoint of the "reasonable investor" rather than simply that of the alleged victim.[330] Nevertheless, it should be an infrequent case in which this principle is invoked to raise the serious possibility that professional participants in the securities markets might not fit within what must surely be the broad confines of the term "reasonable investor."[331]

## DUTY TO DISCLOSE

Item 303(a)(3)(ii) of Regulation S-K requires that a public company "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[332] In 2014, the Ninth Circuit held, in the *NVIDIA Securities Litigation*, that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5."[333] In 2015, the Second Circuit disagreed.

The plaintiffs, in *Stratte-McClure v. Morgan Stanley*, focused on Morgan Stanley's (i) purchase of credit default swaps ("CDSs"), by which Morgan Stanley made annual payments in exchange for the sellers' promises to pay Morgan Stanley if mezzanine tranches of RMBS supporting certain collateralized debt obligations ("CDOs") defaulted or declined in value (referred to in the opinion as the "Short Position"), and (ii) sale of CDSs, by which the purchasers paid Morgan Stanley annual payments in exchange for Morgan Stanley's promise to pay the purchasers if super-senior tranches defaulted or declined in value (referred to in the opinion as the "Long Position").[334] In effect, Morgan Stanley "was betting that defaults in the subprime mortgage markets would be significant enough to impair the value of the higher-risk CDO tranches referenced by the Short Position, but not significant enough to impair the value of the lower-risk CDO tranches referenced by the Long Position."[335] When it turned out that the financial crisis was far more serious than Morgan Stanley anticipated, the firm lost billions of dollars on the combined Short and Long Positions.[336]

The plaintiffs brought a Rule 10b-5 action—on behalf of all those who bought Morgan Stanley stock between June 20, 2007, and November 19, 2007—against Morgan Stanley and six present and former officers, basing the claim, among other things, on the allegation that, "[b]y July 4[, 2007,] at the latest, [d]efendants knew that the Long Position was reasonably expected to have an unfavor-

330. *Id.* at 175, 184.

331. SEC v. Tex. Gulf Sulfur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc) ("The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders.").

332. 17 C.F.R. § 229.303(a)(3)(ii) (2015).

333. *In re* NVIDIA Sec. Litig., 768 F.3d 1046, 1056 (9th Cir. 2014), *cert. denied*, 135 S. Ct. 2349 (2015).

334. 776 F.3d 94, 97 (2d Cir. 2015).

335. *Id.*

336. *Id.*

able material effect on revenue" and that the defendants violated the requirement of Regulation S-K Item 303(a)(3)(ii) by failing to disclose that fact in Morgan Stanley's Forms 10-Q for the second and third quarters of 2007.[337] Specifically disagreeing with the Ninth Circuit's *NVIDIA* decision,[338] the Second Circuit broke the analysis down into two parts: (i) duty to disclose and (ii) materiality.[339] Thus, in a Rule 10b-5 action based on an omission, a plaintiff must plead that the defendants had a duty to disclose the omitted fact.[340] Such a duty "may arise when there is [(a)] 'a corporate insider trad[ing] on confidential information,' [(b)] a 'statute or regulation requiring disclosure,' or [(c)] a corporate statement that would otherwise be 'inaccurate, incomplete, or misleading.'"[341] Regulation S-K Item 303(a)(3)(ii) sufficed—per category (b)—to impose a duty to disclose sufficient for Rule 10b-5.[342] Although a plaintiff must also plead and prove in a Rule 10b-5 omission case that the undisclosed fact was *material*,[343] a plaintiff that shows *both* that the defendant violated the duty to disclose under Item 303(a)(3)(ii) *and* that the undisclosed fact was material, can win a judgment, provided, of course, that the plaintiff can plead and prove all other elements of a Rule 10b-5 claim, including scienter.[344]

In the *Morgan Stanley* case, the Second Circuit held that the plaintiffs "adequately alleged that Defendants breached their Item 303 duty to disclose that Morgan Stanley faced a deteriorating subprime mortgage market that, in light of the company's exposure to the market, was likely to cause trading losses that would materially affect the company's financial condition."[345] Plaintiffs alleged that a Morgan Stanley economist wrote on February 27, 2007, that "the long-awaited meltdown in subprime mortgage lending is now underway," and Morgan Stanley analysts reported in the summer of that year that "[r]atings downgrades in [asset backed] CDO tranches are inevitable and material."[346] Morgan Stanley allegedly had written down the Long Position by $300 million by the time the class period opened and formed a task force to develop strategies to sell down assets at risk as a result of the subprime collapse.[347] This was enough to

337. *Id.* at 96, 98 (quoting joint appendix) (first and second alterations by appellate court).

338. *Id.* at 103–04.

339. *Id.* at 100–03.

340. *Id.* at 100–01.

341. *Id.* at 101 (quoting Glazer v. Formica Corp., 964 F.2d 149, 157 (2d Cir. 1992) (quoting, in the first instance, Roeder v. Alpha Indus., Inc., 814 F.2d 22, 26 (1st Cir. 1987); then quoting, in the second and third instances, Backman v. Polaroid Corp., 910 F.2d 10, 12 (1st Cir. 1990) (en banc))).

342. *Id.* at 101–02; *id.* at 102 ("Item 303 imposes the type of duty to speak that can, in appropriate cases, give rise to liability under Section 10(b).").

343. *Id.* at 102–03. For an explanation of how Item 303(a)(3)(ii) can require disclosure of facts that are not material, see *2014 Caselaw Developments*, *supra* note 68, at 950–51.

344. *Stratte-McClure*, 776 F.3d at 103–04 (reprising the court's "decision that failure to comply with Item 303 in a Form 10-Q can give rise to liability under Rule 10b-5 so long as the omission is material . . . and the other elements of Rule 10b-5 have been established"); *id.* at 100 (listing the elements of a private cause of action in a Rule 10b-5 case, including scienter).

345. *Id.* at 104.

346. *Id.* (quoting joint appendix).

347. *Id.* at 104–05.

plead that the company "was faced with a 'known trend[ ] . . . that [was] reasonably expected to have material effects' on the company's financial position."[348]

The Second Circuit, however, added a significant caveat. While rejecting—as "generic"—the defense claim that Morgan Stanley satisfied its disclosure obligations under Item 303(a)(3)(ii) "by disclosing the deterioration of the real estate, credit, and subprime mortgage markets, and its potential negatively to affect Morgan Stanley," the court held that the firm did not need to "announce its internal business strategies or to identify the particulars of its trading positions such as the Long Position."[349] It "needed to disclose only that it faced deteriorating real estate, credit, and subprime mortgage markets, that it had significant exposure to those markets, and that if the trends came to fruition, the company faced trading losses that could materially affect its financial condition."[350] That caveat not affecting the holding, the complaint adequately alleged an Item 303(a)(3)(ii) violation, and the court then proceeded to the second requirement for an omissions claim under Rule 10b-5, resolving that requirement by "assum[ing], *arguendo*, that [the Morgan Stanley] omission was material."[351]

The Second Circuit nevertheless affirmed the district court's dismissal of the case[352]—insofar as it pertained to the failure to make the Regulation S-K Item 303(a)(3)(ii) disclosure[353]—due to the plaintiffs' failure to plead facts raising a strong inference of scienter.[354] The court read Morgan Stanley's formation of the task force as showing "that Morgan Stanley was in the process of assessing the risk to its proprietary trade during the second and third quarters of 2007," and that the complaint failed to allege "when employees realized that the more pessimistic assessments of the market were likely to come to fruition and that they would be unable to reduce the Long Position."[355] Taking into account that Morgan Stanley was, in the second and third quarters, still making money on the Short Position and that the firm "*did* fully report its exposure to mortgage securities backed by subprime loans in November 2007—less than a month after its third quarter filing and a month in advance of the next quarterly report"—the plaintiffs were simply, in the court's view, complaining that Morgan Stanley should have made a disclosure somewhat earlier than it did, which may

348. *Id.* at 105 (quoting Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, 54 Fed. Reg. 22427, 22429 (May 24, 1989) (to be codified at 17 C.F.R. pts. 211, 231, 241 & 271)).

349. *Id.*

350. *Id.* at 105–06. It is hard to see the difference between the language that Morgan Stanley *did* use, *see supra* note 349 and accompanying text, and the language the court said Morgan Stanley *should* have used, *see supra* text accompanying this note. Perhaps the key was that Morgan Stanley should have linked the subprime mortgage deterioration to the firm's trading activities.

351. *Id.* at 104, 106.

352. *Id.* at 108.

353. The published opinion deals only with the portion of the plaintiffs' case alleging that Morgan Stanley's Item 303 violation concealed the extent of its exposure to the subprime mortgage market. *Id.* at 98, 100. In an accompanying summary order, the court affirmed dismissal of the rest of the case. Stratte-McClure v. Morgan Stanley, 598 F. App'x 25 (2d Cir. 2015).

354. *Stratte-McClure*, 776 F.3d at 106–07.

355. *Id.* at 107.

have suggested negligence, but did not suggest the kind of "consciously reckless" conduct prohibited by Rule 10b-5.[356]

## SCIENTER AND PLEADING SCIENTER

To be successful on a Rule 10b-5 claim, the plaintiff must plead and prove that the defendant acted with scienter—defined by the Supreme Court as "a mental state embracing intent to deceive, manipulate, or defraud,"[357] and expanded by all courts of appeals to include some form of recklessness with respect to misleading investors.[358] The Exchange Act requires that a Rule 10b-5 complaint "state with particularity facts giving rise to a strong inference that the defendant acted with [that] required state of mind."[359] To satisfy the statutory pleading standard, the facts alleged in the complaint, together with judicially noticeable material, must raise an inference of scienter that is "cogent and at least as compelling as any opposing inference of nonfraudulent intent."[360]

Four noteworthy court of appeals opinions in 2015 considered scienter in cases where plaintiffs alleged faulty accounting. The Eleventh Circuit found that plaintiffs failed to adequately allege the scienter of a CFO and auditor as to cash balances where the issuer reported $100 million in cash on hand but defaulted on a $3.5 million debt payment.[361] The Second Circuit held scienter allegations inadequate against an auditor where the issuer's U.S. financial statements reported far more favorable numbers than the statements that the issuer submitted to a regulator in China.[362] The Tenth Circuit found scienter allegations insufficient in a case where an issuer delayed reporting a billing dispute with a major customer, with the decision resting on the defendants' non-culpable explanation that it took time for the dispute to filter up the management chain and that, after top management appreciated that there was an issue, management investigated to get to the bottom of the problem and resolved the billing with the customer, before disclosing it.[363] The Fifth Circuit ruled that plaintiffs failed to allege scienter in a case built around mis-valuation of MBS where the valuations involved subjective judgments.[364]

In another case also involving alleged financial fraud, the Tenth Circuit held that a complaint satisfied the high scienter pleading standard applicable to private Rule 10b-5 claims where a CEO misstated the reason that a strategic partner declined to purchase an interest in assets that the CEO's company owned, with the court rejecting the argument that, if the CEO mischaracterized why the deal failed, he did so only to help his company (and its shareholders) obtain a high

356. *Id.*
357. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).
358. 8 LOUIS LOSS ET AL., SECURITIES REGULATION 150 n.544 (4th ed. 2012 & Supp. 2016).
359. 15 U.S.C. § 78u-4(b)(2)(A) (2012).
360. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).
361. *See infra* notes 370–82 and accompanying text.
362. *See infra* notes 383–406 and accompanying text.
363. *See infra* notes 407–24 and accompanying text.
364. *See infra* notes 425–55 and accompanying text.

price from other potential buyers and therefore committed no securities fraud.[365]

Two decisions ruled on scienter allegations in cases originating in the drug and medical device industry. The First Circuit found scienter pleading inadequate in an action against a medical device company that made various public palliative comments during a long-running dialogue with the FDA over off-label marketing.[366] The Fourth Circuit, however, held that plaintiffs properly alleged scienter where a drug company specifically described communications with the FDA, but omitted negative facts from those descriptions.[367]

Finally, in two cases, courts of appeals considered more general scienter issues. The Ninth Circuit addressed imputation of an officer's scienter to a corporate defendant. The court of appeals held that the "adverse interest" exception to such an imputation has, itself, an exception and does not apply where the officer communicates to investors with apparent authority from the company.[368] The Second Circuit ruled that scienter does not require an intent to harm.[369]

*CFO and auditor liability premised on size of accounting inconsistency*. Investors in *Brophy v. Jiangbo Pharmaceuticals, Inc.* brought a Rule 10b-5 action against Jiangbo's former CFO and its former outside auditor.[370] Plaintiffs based their case against the CFO on the ground that she had signed certifications to the Jiangbo periodic filings that (i) stated the company had adequate internal controls and that the financial statements were accurate, even though the filings overstated the company's cash balances, and (ii) failed to disclose a related-party transaction in which Jiangbo transferred $31 million to a company controlled by the Jiangbo chairman.[371] Plaintiffs based their case against the outside auditor on the auditor's unqualified opinion on annual financial statements for fiscal 2010—statements suffering from the same two defects, overstating Jiangbo's cash balances and failing to disclose the related-party transaction.[372] The Eleventh Circuit affirmed dismissal of the case as to both defendants because the investors failed to adequately plead scienter.[373]

As to the CFO and the cash balances, the investors relied largely on the theory that the misstatement was so large that the CFO must have been aware of it.[374] But, although the plaintiffs pointed to the inconsistency between the approximately $100 million in cash reported in the company's filings during the June 8, 2010, through May 31, 2011, class period and Jiangbo's default in early 2011 on a

365. *See infra* notes 456–68 and accompanying text.
366. *See infra* notes 469–500 and accompanying text.
367. *See infra* notes 501–29 and accompanying text.
368. *See infra* notes 530–39 and accompanying text.
369. *See infra* notes 540–43 and accompanying text.
370. 781 F.3d 1296, 1298–1300 (11th Cir. 2015).
371. *Id.* at 1300–01.
372. *Id.* at 1301.
373. *Id.* at 1298–99, 1307–08.
374. *Id.* at 1302–03.

$3.5 million debt payment,[375] the plaintiffs "fail[ed] to allege any particular amount or even a range" of the actual cash on hand and without such "specifics, [they could not] persuasively allude to the magnitude of the fraud as a basis for a strong inference that [the individual defendant] must have known of the errors as CFO."[376] As to the related-party transaction, plaintiffs alleged that the CFO's resignation during an audit committee investigation, and her obstruction of the investigation into that transaction, demonstrated scienter.[377] However, balanced against the intuition that resigning during a fraud investigation appeared incriminating was "the fact that [the CFO] continued[, after the resignation,] to work for the company on a part-time basis" which "equally supports a nonculpable explanation" for the departure.[378] Moreover, while the CFO did not provide the audit committee with the information it requested, "she personally prepared the materials for review and preliminarily agreed to turn them over pending the company's approval."[379] This weighed so much in her favor that, even though "she neglected a prevailing duty to provide her materials to the committee regardless of the chairman's wishes," these events did not "add much weight to an inference of scienter."[380]

The appellate court found the pleadings against the auditor deficient as well. The auditor was named solely because of one clean opinion on one year's financial statements, and the complaint did "not set out in what ways [the] audit [producing that opinion] was deficient."[381] While the auditor declined to stand for reappointment and did so "around the same time as [the CFO] resigned and [an] SEC investigation began," there was "no connection between the fact of an SEC investigation and [the auditor's] state of mind that a reviewing court may reasonably draw on the face of the complaint."[382]

*Auditor liability premised on issuer submitting financial statements to U.S. regulators that differed from those that the issuer submitted to foreign regulators.* Following dismissal of the auditor defendants from claims in the first amended complaint,

375. *Id.* at 1300. The district court decision includes the class period. *In re* Jiangbo Pharm., Inc. Sec. Litig., 884 F. Supp. 2d 1243, 1248 (S.D. Fla. 2012). The plaintiffs implied that, if the company had really possessed the large amount of cash it reported, it would not have defaulted on the relatively small debt principal payment. *Brophy*, 781 F.3d at 1300.

376. *Brophy*, 781 F.3d at 1304.

377. *Id.* at 1305. The CFO resigned effective on March 31, 2011. *Jiangbo Sec. Litig.*, 884 F. Supp. 2d at 1260. Two members of the company's audit committee resigned on June 6, 2011, and their resignation letter—which complained about unsatisfied investigative requests concerning the $31 million related-party transaction—allegedly disclosed that transaction for the first time. *Brophy*, 781 F.3d at 1300–01.

378. *Brophy*, 781 F.3d at 1305.

379. *Id.*

380. *Id.* As to a general duty to disclose the related-party transaction to investors, the complaint failed to allege when the CFO became aware of that transaction and, therefore, failed properly to allege that its absence constituted a material omission in the company's SEC filings for which the CFO was responsible. *Id.* at 1306. The court also invoked facts that generally argued against the CFO having acted with scienter, including that she was located in Florida while Jiangbo conducted its operations in China, and that she did not sell any company stock during the period of the alleged fraud. *Id.*

381. *Id.* at 1307.

382. *Id.* The court added that, "[a]s an external auditor, [the auditor defendant] was a step more removed than [the CFO] from any alleged indicators of fraud." *Id.*

the *In re Advanced Battery Technologies, Inc.* plaintiff moved to file a second amended complaint, alleging that the auditors "falsely represent[ed] that they performed their audits of Advanced Battery Technologies, Inc. ('ABAT') in accordance with professional standards and that ABAT's filings accurately reflected its financial condition from . . . 2007 through . . . 2010."[383] Following the district court's denial of that motion on the basis that filing the new complaint would be futile, the Second Circuit affirmed the judgment dismissing the auditors on the basis that the proposed new complaint did not plead facts raising a strong inference of the auditors' scienter.[384]

ABAT manufactured rechargeable polymer lithium-ion batteries.[385] The company operated principally in China, but listed its stock on a U.S. exchange after a reverse merger in 2004.[386] ABAT engaged one of the two auditor defendants from 2006 through December 14, 2010 (with this defendant auditing the years 2007 through 2009).[387] ABAT engaged the second from December 14, 2010, to the end of the class period (with this defendant auditing the year 2010).[388]

As to the first auditor, the plaintiff pled that it had access to ABAT's filings with the Chinese Administration of Industry and Commerce ("AIC"), which filings reported dramatically poorer results than the results that ABAT included in its SEC filings.[389] The plaintiff referred to an expert's opinion "that 'no reasonable auditor would have failed to obtain ABAT's AIC filings.'"[390] The plaintiff, however, "conceded . . . [that] none of the accounting standards on which he relies—the Generally Accepted Auditing Standards, Statements on Auditing Standards, or GAAP—specifically requires an auditor to inquire about or review a company's foreign regulatory filings."[391] The "conclusory statement" by the expert did not change the court's view that those accounting standards did not "impos[e] a general duty to inquire[,] the breach of which would constitute recklessness."[392] The plaintiff also contended that a duty to review the AIC filings befell the auditor because the ABAT financial statements prepared for SEC filings showed "unusually high profit margins."[393] The Second Circuit, however, held

383. 781 F.3d 638, 641 (2d Cir. 2015).
384. *Id.* at 641, 644–46.
385. *Id.* at 642.
386. *Id.*
387. *Id.* at 643.
388. *Id.* The class period ran from May 15, 2007 to March 29, 2011. First Amended Consolidated Class Action Complaint at para. 1, *In re* Advanced Battery Techs., Inc., No. 11 Civ. 2279 (CM), 2012 WL 3758085 (S.D.N.Y. Aug. 29, 2012), 2011 WL 12882766.
389. *Advanced Battery*, 781 F.3d at 642, 645. The court provided particulars:

> [F]rom 2007 to 2009 ABAT reported losses to the AIC while it reported significant profits to the SEC. The differences were indisputably material. Taking 2007 as an example, ABAT reported to the AIC that its revenues were approximately $145,000 and that it suffered an operating loss of $1 million, while it reported to the SEC revenues of $31.9 million and a profit of $10.2 million.

*Id.* at 642.
390. *Id.* at 645 (quoting accounting expert).
391. *Id.*
392. *Id.*
393. *Id.*

that "ABAT's report of high profit margins in its SEC filings triggered, at most, a duty to perform a more rigorous audit of *those* filings," rather than a duty to compare those filings with the AIC filings, and added that any failure by the auditor to infer wrongdoing from the high margins did not amount to recklessness.[394] As for the plaintiff's argument that ABAT deserved extra scrutiny because its stock became listed on a U.S. exchange through a reverse merger, the plaintiff did "not allege that heightened scrutiny of Chinese companies that used reverse mergers in the United States began prior to mid-2011—in other words, after the relevant audits in this case."[395] Finally, with respect to the first auditor and ABAT's overall financial results, the plaintiff asserted that the auditor had access to the underlying data that produced the financial statements filed with the AIC, that that data contradicted the numbers in the SEC-bound financial statements the auditor examined, and that the auditor's "failure to spot the discrepancies was reckless."[396] The Second Circuit, however, found "more compelling" the inference "that ABAT maintained two sets of data—one for its Chinese regulators and another for its regulators in the United States—and fed [the auditor] false data to complete its audits."[397]

In addition to contending that the first auditor failed to properly investigate ABAT's financial results, the plaintiff contended that (i) ABAT's audited financial statements for 2007 and 2008 falsely identified ZQ Power-Tech Co. Ltd. ("ZQ") as a wholly owned subsidiary of a wholly owned subsidiary when, in fact, ZQ was owned by the ABAT chairman/CEO and other investors, who supposedly had assigned the "benefits and obligations" of their ownership to ABAT;[398] and (ii) the auditor was reckless in failing to discover that ABAT had only a beneficial interest in ZQ rather than a legal interest.[399] The Second Circuit found that it could, at most, infer negligence from those allegations,[400] not the conscious recklessness required for auditor liability under Rule 10b-5.[401]

The allegations against the second auditor focused on a December 2010 transaction in which ABAT purchased Shenzhen Zhongqiang Energy Science & Technology Co., Ltd. ("SZ Ltd.") for $20 million.[402] The plaintiff alleged that (i) SZ Ltd. had lost money in each year of its existence; (ii) ABAT's chairman/CEO owned SZ Ltd., having bought it in 2008 for only $1 million; and (iii) the second auditor "'would have' discovered the fraudulent nature of the . . . acquisition had it performed 'the most basic of audit duties.'"[403] However, "conditional allega-

394. *Id.* (citing, as to the last point, Chill v. Gen. Elec. Co., 101 F.3d 263, 270 (2d Cir. 1996)).
395. *Id.*
396. *Id.*
397. *Id.* at 645–46.
398. *Id.* at 642–43.
399. *Id.* at 646.
400. *Id.*
401. *Id.* at 644.
402. *Id.* at 642–43.
403. *Id.* at 642–43, 646 (quoting proposed second amended complaint).

tions of the sort 'that [a defendant] "would" have learned the truth' about a company's fraud 'if [it] had performed the "due diligence" it promised' are generally insufficient to establish the requisite scienter for private securities fraud claims 'under the PSLRA's heightened pleading instructions.'"[404] While the plaintiff also contended that the "inflated purchase price should have alerted [the auditor] that the transaction was a sham,"[405] the Second Circuit found no allegation in the complaint that the auditor knew that the price was too high, and the auditor's "failure to uncover and appreciate the significance of the inflated price . . . [did] not represent 'an extreme departure from the standards of ordinary care.'"[406]

*Significance and analysis. Advanced Battery* is very auditor-friendly. Nonetheless, auditors who provide opinions on the financial statements of companies that are filing financial statements with regulators other than the SEC might usefully consider whether the audit should include an examination of those other financials.

*Delay in obtaining information about billing problem and investigation of problem before restatement.* The *In re Gold Resource Corp. Securities Litigation* plaintiff alleged Rule 10b-5 financial fraud beginning with the issuer's January 30, 2012, announcement of 2011 results and continuing to November 8, 2012, when the issuer disclosed that it (i) was resolving a billing dispute with a customer, (ii) was restating its financial results for the first and second quarters of 2012, and (iii) had found a material weakness in internal controls relating to assay sampling by which it billed customers for minerals.[407] The financial fraud allegedly rendered false or misleading (i) reports of record results for 2011 and the first quarter of 2012, (ii) a statement in the issuer's 10-K that management had concluded that internal control over financial reporting was effective, and (iii) statements in the 10-Qs for the first and second quarters of 2012 that there were no changes in internal control over financial reporting.[408]

The asserted financial fraud revolved around the contract between Gold Resource Corporation ("GRC") and its customer for product the company mined in Mexico.[409] The contract permitted GRC to assay samples of the product before shipment and provisionally bill ninety percent of the full price based on that sampling.[410] The customer then assayed the product on arrival at the customer's warehouse.[411] If the customer's assay result differed materially from

404. *Id.* at 646 (quoting S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 110, 112 (2d Cir. 2009)).
405. *Id.*
406. *Id.* (quoting Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000)).
407. 776 F.3d 1103, 1106, 1109, 1111 (10th Cir. 2015).
408. *Id.* at 1109–10.
409. *Id.* at 1106–07. "GRC had only two buyers to whom it sold all of its [product]—subsidiaries of the Trafigura Group." *Id.* at 1107.
410. *Id.* at 1107.
411. *Id.*

GRC's, an umpire conducted an assay and the buyer's final bill was adjusted accordingly.[412] These adjustments eventually led to the restatement.[413]

The plaintiff characterized this set of events as an "overbilling scheme" that GRC implemented to inflate its financial results.[414] The plaintiff pled that GRC and the individual defendants at GRC acted with scienter based on, among other things, the simplicity of the relevant accounting rules, the company's statement in a November 8, 2012 Form 8-K ("8-K"), that, "[a]s of September 30, 2012, management believe[d] the internal control deficiency ha[d] been remediated" (which meant, according to the plaintiff, that the defendants were aware of material billing problems by that date), the company's restatement, the circumstance that the error affected "core operations," and the small number of employees at the company.[415] Affirming the district court's dismissal in favor of the defendants,[416] the Tenth Circuit relied largely on a transcript of statements that GRC's CEO made during a November 2012 conference call to conclude that the defendants provided a "plausible, opposing inference" that their conduct was without fraud.[417]

The plausible explanation was that it took GRC some time to discover and sort out the billing dispute. According to the company's account, employees in Mexico did not initially credit the buyer's assay results and therefore did not advise management in Denver of the assay discrepancy until the umpire's assay results became available in the third quarter of 2012.[418] When the problem then came to management's attention, the company instituted an investigation, which led to the conclusion that the customer had problems at its facility.[419] In settling their dispute, the customer paid GRC's provisional bills for April, May, and June, but paid amounts based upon its own assays for shipments in February and March.[420] In addition, the customer improved security at its receiving facility, and GRC began sending a representative with shipments to watch over the product until the customer took samples for testing.[421] The Tenth Circuit found that the defendants' "explanation regarding the delay in their receiving notice of the variances, particularly given the several months it took until the umpire assays were finalized,"[422] together with the "prudent" decision "to investigate and confirm a claimed discrepancy before disclosing it publicly,"[423] provided an ade-

412. *See id.* at 1107 & n.3.

413. *Id.* at 1107, 1111.

414. *Id.* at 1107.

415. *Id.* at 1111 (quoting 8-K); *id.* at 1113 (quoting GRC's brief).

416. *Id.* at 1119.

417. *Id.* at 1116. "Plaintiff referred to the transcript of [the November 2012] conference call in the amended complaint but then ignored most of its content. The district court took judicial notice of the entire transcript." *Id.* at 1114 n.7.

418. *Id.* at 1114.

419. *Id.* at 1115.

420. *Id.*

421. *Id.*

422. *Id.* at 1116.

423. *Id.* at 1115; *see id.* at 1116 ("Defendants had every reason not to disclose the disputed variance before the dispute was investigated and settled.").

quate competing and nonculpable account, and therefore the court was "not persuaded [that] a reasonable person would deem an inference of scienter more cogent or compelling than an opposing inference of nonfraudulent intent," so that the plaintiff failed to plead facts giving rise to a strong inference of scienter.[424]

*Valuations of MBS*. The plaintiffs in *Owens v. Jastrow* sued former officers of Guaranty Financial Group, Inc. ("GFG")—which owned Guaranty Bank (together with GFG, "Guaranty")—and Temple-Inland, Inc. ("Temple"), GFG's former parent, pleading a Rule 10b-5 claim on behalf of investors that purchased GFG stock between December 12, 2007, and August 24, 2009.[425] The claim centered on allegations that Guaranty held MBS based on risky, adjustable rate mortgages and that, after Temple spun off GFG, Guaranty overvalued those MBS, underreported its losses on the MBS, and failed to record those losses as other-than-temporary impairment ("OTTI").[426] Ultimately, in July 2009, Guaranty recorded a $1.62 billion impairment on its MBS portfolio at the direction of the Office of Thrift Supervision ("OTS").[427] GFG filed for bankruptcy on August 27, 2009.[428]

The Fifth Circuit affirmed a district court dismissal of the second amended complaint on the basis that the plaintiffs' allegations failed to raise a strong inference of scienter.[429] Phrasing the issue as whether the complaint pled "sufficient facts to allege scienter as to each defendant,"[430] the court held initially that, while a district court must analyze the scienter allegations holistically, the district court "may best make sense of scienter allegations by first looking to the contribution of each individual allegation to a strong inference of scienter, especially in a complicated case such as this one[, then] . . . follow[ing] this initial step with a holistic look at all the scienter allegations."[431] The Fifth Circuit also reiterated its rejection of "group pleading" scienter allegations, determined that it generally would "disregard"[432] "allegations that [were] not tied to a particular defendant,"[433] but held that it would consider certain allegations that were tied "to more than one defendant . . . because they [were] sufficiently particularized."[434]

Turning then to the "[a]llegations common to more than one defendant," the Fifth Circuit held that the plaintiffs pled with particularity that three defendants—(i) the CEO/board chair of Temple, who was also the board chair of Guaranty until

424. *Id.* at 1118. The court of appeals also observed that the "defendants hold eighteen percent of the stock of GRC[,] . . . that there is no allegation they sold any of it during the class period," and that those facts cut against any scienter inference too. *Id.* at 1117 n.8.

425. 789 F.3d 529, 533 (5th Cir. 2015) (describing the relationship between Temple, GFG, and Guaranty); *id.* at 534 (identifying the class period, and identifying the claim as an alleged violation of Rule 10b-5); *id.* at 534, 542, 545–46 (identifying the defendants and their positions). The court states that its "opinion uses the general term 'Guaranty' when no distinction between GFG and [GB] is warranted." *Id.* at 533 n.1. This summary uses "Guaranty" where the court uses that word.

426. *Id.* at 533–34.

427. *Id.* at 534.

428. *Id.*

429. *Id.* at 534, 547.

430. *Id.* at 535.

431. *Id.* at 537.

432. *Id.* at 538.

433. *Id.* at 537.

434. *Id.* at 538 & n.4.

August 26, 2008 ("Guaranty's Chairman"), (ii) the Guaranty President/CEO until November 19, 2008, who was also Guaranty's board chair after August 26, 2008 ("Guaranty's CEO"), and (iii) the Guaranty Senior Executive Vice President and CFO until July 10, 2009 ("Guaranty's CFO"), who was also the Principal Accounting Officer ("PAO") there from October 27, 2008, until July 10, 2009—knew that Guaranty was undercapitalized and therefore had a motive to misrepresent Guaranty's financial condition in order to more easily attract additional investment.[435] While that motive "contribute[d]" to scienter allegations against those defendants,[436] the lawsuit did not present "the rare case"[437] in which a strong scienter inference might rest solely on "motive and opportunity" pleading because Guaranty was not a "single product" company, and the MBS portfolio constituted no more than twenty-two percent of Guaranty's assets.[438] Although the plaintiffs alleged that "red flags" alerted defendants that the MBS were overvalued—(i) a 250 percent increase, during the nine months preceding June 30, 2008, in delinquencies on MBS issued by private institutions rather than government-sponsored entities; (ii) a decrease in the value of such MBS to sixty percent of cost by June 30, 2008; and (iii) credit rating downgrades or negative watch warnings in June and July 2008 on ten MBS owned by Guaranty—the Fifth Circuit responded that these events occurred after most of the alleged misrepresentations and, in any event, were disclosed by GFG so that investors could consider them in assessing the value of the MBS that Guaranty owned.[439] Moreover, the court noted that the "defendants' disclosures conveyed to investors that its [model-derived] MBS valuations were far from certain."[440] Combined, the "[d]efendants' disclosure of the 'red flags' and candidness about the uncertainty underlying its models neutralize[d] any scienter inference from 'red flags.'"[441] The final allegation, common to multiple defendants, was that the size of the accounting error—the failure to record $1.62 billion as OTTI—contributed to a scienter inference.[442] The Fifth Circuit held that "the magnitude's contribution to an inference of scienter is small, because the valuation involved subjective accounting concepts that can yield a wide range of reasonable results."[443]

435. *Id.* at 538; *id.* at 542, 545 (identifying the positions that these individual defendants held).
436. *Id.* at 540.
437. *Id.* at 539–40 (expressing skepticism that such a "rare set of circumstances," Nathenson v. Zonagen Inc., 267 F.3d 400, 412 (5th Cir. 2001), could still exist in light of *Goldstein v. MCI WorldCom*, 340 F.3d 238, 246 (5th Cir. 2003)).
438. *Id.* at 540.
439. *Id.* at 540–41.
440. *Id.* at 541.
441. *Id.*
442. *Id.*
443. *Id.*

Moving to allegations against (i) Guaranty's CEO and (ii) Guaranty's CFO, the court noted the assertion that Guaranty's Senior Vice President of Investments and Secretary of the Asset Liability Committee warned those two defendants in January 2007 that Guaranty's model for valuing MBS was deficient in several respects, including by use of outdated parameters.[444] Nonetheless, the Fifth Circuit held that "[a]n inference of severe recklessness is more likely when a statement violates an objective rule than when GAAP permits a range of acceptable outcomes,"[445] and that it was "undeniable that there [was] some subjectivity present in Guaranty's decision to continue using its internal models and to delay recognizing impairments as other than temporary."[446] Further, the alleged January 2007 warning failed to mention GAAP and did "not seem to suggest that any issues were so severe that they could lead to a large overvaluation of the MBS portfolio."[447] In addition, the defendants relied on AAA ratings on all of Guaranty's MBS, as did its regulator, the OTS.[448] While allowing that the plaintiffs "c[a]me closest to alleging scienter by noting that [Guaranty's CEO and Guaranty's CFO] continued to use the internal models even after the ratings agencies downgraded or placed some of Guaranty's MBS on negative watch," the court of appeals pointed out that Guaranty "never purchased the most junior tranche of MBS, meaning that there was a buffer before losses would begin to affect its portfolio."[449] Altogether, the appellate court saw only "allegations . . . combin[ing] poor business judgment with financial motive"—not enough to satisfy the high pleading standard for scienter in private lawsuits.[450]

The court found the scienter allegations against the remaining individual defendants even more deficient. As to Guaranty's Chairman, the plaintiffs did not allege that he was ever told of warnings or internal disagreements over MBS valuation, and his "knowledge of Guaranty's undercapitalization and awareness of the decline of the California real estate market [did] not rise to the level of a 'strong inference' of scienter that [was] at least as likely as the alternative inference that [this defendant] was merely negligent in believing that any decline was temporary and would not affect Guaranty's AAA-rated securities."[451] As to a fourth defendant—who had been Guaranty's Controller until December 2007, when he became Guaranty's Executive Vice President and PAO—the plaintiffs did not plead that he was told that the valuation models were deficient,[452] and, at bottom, sought to infer his scienter from his "position of [PAO] at the

444. *Id.* at 542.
445. *Id.* at 543.
446. *Id.* at 544.
447. *Id.*
448. *Id.* The Fifth Circuit noted that the Second Circuit had "held that UBS was not reckless in relying on the assets' AAA rating in the face of internal and external uncertainty and disagreement about the valuation of mortgage-related assets." *Id.* (citing City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG, 752 F.3d 173, 187 (2d Cir. 2014)).
449. *Id.* at 545.
450. *Id.*
451. *Id.* at 546.
452. *Id.*

time a large misstatement was made, and that red flags existed."[453] Having already held that the size of the misstatement and the red flags were not enough as to other defendants, the Fifth Circuit also found them insufficient as to this defendant.[454]

*Significance and analysis*. Narrowly, *Owens* suggests difficulties in pleading scienter where defendants in cases arising out of the financial crisis failed to write down MBS in a timely way after limiting firm exposure to MBS (twenty-two percent of assets in *Owens*), buying only triple-A rated MBS, purchasing only senior tranches so that defaults would only reach the securities the defendants bought after eating through more junior tranches, and relying on valuation models (that necessarily involved judgments) at a time when there were no reliable market quotations for MBS. The notion seems to be that the entire financial industry was caught by surprise when the valuations for such securities proved far too generous. More broadly, *Owens* suggests that plaintiffs will find it difficult to plead scienter in cases based on accounting errors where the defendants convince the court that the challenged numbers rested on judgments.[455]

*Misstatement of reason for failure of pending transaction*. In *Nakkhumpun v. Taylor*, the plaintiff brought a Rule 10b-5 action based significantly on the statement by Delta Petroleum Corporation's ("Delta") board chair, in a July 2010 press release, that Opon International LLC ("Opon") was not going forward with a previously announced purchase of a 37.5 percent non-operating interest in Delta's Vega Area assets, at a price of $400 million.[456] The board chair said: "While Opon was unable to arrange financing for a transaction on terms acceptable to us, we remain confident in the value of our Vega Area asset[s], and intend to further delineate that value as we consider the Company's other strategic alternatives."[457] Reversing the district court's dismissal of the complaint insofar as it rested on this alleged misstatement,[458] the Tenth Circuit held that the plaintiff pled falsity by alleging that Opon's former CEO said Opon terminated the transaction, not because Opon failed to procure financing, but because Opon concluded that the 37.5 percent interest was not worth $400 million.[459]

The court held that the plaintiff also adequately alleged the board chair's scienter by pleading (i) that Opon's CEO had told plaintiff's counsel that

453. *Id.*

454. *Id.*

455. In three other decisions, two courts of appeals provided scienter rulings where plaintiffs asserted accounting fraud. The Eighth Circuit found no strong inference of scienter where an issuer restated financial results only after lengthy discussions with the SEC's Division of Corporate Finance, during which the company vigorously defended its decision to record pollution control outlays as capital expenditures instead of current period expenses. Podraza v. Whiting, 790 F.3d 828, 832–33 (8th Cir. 2015). The Second Circuit found scienter allegations insufficient in a case where the issuer made seriatum disclosures of internal control weaknesses. *In re* Magnum Hunter Res. Corp. Sec. Litig., 616 F. App'x 442, 445–46 (2d Cir. 2015). That same court found that plaintiffs failed to allege facts demonstrating that a defendant bank, or individuals there, intended to deceive by assurances concerning risk management—given while a rogue trader was exposing the bank to billions in possible losses. Westchester Teamsters Pension Fund v. UBS AG, 604 F. App'x 5, 7–8 (2d Cir. 2015).

456. 782 F.3d 1142, 1145, 1147 (10th Cir. 2015).

457. *Id.* at 1147 (quoting press release).

458. *Id.* at 1162.

459. *Id.* at 1148.

(a) Opon concluded, after conducting due diligence, that the interest was not worth $400 million, (b) Opon had thereupon offered a lower price, and (c) Opon's CEO had dealt directly with the Delta board chair in retracting the $400 million offer; (ii) that Delta had previously advised the market on multiple occasions of the pending deal, in communications that included the $400 million figure; and (iii) that therefore "fact-finders could reasonably infer that someone in [the Delta board chair's] situation would have recognized the risk of deceiving investors, who presumably would have attributed the impasse to Opon's inability to obtain a loan rather than its unwillingness to pay $400 million for a 37.5% interest in the assets."[460] To the Tenth Circuit, the manner in which the board chair phrased his comments ran the risk of Delta shareholders "believ[ing] that Opon continued to value the 37.5% interest at $400 million" and that therefore the investors could "expect offers from other potential buyers with better credit than Opon."[461] The court found that the plaintiff had pled "facts indicating that [the board chair] was at least reckless in disregarding the risk that his statement would mislead existing and potential shareholders," with "reckless disregard of a substantial likelihood of misleading investors" sufficing for scienter.[462]

*Significance and analysis*. The defense argued that the board chair was simply discharging his "fiduciary duty to obtain the highest price for the Vega Area assets"[463] and that, if he mischaracterized the reason for Opon's termination, he did so to preserve Delta's opportunity to obtain a high price for the assets from another buyer.[464] The district court concluded that such a shareholder-focused motivation cut against scienter.[465] The Tenth Circuit, however, held that, regardless of whether the board chair's statement was "intended to mislead strategic partners rather than shareholders," the "statement created a risk of misleading shareholders to believe that at least one potential buyer had valued the 37.5% interest in the Vega assets at $400 million[, and t]his risk was readily apparent, creating an inference of scienter that was at least as strong as an inference of innocence."[466] The upshot is that, with recklessness sufficing for scienter in all circuits,[467] the executive or director who dissembles in a public statement in order to help his or her company make more money may be liable under Rule 10b-5 if,

460. *Id.* at 1150–52; *id.* at 1152 (including quotation).

461. *Id.* at 1152.

462. *Id.* at 1150; *id.* at 1152 ("The risk of misleading investors would have been obvious."). The Tenth Circuit reversed only as to the board chair, as the plaintiff had "not adequately pleaded culpability on the part of other defendants regarding the Opon transaction." *Id.* at 1157. The Tenth Circuit also affirmed dismissal of the plaintiff's claim insofar as it rested on allegedly misleading statements about Delta's financial condition, liquidity, and value in light of transactions in the industry—holding as to those that the plaintiff failed to allege either falsity or scienter. *Id.* at 1157–62.

463. *Id.* at 1153.

464. *Id.* at 1152–53 (rejecting, legally and factually, "defendants['] argu[ment] that [the board chair] lacked a motive to engage in securities fraud because his interests and Delta's were aligned with the interests of shareholders").

465. *Id.* at 1149–50.

466. *Id.* at 1153.

467. *See supra* note 358 and accompanying text.

despite this benign motivation, the executive or director is severely reckless with respect to whether the statement will materially mislead shareholders.[468]

*Disclosures during long-running dialogue with FDA over off-label promotions.* The plaintiffs in *Fire & Police Pension Ass'n of Colorado v. Abiomed, Inc.* brought a Rule 10b-5 action against Abiomed and its CEO and CFO that centered on Abiomed's promotion of its micro heart pump (the Impella 2.5) for uses other than those for which the FDA had approved it.[469] In 2008, the FDA approved the Impella 2.5 "for partial circulatory support for up to six hours."[470] This meant that Abiomed could respond to medical professionals' request to use the device for other purposes, but could not market the pump for other uses.[471] In 2007, the FDA granted Abiomed an investigational device exemption ("IDE") to test the Impella 2.5 against the intra-aortic balloon pump ("IABP") for use during angioplasties (high-risk percutaneous coronary interventions ("PCI")), and in 2008, the FDA granted Abiomed an IDE to test the Impella 2.5 against the IABP in unstable patients who were undergoing PCIs due to heart attacks (acute myocardial infarctions ("AMIs")).[472] The IDEs meant that Abiomed could use the pump for PCIs during the comparative studies but could not, during the studies, represent that the Impella 2.5 was safe and effective for PCIs.[473]

The FDA sent Abiomed an Untitled Letter on January 28, 2010, stating that Abiomed had improperly promoted the Impella 2.5 for use in high-risk PCIs and AMIs.[474] After Abiomed acknowledged that it had made improper efficacy

468. The Tenth Circuit held that the plaintiff pled loss causation under "a theory of 'materialization of a concealed risk.'" *Nakkhumpun*, 782 F.3d at 1153 (quoting from and agreeing with district court). The board chair's statement "concealed the risk that 'the Vega Assets were not marketable at or near the $400 million price.'" *Id.* at 1154 (quoting district court). That risk was foreseeable because, "[i]f Opon decided (after conducting its due diligence) that a 37.5% non-operating interest in the assets was not worth $400 million, Delta might not find any other potential buyers willing to pay $400 million." *Id.* The "risk materialized on November 9, 2011, when Delta disclosed its inability to find a buyer." *Id.* at 1155. Delta's stock declined after that announcement, and the defendants offered no "intervening events that would show disruption of the causal link [between the announcement and the stock decline] as a matter of law." *Id.* at 1156.

Three additional 2015 opinions addressed scienter in financial cases that did not center on accounting. The Second Circuit held that plaintiffs adequately pled scienter where they alleged that management represented the issuer was struggling to keep up with demand when, in fact, the company was swamped with unsold inventory that it was hiding from auditors. Emps.' Ret. Sys. of Gov't of the V.I. v. Blanford, 794 F.3d 297, 300–02 (2d Cir. 2015). In *Lucas v. Icahn*, 616 F. App'x 448, 450 (2d Cir. 2015), the same court ruled that, even assuming an issuer's description of a transaction was false with respect to the value of one component (an assumption the court found difficult to accept), the issuer's disclosure of "all the information an investor would need to perform a valuation" was "flatly inconsistent with an intent to mislead investors." The Tenth Circuit found scienter allegations inadequate in a case where plaintiffs alleged that an issuer failed to footnote its ownership tables to disclose a CEO's pledge of stock, but the CEO disclosed, in Rule 144 and Form 4 filings, that his pledged stock was sold to meet margin calls. *In re* ZAGG, Inc. Sec. Litig., 797 F.3d 1194, 1197, 1198–99, 1203–04 (10th Cir. 2015).

469. 778 F.3d 228, 231–32 (1st Cir. 2015).

470. *Id.* at 233.

471. *Id.* at 232–33.

472. *Id.* at 233.

473. *Id.* at 232–33.

474. *Id.* at 233. An Untitled Letter addresses "regulatory violations that do not meet the threshold for regulatory significance warranting a Warning Letter." *Id.*

claims, the company stated that it would revise its promotional materials, had enhanced its review of promotional materials, and had made other changes.[475] The FDA told Abiomed on April 20, 2010, that the company's "'response appear[ed] adequate' and that no further action was necessary."[476] Abiomed did not disclose this regulatory exchange.[477]

On June 10, 2011, the FDA sent Abiomed a formal Warning Letter, complaining that the company's "marketing materials continued to improperly compare the Impella 2.5 to the IABP and promote the device for non-cleared uses."[478] The FDA posted this letter on its website.[479] Abiomed conducted a "clarification call" with the FDA in July, then formally responded in August that it would pull the advertisement to which the FDA objected, remove from its website materials relating to a medical conference at which the company claimed that the Impella 2.5 could improve cardiac output in AMI shock patients, and implement a plan to prevent further violations.[480] In April 2012, the FDA told Abiomed that the company was still engaged in improper marketing—referring among other things to videos on the AbiomedImpella YouTube channel, which discussed unapproved uses of the Impella 2.5, a link on the Abiomed website to "Patient Stories" about unapproved uses of the pump, and comments by the Abiomed CEO during a Mad Money appearance suggesting that the Impella 2.5 could be used during heart attacks.[481] Following an August 7, 2012, meeting between Abiomed and the FDA, the FDA conducted a compliance audit at the company, and Abiomed simultaneously conducted its own internal audit.[482] On August 20, 2012, Abiomed wrote a letter to the FDA saying "that it understood its prior approach to compliance was 'too narrow in focus' and so was 'adopting a broad, systemic approach to address the issues raised by [the] FDA,'" and that the company was "destroy[ing] the Impella marketing brochures cited by [the] FDA, stopp[ing] distribution of *all* marketing labeling, recall[ing] *all* marketing labeling held by Abiomed field personnel, and stopp[ing] any planned updates to *all* labeling and the [Abiomed] website."[483]

On November 1, 2012, Abiomed disclosed the FDA compliance audit and an investigation by a U.S. Attorney into Abiomed's advertising and promotions.[484] The company's stock price dropped by thirty-two percent.[485] By a February 19,

475. *Id.* at 233–34.
476. *Id.* at 234 (quoting FDA letter).
477. *Id.*
478. *Id.* (quoting FDA letter).
479. *Id.* A Warning Letter "is a step above an Untitled Letter in the FDA's enforcement hierarchy." *Id.* at 234. It "communicates that the FDA believes the regulated entity has committed a violation of regulatory significance but does not commit the FDA to taking enforcement action." *Id.*
480. *Id.* at 234–35.
481. *Id.* at 235.
482. *Id.* at 236.
483. *Id.* (quoting Abiomed's letter).
484. *Id.* at 236–37.
485. *Id.* at 237.

2013 close-out letter, the FDA advised Abiomed that it had taken adequate corrective action, and the company's stock price subsequently recovered.[486]

Plaintiffs alleged that throughout the period from August 4, 2011, to October 31, 2012, the defendants, among other things, made half-hearted corrective efforts to hold the FDA at bay while fraudulently (i) reporting revenues and earnings in press releases, conference calls, and SEC filings, without disclosing that the company produced those financial results by improper promotional activities,[487] and (ii) representing that it had a policy against off-label marketing, and that it was cooperating with the FDA, while the company was actually engaging in widespread management-directed off-label marketing and promotion.[488] Affirming dismissal of the complaint, the First Circuit held that the plaintiffs had failed to plead facts supporting a strong inference of scienter.[489]

As to the alleged fraud in reporting the financial results without connecting them to illegal marketing, the First Circuit noted the connection between materiality and scienter—in particular that, "[i]f it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact."[490] In *Abiomed*, the plaintiffs did "not state or even suggest what proportion of sales were made as a result of [prohibited promotional] efforts, or the significance of the contribution of those sales to Abiomed's stock price," so that "[t]he marginal materiality of the alleged statements and omissions concerning revenues weighs against an argument that defendants . . . possessed the requisite scienter."[491] Moreover, "Abiomed *explicitly* warned investors both (a) that the FDA might disagree with the company's assessment of the legality of its marketing practices and (b) that, if the FDA took enforcement action against [Abiomed], that 'could result in reduced demand for our products and would have a material adverse effect on our operations and prospects.'"[492] Also weighing against a scienter inference were that the company "did not withhold information about the FDA's concerns once the FDA issued a Warning Letter" and "stated repeatedly throughout the Class Period that the FDA 'could dis-

486. *Id.*

487. *Id.*

488. *Id.* at 237–38 (with plaintiffs pointing to representations in passages contained in 10-Qs and a 10-K quoted at 238).

489. *Id.* at 231–32, 247.

490. *Id.* at 242 (quoting City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp., 632 F.3d 751, 757 (1st Cir. 2011)).

491. *Id.* at 243. The court noted that it would have to indulge a series of inferences to find that the improper marketing materially affected revenues and earnings—that a substantial proportion of the company's total revenues derived from sale of the Impella 2.5 as opposed to other Impella products; that a substantial proportion of Impella 2.5 sales resulted from sales of that pump for off-label use; that a substantial portion of the Impella 2.5 sales for off-label *use* resulted from improper off-label *marketing*; and that those sales were "substantial enough to have a material effect on the stock price." *Id.* at 242–43. For another 2015 decision relating materiality to scienter, see *supra* notes 296–311 and accompanying text.

492. *Abiomed, Inc.*, 778 F.3d at 243 (quoting Abiomed's 10-K, filed on June 4, 2012); *see id.* at 238 (quoting Abiomed's SEC filings more fully).

agree [with Abiomed's position that its marketing was lawful] and conclude that [it had] engaged in off-label promotion.'"[493] Those were "not the actions of a company bent on deceiving investors as to . . . future earnings prospects."[494]

Turning to the alleged fraud through deceptive statements that the company had a policy against off-label marketing and that it was cooperating with the FDA, the First Circuit focused on the defendants' careful wording in public statements, where Abiomed said that "its policy was to 'refrain from statements that could be considered off-label promotion,' but that the FDA could disagree with Abiomed's view on that question; and that, while it 'believe[d]' the issue had been resolved, it could come up again in the future and could entail 'significant consequences.'"[495] Thus, even if the defendants, in fact, had a policy or practice that generated improper off-label marketing (while they mistakenly believed the advertising was legal), and even if, in fact, the dispute with the FDA had not been resolved (while they mistakenly believed it was), those facts did not raise the requisite inference that the defendants lied to investors.[496] As to the statements about company cooperation with the FDA, the court viewed Abiomed's requests to meet with the FDA and the FDA's ultimate conclusion to close out the off-label marketing correspondence to support the inference that the company "was not involved in a scheme to defraud investors but rather in finding a solution amenable to the FDA while meeting its need to market its products."[497]

*Significance and analysis. Abiomed* contains some very issuer-friendly language. In particular, the First Circuit rejected the notion that the company "should have affirmatively admitted widespread wrongdoing rather than stating that the outcome of its regulatory back-and-forth with the FDA was uncertain."[498] The court posited that "[t]here must be some room for give and take between a regulated entity and its regulator."[499] Moreover, the court parsed the company's statements in a manner quite favorable to the defendants, emphasizing that the company said that the FDA might disagree with the company's conclusion that its marketing was within legal limits and that, while the company believed at one point that it had resolved the matter with the agency, the matter might surface again. Note, however, that the court of appeals provided all of this defendant-supportive prose against the backdrop of the FDA ultimately having decided that

493. *Id.* at 243 (quoting a statement, some version of which appeared in Abiomed's 10-Qs for the first, second, and third quarters of 2012); *see id.* at 238 (quoting Abiomed's SEC filings more fully).

494. *Id.* at 243.

495. *Id.* at 244 (quoting a statement, some version of which appeared in Abiomed's 10-Qs for the first, second, and third quarters of 2012); *see id.* at 238 (quoting Abiomed's SEC filings more fully).

496. *Id.* at 244. Indeed, the First Circuit assumed, for purposes of its analysis, that Abiomed *had* a policy or practice that in fact produced improper off-label promotion. *Id.*

497. *Id.* The court added that Abiomed's statements about its device were aimed at customers and not investors. *Id.* at 245. Moreover, the First Circuit brushed aside the complaint's reference to confidential witness statements, noting that some of those witnesses had not worked at Abiomed during the class period and others failed to provide the time period to which their statements referred. *Id.* The court found their statements collectively "undermined by the fact that the FDA eventually closed out its investigation of Abiomed without taking any action adverse to the company." *Id.*

498. *Id.* at 244.

499. *Id.*

Abiomed had done enough to warrant closing out its off-label marketing concerns without imposing any penalty.[500] Companies should not assume that courts will take this approach in a case where the agency ultimately sanctions the issuer. In those cases, defendants can expect much closer scrutiny of whether the public representations of law-abiding behavior had a substantial basis and whether any qualifications deliberately created an impression that the government scrutiny was not as serious as it was.

*Omissions of negative information from summaries of FDA communications*. Chelsea Therapeutics International, Ltd. ("Chelsea") conducted four clinical studies of a drug to treat neurogenic orthostatic hypotension, which results from low blood pressure when a person stands up, producing dizziness and weakness.[501] Chelsea labeled the studies 301, 302, 303, and 306.[502] Chelsea began the 301 and 302 studies in 2008.[503] The complaint alleged that the 302 study failed to show a statistically significant effect on lightheadedness and dizziness and that the 303 study did not meet its endpoint and failed to demonstrate any "duration effect" on symptoms.[504] The company halted the 306 study after an interim analysis suggested that it would not meet its endpoint.[505] The case centered on Chelsea's efforts to win approval for its drug through the 301 study, supplemented with data from the 302 study.

After Chelsea announced the 302 study results to investors and agreed, in November 2009, with the FDA to modify the assessment scale for the ongoing 301 study, the company stated in September 2010 that the 301 study had demonstrated statistically significant improvement in participants' symptoms.[506] The special protocol assessment for the 301 study "stated that the FDA expected two successful efficacy studies before it would grant regulatory approval of the new drug."[507] The FDA told Chelsea, in a meeting on December 10, 2010, "that a single successful study typically was not sufficient to support approval of a new drug."[508] Nonetheless, Chelsea announced that the FDA had "agreed" that Chelsa, without any further studies, could submit a new drug application on the basis of the 301 study, together with data from the 302 study.[509] Moreover, on a conference call with investors, Chelsea's CEO characterized the December 10 meeting with the FDA as a "'successful outcome' that 'reflect[ed] the strength of the data,'" reaffirming in the same call "that the FDA officials had clarified 'that additional efficacy studies were not required' for a new drug application filing."[510]

500. *Id.* at 237, 245.
501. Zak v. Chelsea Therapeutics Int'l, Ltd., 780 F.3d 597, 601 (4th Cir. 2015).
502. *Id.*
503. *Id.*
504. *Id.* at 601–02.
505. *Id.* at 602.
506. *Id.*
507. *Id.* at 601–02.
508. *Id.* at 602.
509. *Id.* at 602, 614 (quoting press release).
510. *Id.* at 602 (quoting CEO).

After Chelsea submitted its new drug application, an FDA staffer prepared a briefing document for the FDA's Cardiovascular and Renal Drugs Advisory Committee in which the staffer recommended against approval in part because the application did not show a "durable effect (i.e., more than 4 weeks)."[511] On February 13, 2012, Chelsea issued a press release stating that the briefing document raised "several lines of inquiry . . . as [to] significant components of the benefit-risk analysis of [the drug]" because the evidence that Chelsea submitted to the FDA "'may not adequately establish a durable treatment effect as a result of the short duration of' the clinical trials."[512] The press release did not disclose, however, that the briefing document recommended against approving the drug.[513] The FDA made the document available on its website eight days after Chelsea issued its press release.[514] Chelsea's stock price declined after the press release and again after the FDA released the briefing document.[515] On February 23, 2012, the FDA advisory committee announced that it recommended approving the drug, although virtually all members concluded that the failed studies did not provide "confirmatory evidence of benefit[ a]nd . . . [the] 301 [Study] also did not provide evidence regarding the duration of effect in any direct way."[516] The FDA denied the drug application on March 28, 2012.[517]

On behalf of all those who bought Chelsea stock between November 3, 2008, and March 28, 2012, the plaintiffs brought a Rule 10b-5 case against Chelsea and four executives.[518] Vacating and remanding the district court's dismissal, the Fourth Circuit focused on whether the complaint alleged facts raising a strong inference that the defendants (i) "intentionally or recklessly failed to disclose that the FDA expected Chelsea to produce two successful studies showing evidence of durability of effect," and (ii) "intentionally misled investors in the February 13, 2012, press release, by failing to disclose that the FDA briefing document included a recommendation against approval."[519] Taking the allegations of the complaint as true for purposes of evaluating the dismissal below, the Fourth Circuit concluded that, even if Chelsea's announcement after the December 10, 2010, meeting with the FDA correctly stated that the FDA could submit a new drug application based on one completed study that showed efficacy, Chelsea's announcement "was misleading given the FDA's continuing expectation that two successful efficacy studies would be required for approval of [the drug]."[520] In addition, the complaint alleged that "Chelsea was aware of Study 301 and Study 302's durational-benefit shortcomings."[521] Further, the

511. *Id.* at 603 (quoting briefing document).
512. *Id.* (quoting press release).
513. *Id.*
514. *Id.*
515. *Id.*
516. *Id.* (quoting advisory committee chair).
517. *Id.*
518. *Id.* at 600 n.1, 603.
519. *Id.* at 608, 611.
520. *Id.* at 609.
521. *Id.* (quoting complaint).

omission of the adverse FDA staffer's recommendation in Chelsea's description of the pre-advisory committee briefing "when viewed in the context of the known problems of the efficacy studies and Chelsea's earlier remarks regarding those studies, supports the inference that Chelsea intentionally or recklessly misled investors."[522] Together, the allegations "permit[ted] a strong inference that the defendants either knowingly or recklessly misled investors by failing to disclose critical information received from the FDA during the new drug application process, while releasing less damaging information that they knew was incomplete."[523]

*Significance and analysis. Chelsea* was a two-to-one decision, with the dissent pointing out that (i) federal law expressly permits the FDA to approve a drug based on a single study;[524] (ii) the CEO stated in a December 2010 conference call "that the FDA had expressed an interest in seeing 'two additional studies'";[525] and (iii) Chelsea did not depend solely on the 301 study when submitting its application for drug approval but also on supplemental data from the 302 study.[526] The dissent also noted that (i) Chelsea set out in a September 30, 2011, quarterly report "numerous reasons why the FDA 'may not accept or approve' the [drug] application";[527] and (ii) Chelsea warned in its press release describing the pre-advisory committee briefing that the briefing raised questions regarding the drug's benefit-risk analysis.[528] The most important message from the majority opinion therefore is that even specific warnings like these may not suffice where a drug or device company (i) describes a communication with, or analysis from, the FDA, such as the briefing document that Chelsea obtained before the FDA made it public, but (ii) fails to include in the description particular adverse comments that the FDA made in that very communication or analysis, such as the briefing paper's recommendation against drug approval.[529]

*Imputation of officer scienter to corporation. In re ChinaCast Education Corp. Securities Litigation* provided the Ninth Circuit with the opportunity to address imputation of scienter from a corporate officer to a corporate defendant.[530] The complaint included a Rule 10b-5 claim against ChinaCast Education Corporation based on assurances from its CEO—while he was looting the company

522. *Id.* at 610.

523. *Id.*

524. *Id.* at 614 (Thacker, J., dissenting) ("[F]ederal law expressly authorizes the FDA to make the requisite finding of 'substantial evidence' based solely on 'data from one adequate and well-controlled clinical investigation and confirmatory evidence (obtained prior to or after such investigation . . . .") (quoting 21 U.S.C. § 355(d) (2012))).

525. *Id.* at 615 (quoting CEO).

526. *Id.* at 614–15.

527. *Id.* at 615 (quoting quarterly report).

528. *Id.*

529. In one other life sciences case last year, the Third Circuit found scienter allegations insufficient where the plaintiffs alleged that the defendants recklessly disregarded (i) an asserted FDA requirement that results from a clinical test meet a particular p statistic test and (ii) an asserted need to show statistical significance in results from a U.S. subgroup alone. *In re* Columbia Labs., Inc., Sec. Litig., 602 F. App'x 80, 81–82 (3d Cir. 2015).

530. 809 F.3d 471, 472 (9th Cir. 2015).

by, among other things, transferring $120 million of assets to accounts that he and his allies controlled—that the company enjoyed financial health and stability and that "no questions or concern[s] have ever been raised by the company's auditors or audit committee about [the company's] cash balances."[531] The complaint also alleged that the CEO committed fraud by signing SEC filings for the company without disclosing his defalcations.[532] The district court dismissed the case, holding that the CEO's scienter could not be imputed to the corporation because the CEO had been acting adversely to the corporation, to benefit himself rather than to benefit the corporation in any way.[533]

In reversing,[534] the Ninth Circuit reprised that, "[i]n the context of Rule 10b-5, [it had] adopted the general rule of imputation and held that a corporation is responsible for a corporate officer's fraud committed 'within the scope of his employment' or 'for a misleading statement made by an employee or other agent who has actual or apparent authority.'"[535] While not disputing that the CEO had "acted within the scope of his apparent authority," the corporation relied on the "adverse interest" exception to the rule that an agent's state of mind is imputed to a principal—an exception by which "a rogue agent's . . . knowledge [is] 'not imputed to the principal if the agent acts adversely to the principal in a transaction or matter, intending to act solely for the agent's own purposes or those of another person.'"[536] The Ninth Circuit, however, invoked the exception to this exception, namely that "the adverse interest rule collapses in the face of an innocent third party who relies on the agent's apparent authority."[537] Here, the complaint pled facts sufficient to impute the CEO's scienter to the corporation because the complaint "allege[d] that third-party shareholders understandably relied on [the CEO's] representations, which were made with the imprimatur of the corporation that selected him to speak on its behalf and sign SEC filings."[538]

*Significance and analysis*. Circuit decisions seem to converge on the rule that in a Rule 10b-5 case corporate scienter requires scienter on the part of the individuals inside the corporation who, acting within their authority, author or speak the challenged statements.[539] If such an individual had scienter and spoke or wrote with even apparent authority of the company, it seems unlikely, in light of *ChinaCast*, that the company can defend on the basis that the individual was not seeking by the fraud to benefit the company but only to put money into his or her own pocket.

531. *Id.* at 473 (quoting press release and conference call from fall 2011) (first alteration by appellate court).

532. *Id.*

533. *Id.* at 474.

534. *Id.* at 473, 479.

535. *Id.* at 476 (quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1577 n.28 (9th Cir. 1990) (en banc)).

536. *Id.* (quoting Restatement (Third) of Agency § 5.04 (Am. Law Inst. 2006)). The court of appeals noted that "this is a question of federal securities law, albeit one guided by (common law) agency principles." *Id.* at 475 n.4.

537. *Id.* at 477.

538. *Id.*

539. *See* Southland Sec. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 366 (5th Cir. 2004).

*Scienter does not require intent to harm*. While scienter includes intent to deceive or severe recklessness with respect to deception,[540] the Second Circuit held in *United States v. Litvak* that proof of scienter does not require intent to harm.[541] Although *Litvak* case was a criminal prosecution, scienter is an element common to both government enforcement actions[542] and private Rule 10b-5 lawsuits.[543] Therefore the holding should apply to both.

## Primary Violation of Rule 10b-5(b)

Rule 10b-5 makes it unlawful for any person, in connection with the purchase or sale of any security in interstate commerce, "(a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[544] In *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court held that only "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it" "make[s]" a statement for purposes of subsection (b).[545] Because there is no aiding and abetting liability in a private Rule 10b-5 action, *Janus* means that only "maker[s]" of a statement can be liable in a private action brought under subsection (b).[546]

In *Janus*, the Court held that an investment adviser did not "make" the statements in prospectuses for mutual funds it managed because the funds, rather than the adviser, had ultimate authority over the content and dissemination of the prospectuses.[547] In reaching that conclusion, the Court observed that the business trust containing the funds was a separate legal entity from the adviser

540. *See supra* notes 357–58 and accompanying text.

541. 808 F.3d 160, 179 (2d Cir. 2015) ("'[I]ntent to harm' is not a component of the scienter element of securities fraud under Section 10(b) . . . ."). The Second Circuit distinguished mail fraud. *Id.* at 178–79; *see supra* notes 312–31 and accompanying text (discussing the *Litvak* case generally).

Further as to scienter, the trial court had instructed the jury: "if you find that Mr. Litvak acted in good faith, or held an honest belief that his actions (as charged in a given count) were proper and not in furtherance of any unlawful activity, you cannot convict him of that count." *Litvak*, 808 F.3d at 189 (quoting jury instruction). The lower court permitted Mr. Litvak "to adduce evidence that his supervisors 'approved' or 'encouraged' him to misrepresent price, cost, or a seller's identity" as that could cut against a conclusion that he intended to defraud. *Id.* at 188 (quoting joint appendix). The district court, however, excluded evidence "of Jefferies managers', including Litvak's supervisors, knowledge or approval of *other employees'* similar conduct" on the ground that such evidence would "improperly 'suggest that everybody did it and therefore it isn't illegal.'" *Id.* (quoting joint appendix); *id.* at 189–90 & n.35 (quoting district court) (emphasis by appellate court). The Second Circuit held this exclusion "exceeded [the district court's] allowable discretion," as this testimony was relevant to intent to defraud "under the low threshold set . . . by Federal Rule of Evidence 401." *Id.* at 190.

542. *Id.* at 178.

543. Dura Pharms. Inc. v. Broudo, 544 U.S. 336, 341 (2005).

544. 17 C.F.R. § 240.10b-5 (2015).

545. 131 S. Ct. 2296, 2302 (2011).

546. *Id.* at 2302. Plaintiffs can pursue others as "control persons." *Id.*; *see* 15 U.S.C. § 78t(a) (2012).

547. *Janus*, 131 S. Ct. at 2304.

and had an independent board.[548] The Court therefore left open whether the rule it announced in *Janus* would apply when the defendant was not a separate legal entity but an officer of a corporation issuing an allegedly fraudulent statement.

In *Glickenhaus & Co. v. Household International, Inc.*, the Seventh Circuit held that *Janus does* apply to individuals inside a company.[549] The misstatements concerned lending practices, delinquency rates, and earnings from credit-card agreements.[550] A jury found the corporation and three individual defendants (the CEO, the CFO, and the vice-chair and president of consumer lending) liable after a trial.[551] The company stipulated that it had "made" all of the challenged statements in its SEC filings and press releases, and the Seventh Circuit held that the corporate defendant also made the "statements delivered by the three executives" because "[n]othing in *Janus* undid the longstanding rule that '[a] corporation is liable for statements by employees who have apparent authority to make them.'"[552]

The trial court, however, instructed the jury that it could also hold an individual defendant liable on a statement if the plaintiffs "proved that the [individual] defendant '*made, approved, or furnished information* to be included in a false statement'" and denied a new trial motion that the individual defendants based on the then-recent *Janus* opinion, reasoning that *Janus* "applied only to legally independent third parties . . . , not to corporate insiders."[553] The Seventh Circuit ruled "[t]hat was error" and held that "[n]othing in *Janus* limits its holding to legally independent third parties," so that "[t]he instruction plainly misstated the law."[554] The circuit court then proceeded to apply *Janus* to the three executives.

The CEO conceded that he had "made" the statements in the company's SEC filings and his own presentation to Goldman Sachs.[555] This left open whether he "made" statements in the company's press releases. Because no evidence showed that the CEO signed the press releases or that his "name appeared in the press releases in the sense of an attribution" or that the CEO "actually delivered the statements in the press releases himself—say, for example, by reading them at a press conference"—the court of appeals held that the CEO was entitled to a new trial for his liability for those statements.[556] At that trial, plaintiffs would have to prove that the CEO "*actually exercised* control over the content of the press releases and whether and how they were communicated," which is "an in-

548. *Id.* at 2299.
549. 787 F.3d 408, 424–29 (7th Cir. 2015).
550. *Id.* at 413.
551. *Id.* at 412, 426.
552. *Id.* at 426 (quoting Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 708 (7th Cir. 2008)); *id.* at 413 (holding that the corporate defendant "itself 'made' all the false statements, as *Janus* defined that term").
553. *Id.* at 425 (quoting jury instructions) (emphasis by appellate court).
554. *Id.*
555. *Id.* at 426.
556. *Id.* at 426–27.

herently fact-bound inquiry."[557] The court, however, held that the CEO was not prejudiced by the faulty instruction insofar as he was held liable for a false statement made by the vice-chairman/president of consumer lending because the CEO had "drafted the statement" and sent it to other executives with an email saying: "Attached . . . is our media holding statement."[558] The vice-chair/president of consumer lending "simply read the statement verbatim to the media."[559] Because "the CEO [was] the actual author of the statement, [he] had the 'ultimate authority' over its content and whether and how to communicate it, the touchstone of *Janus*."[560] Accordingly, he could be liable for the statement, as could the vice-chair/president of consumer lending too, as "[n]othing in *Janus* precludes a single statement from having multiple makers."[561]

The CFO also conceded that he "made" the statements in an SEC filing and in his own presentation at an investor relations conference.[562] He, too, however was entitled to a new trial on liability for statements in the press releases, under the same actual control standard applicable to the CEO.[563] The vice-chair/president of consumer lending was liable for the one statement that he read to the media himself, but was entitled to a new trial on his liability for statements in the SEC filings and press releases.[564]

## Damages, Loss Causation, and Reliance in Open Market Cases[565]

Plaintiffs in a private Rule 10b-5 action must prove reliance, economic loss (damages), and loss causation.[566] The three elements interact in an open market case because plaintiffs prove them all through the effect of misstatements and corrective disclosures on securities prices.[567] Two opinions dealt with that interaction in 2015. The Seventh Circuit set out a rule that, where the plaintiff is proving loss causation and damages by a model that computes the amount of inflation based on the difference between actual returns and returns estimated by the relationship between the stock price at issue and market or industry in-

557. *Id.* at 427. The court commented that it was "hesitant to hold as a matter of law that a CEO 'makes' all statements contained in a company press release, as that term was narrowly defined in *Janus*." *Id.* at 426.

558. *Id.* at 427 (first quoting appellate court; then quoting CEO's email).

559. *Id.*

560. *Id.* (quoting Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011)).

561. *Id.*

562. *Id.* at 428.

563. *Id.*

564. *Id.*

565. In a decision involving a face-to-face transaction, rather than open market trading, the Sixth Circuit held that a plaintiff's reliance on misrepresentations was unjustified where the plaintiff did not read the relevant documents before signing them and those documents provided the truth. Bender v. Logan, 608 F. App'x 356, 360–63 (6th Cir. 2015).

566. Dura Pharms. Inc. v. Broudo, 544 U.S. 336, 341–42 (2005); *see also* 15 U.S.C. § 78u-4(b)(4) (2012) (requiring that private plaintiff prove loss causation).

567. *See* William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 Emory L.J. 843, 874–83 (2005).

dices, the model may go to a jury if the plaintiff's expert testifies in nonconclusory terms that no company-specific non-fraud information influenced the calculations, shifting the burden of identifying such information to the defense, after which—if the defense presents such information—the burden shifts backs to the plaintiff to account for that information.[568] In the same case, the Seventh Circuit approved protocols by which a district court, following trial of class-wide issues, provided the defendants with an opportunity to test whether individual members of the class relied on the integrity of the market.[569] The Fifth Circuit found no abuse in the certification of one class in the Gulf oil spill securities case, holding that any quarrel over whether particular disclosures were "corrective" raised questions common to the class, and found no abuse in denial of certification of a second class, in which recovery depended on whether individual class members would have purchased the issuer's securities at all if they had known the risk created by the company's unpreparedness to deal with a deep water blowout.[570]

In *Glickenhaus & Co. v. Household International, Inc.*, the Seventh Circuit addressed both reliance and loss causation in a rare case that was tried to a jury verdict, resulting in a $2.46 billion judgment.[571] The court of appeals ordered a new trial on loss causation, but found no error in the lower court's treatment of reliance.[572]

*Loss causation when the truth leaks out over time*. Plaintiffs alleged that the corporate defendant and its executives had inflated the price of the Household International, Inc. ("Household") stock by making false statements about the company's lending practices, the delinquency rates on loans it had made, and its earnings from credit-card agreements.[573] The jury found seventeen actionable misrepresentations.[574]

Loss causation required the plaintiffs to prove "that the price of the securities they purchased was 'inflated'"—with "the best way to determine the impact of a false statement" on price being "to observe what happens when the truth is finally disclosed and use that to work backward, on the assumption that the lie's positive effect on the share price is equal to the additive inverse of the truth's negative effect."[575] The plaintiffs' expert presented two different economic models with which to accomplish that task.[576] The jury selected the "leakage" model, which assumed that the truth leaked out over the class period, and calculated the

568. *See infra* notes 575–90 and accompanying text (discussing loss causation and burden shifting); *see also infra* notes 571–604 and accompanying text (discussing the case generally).
569. *See infra* notes 591–604 and accompanying text (discussing rebuttal of presumption of reliance); *see also infra* notes 571–604 (discussing the case generally).
570. *See infra* notes 605–28 and accompanying text.
571. 787 F.3d 408, 412 (7th Cir. 2015).
572. *Id.* at 433. The Seventh Circuit also ordered a new trial on the responsibility of individual defendants for certain company statements. *See supra* notes 544–64 and accompanying text.
573. *Glickenhaus*, 787 F.3d at 413.
574. *Id.* at 414.
575. *Id.* at 415.
576. *Id.* at 415–16

inflation caused by the fraud, on each trading day, as the difference (called the "residual") between the actual Household stock price on that day and the price for that day as predicted by a regression analysis built on the relationship between the historical movement of Household's stock price and the movement of the S&P 500 and the S&P 500 Financials Index.[577] Using this model, the "amount the stock is overpriced on any given day is the sum of all *subsequent* residual returns."[578] Thus, because the residuals totaled $23.94, that was the amount by which the stock was overpriced on the first day of the fraud, with that amount declining as the truth leaked out and the price of the company's stock fell lower relative to the two indices.[579]

On appeal, the defendants attacked the leakage model in three ways. First, they argued that, because the stock price on the first day of the fraud increased by only $3.40/share and the regression analysis reflected a residual on that day of only $0.67, the fraud could not possibly have inflated the price of the stock by $23.94 at that time.[580] The court rejected this argument because the question was not the amount by which the first fraudulent statement increased the price of the stock but the price to which the stock would have fallen if the full truth had been known on the first day.[581]

The defendants' second argument fared better. They pointed out that the regression analysis controlled only for general market trends (by using the S&P 500 index) and industry-specific trends (by using the S&P 500 Financials Index) but not for nonfraudulent company-specific news.[582] The plaintiffs' expert testified generally that "he looked for company-specific factors during the relevant period and did not find any significant trend of positive or negative information apart from the fraud-related disclosures."[583] The defendants contended that this was inadequate and that the plaintiffs needed to affirmatively "eliminate any firm-specific, nonfraud related factors that might have contributed to the stock's decline."[584] Noting that the defendants did not identify any such information that "could have significantly distorted the [plaintiffs'] model,"[585] the Seventh Circuit provided the following rule:

577. *Id.* at 416–17. The Financials Index was relevant because Household's "business centered on consumer lending—mortgages, home-equity loans, auto financing, and credit-card loans." *Id.* at 413.

578. *Id.* at 416.

579. *Id.* at 416–17.

580. *Id.* at 417.

581. *Id.* at 417–18. The court reasoned:

> As soon as the first false statement was made, that overpricing became fully attributable to the false statement, even if the stock price didn't change at all, because had the statement been truthful, the price would have gone down by $23.94—after all, that's what it did once the truth was fully revealed . . . .

*Id.* at 417–18; *see also id.* at 419 (noting that a false statement that does not raise the price of stock, but keeps it at an inflated level, can cause loss).

582. *Id.* at 419.

583. *Id.*

584. *Id.* at 420.

585. *Id.* at 422.

> If the plaintiffs' expert testifies that no firm-specific, nonfraud related information contributed to the decline in stock price during the relevant time period and explains in nonconclusory terms the basis for this opinion, then it's reasonable to expect the defendants to shoulder the burden of identifying some significant, firm-specific, nonfraud related information that could have affected the stock price. If they can't, then the leakage model can go to the jury; if they can, then the burden shifts back to the plaintiffs to account for that specific information or provide a loss-causation model that doesn't suffer from the same problem . . . . One possible way to address the issue is to simply exclude from the model's calculation any days identified by the defendants on which significant, firm-specific, nonfraud related information was released.[586]

Because the leakage model did not account for the possibility that firm-specific, nonfraudulent information affected the defendant company's stock price, and because "the expert's general statement that any such information was insignificant . . . [was] not enough," the court ordered a new trial on the issue of loss causation, to be conducted according to the rule set out above.[587]

Third and finally, the defendants argued that the leakage model purported to prove loss caused by all three categories of misrepresentations (lending practices, delinquency rates, and earnings from credit-card agreements), while the first misstatement dealt only with lending practices.[588] The court of appeals suggested that this problem be solved by "instruct[ing] the jurors that if the first actionable misrepresentation relates only to one or two of the three categories of fraud, they should find zero inflation in the stock (or some fraction of the model they've chosen) until there are actionable misrepresentations addressing all three."[589]

*Significance and analysis*. Much of the *Glickenhaus* reasoning seems confused because the court fails to separate loss causation from damages. Properly analyzed, loss causation requires only that the fraud caused loss, while damages focuses on the amount of loss caused by the fraud. Accordingly, a plaintiff proves loss causation by showing that the fraud was a substantial reason for the plaintiff's loss, even if other factors also contributed. A plaintiff, however, can recover damages attributable to the fraud alone and so must, for damages proof, show the loss that he or she suffered after isolating and removing any loss appropriately attributed to other factors.[590] The doctrinal mixup is important. Plaintiffs have the burden of proof on both elements. Thus, on damages, plaintiffs must prove the amount of price inflation *caused by the fraud* on each day of the class period. The court's rule may effectively create a damages presumption in favor of an expert model that the defendants must refute, thus disturbing the proof burden.

*Rebutting the reliance presumption in the second phase of a fraud-on-the-market case*. The *Glickenhaus* trial court divided the case into two phases, with the

586. *Id.* at 422–23.
587. *Id.* at 423.
588. *Id.*
589. *Id.* at 424.
590. *See* Miller v. Asensio & Co., 364 F.3d 223, 228–33 (4th Cir. 2004).

first devoted to questions common to the plaintiff class, and the second addressing reliance issues for individual class members by permitting the defense to rebut a class-wide reliance presumption.[591] The plaintiffs invoked the fraud-on-the-market ("FOTM") presumption that stock purchasers rely on misstatements, even if those purchasers never hear or read them, because the purchasers rely on the integrity of the market prices that impound the information made public in those misstatements.[592] The presumption can be rebutted by "[a]ny 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."[593] The district court determined that—in the second phase here—the only method of rebuttal available to the defense was that "individual plaintiffs bought or sold Household stock without relying on the integrity of the market."[594] Accordingly, the judge required each class member to answer a written question asking whether the class member would still have purchased the stock if the member had known that defendants' false statements had inflated the price.[595] When some members failed to respond, the court allowed the plaintiffs to send out the question again.[596] The judge also permitted defendants to depose up to fifteen class members (the defendants deposed twelve) and to serve written discovery (which defendants sent to about 100 class members) asking about trading strategies and any nonpublic information on which those class members relied.[597] Almost 11,000 class members answered "no" to the court's question.[598] The trial court entered judgment for each of those class members, provided that (i) discovery had produced no evidence inconsistent with the answer and (ii) the class member's claim exceeded $250,000.[599] Those were the judgments subject to the appeal.[600]

On the appeal, the defendants objected to that process,[601] arguing that "class members should have been asked whether they would have transacted if they had known that the statements were false."[602] The Seventh Circuit rejected this view because investors who might have purchased if they had known that the defendants' statements were false might not have purchased if they also

591. *Glickenhaus*, 787 F.3d at 413–14.

592. *Id.* at 429.

593. *Id.* (quoting Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2408 (2014) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988) (plurality))).

594. *Id.* at 430. The trial judge concluded that other avenues of rebutting the FOTM presumption—either showing that market makers were aware of the truth or that the truth had entered the market and dissipated the effects of the falsehoods—"had already been rejected by the jury in Phase I." *Id.*

595. *Id.*

596. *Id.* at 431.

597. *Id.*

598. *Id.*

599. *Id.*

600. *Id.* at 414, 431 n.14. The defendants were entitled to judgment against class members who (i) failed to answer the court's question either time it was sent out and (ii) had claims exceeding $250,000. *Id.* at 431. About 30,000 claims had not been resolved. *Id.* at 431–32.

601. *Id.* at 432.

602. *Id.* (emphasis deleted).

had known that those statements had inflated the price that the investors would have to pay.[603] To defendants further point that the court's question was "meaningless" because "all class members could see how they needed to respond in order to recover," the appellate court responded that, while the question was "imperfect," class members had to answer under penalty of perjury and some of them had answered that they would have purchased the shares even knowing that the defendants had inflated the price.[604]

*Damages, reliance, and class certification.* BP, P.L.C. ("BP") co-owned and co-leased the Macondo exploratory well in the Gulf of Mexico.[605] An April 20, 2010 blowout at that well poured oil into the Gulf until the well was capped on July 15, 2010.[606] Plaintiffs brought a Rule 10b-5 action against BP and two executives, suing on behalf of two classes of investors: (i) those who acquired BP ADS between November 8, 2007, and April 20, 2010 (the "pre-spill class"); and (ii) those who acquired BP ADS between April 26, 2010, and May 28, 2010 (the "post-spill" class).[607] On a motion to certify the classes under Federal Rule of Civil Procedure 23(b)(3)—which requires "that the questions of law or fact common to class members predominate over any questions affecting only individual members"[608]—the district court certified the post-spill class but denied certification to the pre-spill class, and the Fifth Circuit affirmed on Rule 23(f) review.[609] The alleged misrepresentations in the pre-spill class period included (i) assertions that BP was implementing safety improvements recommended by a commission established after an explosion at a BP refinery in Texas; (ii) statements about the company's Operating Management System, which the company said would standardize safety processes across all of its lines of business but which did not apply to sites such as the one at which the Gulf blowout occurred; and (iii) representations in filings with regulatory agencies that BP had the ability and equipment to respond to a deepwater oil spill.[610] The alleged misrepresentations in the post-spill period concerned the rate at which oil was flowing into the Gulf at the blowout site.[611]

The plaintiffs proposed to calculate damages as the difference between the price paid by each purchaser and the price that the purchaser would have paid had the

603. *Id.*

604. *Id.* at 432–33. The court also rejected defense arguments based on discovery limitations during the second phase. *Id.* at 432.

605. Ludlow v. BP, P.L.C., 800 F.3d 674, 678 (5th Cir. 2015).

606. *Id.*

607. *Id.* at 677 (identifying defendants); *id.* at 679–80 (identifying claim as brought under Rule 10b-5 and also the classes); *In re* BP P.L.C. Sec. Litig., No. 10-md-2185, 2014 WL 2112823, at *2 (S.D. Tex. May 20, 2014) (providing dates for two class periods, but stating that the first date of the second class would begin on either April 26 or 29, depending on whether the court granted the plaintiffs' motion to amend); *id.* at *14 (stating that a third amended complaint would include an alleged misrepresentation on April 24 so that the start date for the second class could begin on April 26); *id.* at *17 (granting leave to amend).

608. Fed. R. Civ. P. 23(b)(3).

609. *Ludlow*, 800 F.3d at 677, 680, 692.

610. *Id.* at 678–79.

611. *Id.* at 679.

misrepresentations not been made (the "true value" of the equity).[612] Turning first to the post-spill class, the Fifth Circuit noted that the plaintiffs' expert computed the true value of the equity on each day of the post-spill period by identifying six events that the expert concluded to have alerted the market that the spill rate was greater than BP represented ("corrective events"), using an event study to isolate the abnormal decline in BP's share price after each of these events, starting with the last one, then carrying the abnormal declines back through the class period while adjusting the amount of the price inflation after each event.[613] Using this model, those buying at the beginning of the post-spill class period would have overpaid by the total of all of the abnormal declines, those buying after the first corrective event and before the second corrective event would have overpaid by the total of all abnormal declines *minus* the abnormal decline after the first corrective event, and so forth.[614] The defendants contended that some of the corrective events identified by plaintiffs' expert were not related to the alleged misrepresentations about the spill rate.[615] The Fifth Circuit responded that this possibility did not counsel against Rule 23(b)(3) class certification because "the question of whether certain corrective disclosures are linked to the alleged misrepresentations in question is undeniably common to the class."[616]

The defendants also argued that the post-spill certification was improper because some of the corrective events concerned damages from the oil spill rather than alleged misrepresentations about the spill rate.[617] The Fifth Circuit agreed "that damages stemming from the spill itself are not recoverable under the plaintiffs' theory of liability"[618] but held that the "tightness of th[e] fit" "between the corrective event and the misstatements . . . is a question common to the class."[619] Relevant to both defense arguments, the court noted that the plaintiffs' expert's methodology allowed for removal of any particular corrective event from the model (and therefore removal of the associated abnormal stock price change after the event) if the event was found not to correct the misrepresentation on which the plaintiffs sued.[620]

The Fifth Circuit reasoned that, because the plaintiffs could not, under Supreme Court authority, be required to prove loss causation in order to win class certification, they could not, in order to win certification, be required to

612. *Id.* at 683.
613. *See id.* at 683–84.
614. *See id.* at 684.
615. *Id.* at 687 (citing an announcement by BP that its board was meeting "to discuss alternatives to paying a dividend").
616. *Id.* at 688.
617. *Id.*
618. *Id.*
619. *Id.*
620. *Id.* at 688–89.

prove a perfect damages case.[621] Accordingly, "the district court did not err in refusing to resolve concerns about the inclusion of certain corrective events at the class certification stage."[622]

Moving to the pre-spill class, the court of appeals observed that the plaintiffs were proceeding on the "materialization of the risk" theory—i.e., that the defendants "allegedly misstated the efficacy of its safety procedures, creating an impression that the risk of a catastrophic failure was lower than it actually was . . . , taking away plaintiffs' 'opportunity to decide whether to divest in light of the heightened risk.'"[623] This meant, however, that the key question was not whether a class member paid an inappropriately high price for the stock but whether the class member "would not have bought BP stock *at all* were it not for the alleged misrepresentations—a determination not derivable as a common question, but rather one requiring individualized inquiry."[624] The plaintiffs' expert offered no "mechanism for separating" those class members who would *not* have bought if the market had known of the higher-than-represented risk from those class members who would have purchased anyway.[625] While the plaintiffs argued that the FOTM presumption removed these individual questions, the Fifth Circuit responded that "[t]he [FOTM] theory does not provide any presumptions with regard to loss causation—whether the misstatement caused the loss. And here, where the economic loss depends on the posture of the plaintiff vis-à-vis risk tolerance, that loss causation, and thus damage, cannot be presumed nor can it be found class-wide."[626]

*Significance and analysis*. The *BP* decision merits two comments. First, it reminds us that proof of damages—in a securities class action lawsuit where plaintiffs rely on the FOTM presumption and seek out-of-pocket damages[627]—requires two steps: (i) determination of the price at which the stock would have traded absent the asserted fraud and (ii) submission by individual class members of claims proving their purchases during the period of the fraud. While the second obviously raises individual questions that do not prevent class certification, class certification is dependent on a common way to prove the first.

Second, doctrinally, the court seems to lose its way when discussing the pre-spill class. The court's analysis seems to center not on loss causation or damages but reliance—proof of the facts on which the plaintiff class members relied in

621. *Id.* at 687–88 (citing Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2186 (2011)).

622. *Id.* at 688. The Fifth Circuit said, at the outset of its analysis, that it was reviewing the certification decision "for abuse of discretion within the ambit of the controlling rules of substance and procedure." *Id.* at 680.

623. *Id.* at 689 (quoting plaintiffs, without sourcing quotations).

624. *Id.* at 690.

625. *Id.*

626. *Id.* at 690–91 (footnote omitted).

627. *Id.* at 683 (explaining out-of-pocket damages as "the difference between the *inflated* price at which the plaintiffs bought their stock, buoyed by BP's alleged misrepresentations about the magnitude of the spill, and the '*true*' price, meaning the theoretical price that the BP stock would have traded for had the relevant information been properly disclosed").

deciding whether to purchase. Indeed, the Fifth Circuit employed, as an alternative basis for its ruling on the pre-spill class, the conclusion that the plaintiffs themselves rebutted the FOTM reliance presumption by taking the position that the pre-spill purchasers did not purchase on the basis of price alone.[628]

## Securities Litigation Uniform Standards Act ("SLUSA")

SLUSA defines a "covered class action" as a lawsuit brought on behalf of more than fifty persons.[629] SLUSA requires that covered class actions be based on federal securities law and proceed in federal court if plaintiffs "alleg[e 'an untrue statement' or 'a misrepresentation'] or omission of a material fact in connection with the purchase or sale" of a "covered security"—essentially a security listed on a national exchange.[630] SLUSA forbids the "maint[enance]" of a covered class action in which the plaintiffs make such an allegation where the class action is "based upon the statutory or common law of any State."[631] If plaintiffs file a covered class action in state court—asserting state law claims based on misrepresentations or omissions in the purchase or sale of a covered security—defendants can remove the case to federal court.[632] The federal court then properly dismisses the case as precluded by SLUSA.[633]

The *In re Kingate Management Ltd. Litigation* plaintiffs purchased shares in funds (the "Funds")—which shares were not "covered securities"—after the Funds declared that they would in turn invest in exchange-listed stocks issued by S&P 100 companies—which stocks were "covered securities."[634] The Funds gave the money to Bernard L. Madoff Investment Securities LLC ("BMIS"), and, although BMIS provided statements purporting to show that it had invested the money in shares issued by S&P 100 companies, BMIS in fact used the money for Mr. Madoff's personal benefit and to pay investors who sought to redeem amounts previously placed with BMIS.[635] In *Kingate Management*, the plaintiffs asserted a variety of

628. *Id.* at 691. In one more open market case addressing loss causation, the Fifth Circuit held that neither news of government subpoenas served on the issuer nor an analyst report summarizing a whistleblower lawsuit filed months before that report constituted a "corrective disclosure" independently and, even when considered together, they were not corrective. Sapssov v. Health Mgmt. Assocs., Inc., 608 F. App'x 855, 863–64 (11th Cir. 2015) (per curiam).

629. 15 U.S.C. §§ 77p(f)(2)(A)(i), 78bb(f)(5)(B)(i) (2012). The statutes carve out derivative actions. *Id.* §§ 77p(f)(2)(B), 78bb(f)(5)(C).

630. *Id.* § 77p(b)(1) (2012) (referring to "an untrue statement"); *id.* § 78bb(f)(1) (referring to "a misrepresentation"); *see id.* § 77p(f)(3) (cross-referencing the definition of "covered securities"); *id.* § 78bb(f)(5)(E) (same). *See generally id.* § 77r(b) (defining "covered securities").

631. *Id.* §§ 77p(b), 78bb(f)(1).

632. *Id.* §§ 77p(c), 78bb(f)(2).

633. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 87 (2006) ("[SLUSA] . . . denies plaintiffs the right to use the class-action device to vindicate certain [state-law] claims."); Kircher v. Putnam Funds Trust, 547 U.S. 633, 643 (2006) ("§ 77p(c) 'provides that any class action described in Subsection (b) that is brought in a State court shall be removable to Federal district court, and may be dismissed pursuant to the provisions of subsection (b).'" (quoting S. Rep. No. 105-182, at 8 (1998))); *id.* at 644 ("If the action is precluded, neither the district court nor the state court may entertain it, and the proper course is to dismiss.").

634. 784 F.3d 128, 133 (2d Cir. 2015).

635. *Id.* at 133–34.

state law claims against the Funds and individuals and entities affiliated with the Funds—including officers, directors, managers, auditors, a consultant, and a fund administrator.[636] The district court dismissed all of the claims as SLUSA-precluded.[637]

The Second Circuit concluded that, because the plaintiffs bought uncovered securities, but expected that the proceeds of their purchases would be invested in covered securities, and because the proceeds were not so invested, "the essential element of SLUSA that requires falsity 'in connection with' a purchase or sale of a covered security is satisfied in this case."[638] The court then turned to "the meaning of SLUSA's ambiguous use of the word 'alleging,' when it proscribes the 'maint [enance]' of a covered class action 'alleging . . . [false conduct] in connection with the purchase or sale of a covered security,'" characterizing the issue as one of "first impression" in the Second Circuit.[639] The court rejected two possible interpretations: (i) "'alleging' . . . mean[s] that SLUSA applies to any claim that includes any reference whatsoever to the false conduct specified in SLUSA, even if the false conduct is completely irrelevant to the state law theory of the defendant's liability"; and (ii) "alleging" does not cover "extraneous pleaded facts," but it "encompasses any assertion of the types of false conduct specified in SLUSA's references to the anti-falsity provisions of the [Securities and Exchange] Acts that must be proved in order for the state law claim to succeed—even when the *defendant* is not alleged to have participated in the falsity."[640] The Second Circuit instead selected a third interpretation: (iii) "alleging" means "that the complaint must allege conduct by the defendant that is specified in SLUSA *and* that forms the basis for the defendant's state law liability."[641]

This selection meant that "SLUSA's preclusion applies when the state law claim is predicated on conduct *of the defendant* specified in SLUSA's operative provisions, which reference the anti-falsity provisions of the [Securities and Exchange] Acts."[642] The preclusion extends to a claim based on conduct by the defendant that violates those anti-falsity provisions (i) even if the plaintiff has no private cause of action against the defendant under the federal securities laws, as would be true if the conduct violated only Rule 10b-5 and the plaintiff simply had held stock as a result of the defendant's conduct instead of having bought or sold securities as a result of that conduct,[643] and (ii) even if the anti-falsity provi-

636. *Id.* at 133; *id.* at 134 (listing some of the claims as "fraud, constructive fraud, negligent misrepresentation, negligence, gross negligence, breach of contractual obligations, breach of fiduciary duties, constructive trust, mutual mistake, unjust enrichment, and aiding and abetting various aforementioned violations").

637. *Id.* at 135.

638. *Id.* at 142.

639. *Id.* at 143 (quoting 15 U.S.C. §§ 77p(b), 78bb(f)(1) (2012)).

640. *Id.* at 143–44 (articulating two interpretations); *id.* at 144–50 (rejecting those interpretations).

641. *Id.* at 144, 149. The court provided examples of claims that, under its interpretation of "alleging," SLUSA does *not* bar. *Id.* at 148–49.

642. *Id.* at 149.

643. *Id.* (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

sion that the defendant's conduct allegedly violated does not create a private cause of action at all, as would be true if the conduct violated only section 17(a)(2) of the Securities Act.[644] The Second Circuit emphasized that SLUSA's preclusion extends to state law claims based on such *conduct*, even though the state law claim (such as a breach of contract claim) does not, itself, require that the defendant have spoken or written a falsehood.[645]

The court of appeals applied this interpretation to the five relevant categories of the plaintiffs' allegations ("Groups 1–5").[646] The court concluded that Group 1—"predicat[ing] liability on charges that Defendants fraudulently made misrepresentations and misleading omissions regarding the Funds' investments with Madoff and their oversight of the Funds' investments"—alleged "falsity 'in connection with' covered securities" and "conduct by Defendants falling within SLUSA's specifications of conduct prohibited by the anti-falsity provisions of the [Securities and Exchange] Acts."[647] SLUSA precluded those allegations.[648] The Group 2 allegations differed from those in Group 1 only by charging that the defendants *negligently* made misrepresentations and omitted material facts about "the Funds' investments with Madoff and . . . oversight of Madoff's operations."[649] Because those allegations were based on the same conduct by the defendants—"conduct prohibited by not only the anti-fraud provisions of the [Exchange] Act, but also § 17(a)(2) of the [Securities] Act,"[650] which imposes culpability based on the defendant's negligence[651]—the court saw "no reason why the absence of scienter should prevent SLUSA from barring the Group 2 allegations," and ordered that the district court "dismiss any allegations of the type defined as Group 2."[652] Similarly, the Group 3 allegations—"that Defendants aided and abetted (rather than directly committed) the frauds described in Group 1"—were SLUSA-precluded.[653]

The Second Circuit, however, held that SLUSA did not preclude the Group 4 or Group 5 allegations.[654] The plaintiffs predicated Group 4 "on Defendants' breach of contractual, fiduciary, and/or tort-based duties to Plaintiffs to provide competent management, consulting, auditing, or administrative services to the Funds, thus allowing Madoff's frauds to go undetected, causing Plaintiffs' losses."[655] Those allegations did not "requir[e] a showing of false conduct *by*

644. *Id.* at 149–50 (citing Finkel v. Stratton Corp., 962 F.2d 169, 175 (2d Cir. 1992)).

645. *Id.* at 149. The court also held that a district court on a SLUSA preclusion motion may "ascertain . . . independently" that the defendant's alleged false conduct involved "covered securities" where the complaint does not disclose the status of the securities involved. *Id.* at 150.

646. *Id.* at 134–35 (identifying the categories).

647. *Id.* at 151.

648. *Id.*

649. *Id.*

650. *Id.*

651. SEC v. Ginder, 752 F.3d 569, 574 (2d Cir. 2014).

652. *Kingate Mgmt.*, 784 F.3d at 151.

653. *Id.* The Second Circuit noted that the SEC can pursue aiders and abettors, although private claimants cannot do so through claims under Rule 10b-5. *Id.* at 151 & n.22.

654. *Id.* at 151–52.

655. *Id.* at 151.

*the named Defendants* of the sort specified in SLUSA" and therefore survived a SLUSA preclusion attack.[656] The Group 5 allegations "assert[ed] that Plaintiffs are entitled to compensation for fees paid by the Funds to certain Defendants pursuant to contracts between the Funds and those Defendants because those Defendants failed to perform the duties for which the fees were paid, and because the fees based on purported profits and values of the Funds were computed on the basis of inaccurate values."[657] Those allegations, too, survived SLUSA challenge because they did "not depend on conduct *by Defendants* within SLUSA's specifications"; indeed, those allegations did not depend on defendants having committed any deception at all.[658]

The Second Circuit follows the rule that, where SLUSA precludes some claims in a complaint but not others, the court should dismiss the precluded claims and proceed with the rest.[659] Accordingly, the court of appeals remanded for the district court to dismiss the "claims (or portions thereof) [that] fall within the terms of SLUSA's preclusion" and "proceed with respect to the other claims."[660]

## Miscellaneous Cases

The Eighth Circuit held last year that an issuer had violated Rule 10b-9 and Rule 10b-5 by breaking escrow and accessing funds in an all-or-none issuance before the issuer had actually received the minimum amount that the offering specified.[661] The Sixth Circuit held that Rule 15c3-3(*l*) does not create an implied right of action.[662] In another case, the Sixth Circuit held that notes, sold to finance purchases of oil that would be held in tankers until the oil price increased, fell within the "any note" phrase in the federal law definition of "security."[663] The Third Circuit found an interest in a limited liability company ("LLC") to fall outside the "investment contract" phrase in that definition, in part because of the role the purchaser played in a partnership that was legally different from, but was associated with, the LLC.[664]

656. *Id.* at 152.

657. *Id.*

658. *Id.* (emphasis added).

659. *Id.* at 153 (citing Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 47 (2d Cir. 2005), *vacated on other grounds*, 547 U.S. 71 (2006)).

660. *Id.* at 153–54.

661. Doud v. Toy Box Dev. Co., 798 F.3d 709, 712–14 (8th Cir. 2015).

662. Harris v. TD Ameritrade, Inc., 805 F.3d 664, 666–67 (6th Cir. 2015).

663. SEC v. Zada, 787 F.3d 375, 379–81 (6th Cir. 2015) (citing 15 U.S.C. § 77b(a)(1) (2012) (defining "security" to include "any note"); *id.* § 78c(a)(10) (same)).

664. Rossi v. Quarmley, 604 F. App'x 171, 175 (3d Cir. 2015) (noting that, because the plaintiff's "control of [the related partnership] was . . . essential to the success of [the LLC]," his contribution to the LLC "was hardly limited to an investment of money, and his interest was not an investment contract but a commercial venture").