LATHAM & WATKINS LLP

Compendium of Securities Law in 2009

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a. *NECA-IBEW Pension Fund, et al. v. Neurometrix Inc.*, No. 08-10434-RWZ (D. Mass. 2009).

Plaintiffs brought suit against an issuer, its founder, and former CFO and COO for violation of Sections 10(b) and 20(a) of the Exchange Act, accusing the medical device maker of issuing misleading financial statements that did not disclose billing problems associated with the company's flagship product. Plaintiffs alleged that the issuer was required to tell its shareholders that health insurers were routinely denying reimbursement to physicians and raising payment issues for procedures using the company's device.

The court dismissed the complaint for failure to identify any material misrepresentations or omissions, finding that the alleged misstatements contained express warnings of the risk associated with third-party reimbursements that were critical to the company's success. The court also stated that investors were informed as to the defendants' reimbursement strategy and the substance of the dispute with insurance companies, and "they could make their own judgment as to whether that strategy was wise or ill-considered."

2. Sarbanes-Oxley Act

a. *Day v. Staples*, 555 F.3d 42 (1st Cir. 2009).

Plaintiff brought an action against his former employer for, *inter alia*, violation of the whistleblower provisions of the Sarbanes-Oxley Act. Plaintiff alleged that he had observed the defendant company defraud shareholders during his seven weeks of employment at the company.

The district court dismissed the complaint, finding that plaintiff did not have the requisite knowledge and training to make an allegation of shareholder fraud. The 1st Circuit affirmed, holding that "[c]omplaints about purely internal practices that are not financial in nature and are not reported to shareholders do not meet the materiality requirement for an objectively reasonable belief in shareholder fraud."

3. Other

a. *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009).

During the course of its 2003 audit of defendant issuer, the Internal Revenue Service ("IRS") sought the company's tax accrual work papers. The papers had been prepared by internal lawyers and tax department employees at Textron to support the company's calculation of tax reserves for its audited corporate financial statements. The papers identified vulnerable tax return positions and the quantity of the revision that would be required should the IRS dispute the position. The company refused to turn over the papers in response to an IRS summons, and the IRS brought an enforcement action in federal district court. Textron challenged the summons on the grounds that, *inter alia*, the papers were protected by the work product doctrine. The district court denied the petition for enforcement, finding that the papers were protected work product, which had not been waived by disclosure to the company's accountants. On appeal, a divided panel upheld the district court's decision, and the 1st Circuit agreed to rehear the case *en banc*.

The 1st Circuit *en banc* (in a 3-2 decision) held that the tax accrual work papers were not protected under the work product doctrine. The court found that Rule 26(b)(3)'s requirement that materials are protected when prepared "in anticipation of litigation" means that they must be prepared "for use in" litigation. While the court acknowledged that the subject matter of the tax accrual papers related to conceivable litigation with the IRS, the papers were drafted for the purpose of preparing the company's financial statements and obtaining a clean audit opinion, not "for use in" litigation. The court cited its own precedent that the work product doctrine does not extend to documents prepared in the ordinary course of business. The court also noted the strong public interest in ensuring that corporations pay their taxes in full.

b. *Baldwin v. Bader*, 585 F.3d 18 (1st Cir. 2009).

Plaintiff, one of seven shareholders and founders of a company, alleged that the company's directors breached their fiduciary duties to him during the course of two transactions. The transactions consisted of the company issuing equity shares as compensation for agreements made by its shareholders to personally guarantee loans made to the company. The first transaction occurred after plaintiff resigned as chairman in 2004, at which point the remaining directors decided that the company needed a new line of funding to stave off bankruptcy. The loan agreement signed by the directors required each shareholder to provide personal guarantees, and the directors sent plaintiff a letter explaining that the board had agreed to issue shareholders who guaranteed the financing common shares equaling 5 percent of the company's outstanding equity, and that if he did not provide a guaranty, his equity would be diluted. After plaintiff refused to provide a guaranty, the directors voted to issue compensatory shares for themselves, diluting plaintiff's stock. Two years later, the directors asked plaintiff to guarantee a new loan

that would increase the company's loan and line of credit in exchange for the same compensatory share rate. The plaintiff declined again, and his shares were diluted. Plaintiff filed suit in district court alleging that both issuances of compensatory shares comprised a breach of the directors' fiduciary duties as directors and shareholders. Both parties moved for summary judgment, and the district court found in favor of the directors with respect to the first transaction and in favor of plaintiff with respect to the second transaction. Both parties appealed.

The 1st Circuit affirmed the lower court's ruling that the directors exercised due care in completing the first of two issuances, holding that no jury could reasonably find that the directors, facing emergency conditions on the brink of insolvency, breached their duty of care in accepting the loan agreement and issuing compensatory shares to themselves for their personal guarantees. The court also affirmed the district court's ruling that the directors breached their fiduciary duty with respect to the second transaction because the directors issued a second round of compensatory shares without reconsidering its rate from a year prior, despite the lower risk involved with the guaranty and the increased financial stability of the company. The appeals court also questioned why the directors executed the second financing on such a tight timetable instead of agreeing to provide personal guarantees at once with fair compensation to be fixed after a more careful study.

II. SECOND CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

During 2009, the 2d Circuit in *In re Flag Telecom Holdings, Ltd. Securities Litigation* found that a putative class of securities fraud plaintiffs should not include "in-and-out traders," *i.e.*, putative class members who sold their stock before the alleged corrective disclosures were made. In *United States v. Kelley*, the court held that the district court did not abuse its discretion in admitting as evidence fraudulent account statements sent to the defendant's clients two to four years after the clients' purchase of the securities at issue, because the account statements indicated that the defendant's allegedly fraudulent actions were not a mistake, but rather part of a larger scheme to defraud. In *SEC v. Dorozhko*, the court held that a breach of fiduciary duty is not required to state a claim under Section 10(b) of the Exchange Act, and that misrepresenting one's identity to gain access to an issuer's confidential information is a "deceptive" practice under the Act.

The Southern District of New York issued several notable decisions on pleading standards under Section 10(b) of the Exchange Act and Rule 10b-5. For example, in *City of Sterling Heights Police & Fire Retirement System v. Vodafone Group Public Ltd. Co*., the court dismissed plaintiffs' claims arising from an alleged failure to take an impairment charge, in part because the plaintiffs failed to allege at what point in time an impairment charge should have been taken and which specific losses known to the company should have triggered an impairment charge. In *In re Dynex Capital, Inc. Securities Litigation*, the court addressed a motion to dismiss plaintiffs' second amended complaint on various grounds, including failure to plead scienter. The 2d Circuit previously reversed the district court's denial of a motion to dismiss the first amended complaint. Although the Court of Appeals' opinion left the door open to pleading "collective scienter," the district court on remand denied the motion to dismiss without reaching the issue of collective scienter, finding that plaintiffs adequately pleaded scienter by alleging that the defendants failed to follow internal policies and issued public statements that contradicted internal reports.

On the issue of loss causation, the Southern District of New York in *Police and Fire Retirement System v. Safenet, Inc.* found that loss causation had not been adequately alleged with respect to two corrective disclosures because, although significant, the losses were consistent with previous stock movements. The court issued two noteworthy decisions on motions to lift the PSLRA discovery stay. In *Waldman v. Wachovia*, the court lifted the stay where the SEC had already settled with the defendant, and the defendant had produced to the SEC the same documents sought by the plaintiffs. In *Koncelik v. Savient Pharmaceuticals, Inc.*, the court also lifted the stay where plaintiffs sought the identity of certain third party corporations that were free to destroy potentially relevant information without preservation subpoenas.

The Southern District of New York also handed down significant decisions on a variety of additional topics. In *In re Refco, Inc. Securities Litigation*, the court granted a defendant law firm's motion to dismiss claims that the firm aided and abetted an issuer in falsifying its financial statements, holding that the defendant's facilitation of the alleged fraudulent loan transactions was too remote to show reliance under Rule 10b-5. In *In re Take-Two Interactive Software, Inc. Derivative Litigation*, the court denied the plaintiff's motion to strike the recommendation of a

Special Litigation Committee to dismiss some of plaintiff's claims and assign the remaining claims to the company for prosecution or other disposition. In *In re Fannie Mae 2008 Securities Litigation*, the court granted a motion to dismiss claims under Section 12(a)(2) of the Securities Act, holding that the issuer's securities were exempt under its statutory charter and because the issuer was a government instrumentality.

B. NOTEWORTHY CASES IN 2009

1. Pleading Standards for Securities Fraud

a. *In re Refco, Inc. Sec. Litig.*, No. 05-8626, 2009 WL 724378 (S.D.N.Y. Mar. 17, 2009).

Plaintiff investors asserted claims under Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 against defendant law firm, alleging that the firm aided and abetted the issuer in falsifying its financial statements. Specifically, the plaintiffs alleged that the defendant assisted in the structuring and facilitating of fake loans, and that it drafted an offering memorandum and registration statement that incorporated the misleading financial information. Defendant moved to dismiss, and the court granted the motion on two grounds. First, the court found that none of the alleged misstatements were actually made by, or otherwise attributable to, the defendant. Second, the court found that the defendant's actions in facilitating the fraudulent loan transactions were too remote to satisfy the reliance element of Rule 10(b). Under the Supreme Court's decision in *Stoneridge Investment Partners, LLC, v. Scientific-Atlanta, Inc.,* 128 S.Ct. 24 (2007), mere allegations that the defendant participated in a fraudulent scheme, without more, were insufficient to establish reliance.

b. *In re Flag Telecom Holdings, Ltd. Sec. Litig*., 618 F. Supp. 2d 311 (S.D.N.Y. 2009).

Plaintiff investors brought claims against an issuer alleging violations of Sections 11, 12(a)(2) and 15 of the Securities Act in the issuer's registration statement regarding "presales" which gave rise to material misrepresentations or omissions. Specifically, the issuer claimed that it was financing its expansion of fiberoptic networking through the presales of tranches of capacity to companies who would in turn make a commitment to pay before the fiberoptic cable was built. The defendants moved for summary judgment on the claims, and the court denied defendants' motion. First, the court considered plaintiffs' claim that the information about the presales was material, which the defendants denied. The court noted that a reasonable investor could understand information about presales of the fiberoptic cable network to reflect market demand; market demand for a product is material to a reasonable investor**;** and therefore the statements in the registration statement could be considered material. Furthermore, the court found that even if statements in the registration statement and prospectus were factually true, a trier of fact could indeed find that the statements were still misleading to a reasonable investor. Finally, the court rejected the defendants' contention that the amendments, annexes and exhibits to the prospectus and registration statement were sufficient as a matter of law to disclose the material facts necessary to reasonable investors.

c. *City of Sterling Heights Police & Fire Ret. System v. Vodafone Group Public Ltd. Co*., 655 F. Supp. 2d 262 (S.D.N.Y. 2009).

Investors filed a class action against an issuer and its officers, alleging violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Plaintiffs alleged that the corporation failed to take timely impairment charges for the declining good will of the corporation and did not disclose that the corporation would likely incur $8.7 billion in tax obligations. The court dismissed plaintiffs' claims for failure to plead fraud with particularity, in part because plaintiff failed "to allege at what point in time an impairment charge should have been taken and which specific losses known to the company should have triggered an impairment charge." The court also found that plaintiff failed to plead with particularity that the issuer fraudulently violated GAAP accounting standards and that the defendants' statement regarding tax charges constituted fraud.

2. Misstatements and Omissions

a. *AIG Global Sec. Lending Corp. v. Banc of America Sec. LLC*, 646 F. Supp. 2d 385 (S.D.N.Y. May 14, 2009).

Defendant investment bank moved for judgment as a matter of law and for a new trial after a jury returned a verdict in favor of eight institutional investors who sued the bank and other defendants pursuant to Section 10(b) of the Exchange Act, Rule 10b-5, and common law fraud. Plaintiffs' claims arose from the sale of asset-backed securities which were backed by consumer installment contracts entered into by a specialty retailer of home furnishings. The court found that there was sufficient evidence introduced at trial for the jury to conclude that false statements were made and material facts were omitted, which led investors to believe that the installment contracts were of a higher credit quality than they actually were. The court also found that there was sufficient evidence presented to show that the defendants' conduct caused the plaintiffs' losses.

b. *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009).

Plaintiff appealed a decision by the district court denying plaintiff's request for a preliminary injunction in an action under Section 10(b) of the Exchange Act. Plaintiff alleged that defendant violated Section 10(b) by "hacking" material information of a company and using that information to purchase and sell the company's stock. Plaintiff alleged that defendant—a corporate outsider with no special relationship to the company—hacked the server of the entity responsible for maintaining the online release of the company's earnings reports. The district court found that a breach of fiduciary duty of disclosure is a required element of any "deceptive" device under Section 10(b). The court concluded that because defendant was an outsider, he owed no fiduciary duty to the company. On appeal, plaintiffs further clarified their allegations, arguing that computer hackers either 1) engage in false identification and masquerade as another user, or 2) exploit a weakness in an electronic code within a program to cause the program to malfunction in a way that grants the user greater privileges. On appeal, the 2^{d} Circuit found that precedent has not established that a breach of fiduciary duty is a required element of an actionable securities claim under Section 10(b). The 2^{d} Circuit further noted that plaintiff's allegations were not based on defendant's alleged failure to disclose, but rather the allegation

that defendant affirmatively misrepresented himself in order to gain access to material, nonpublic information, which was then used for trading. The 2d Circuit found that misrepresenting one's identity in order to gain access to information that is otherwise off limits is deceptive within the ordinary meaning of the word. The 2d Circuit stated that it was "unclear" whether exploiting a weakness in an electronic code to gain unauthorized access is "deceptive" rather than theft. The 2d Circuit vacated the district court's order denying plaintiff's motion for a preliminary injunction, for further findings as to whether defendant's computer hacking involved a fraudulent misrepresentation that was deceptive within the meaning of Section 10(b).

3. Scienter

a. *In re Dynex Capital, Inc. Sec. Litig.*, No. 05 Civ. 1897, 2009 WL 3380621 (S.D.N.Y. Oct. 19, 2009).

Plaintiff bondholders brought class actions against defendant bond servicers alleging that defendants engaged in a fraudulent scheme to artificially inflate the price of the defendants' bonds in order to conceal their own reckless loan underwriting and origination practices. At issue was whether plaintiffs adequately alleged facts to show scienter; the court noted that to prove scienter in the 2d Circuit, plaintiffs either need to show that (i) defendants had the motive and opportunity to commit fraud, or (ii) there is strong circumstantial evidence of recklessness. In this case, the court found that the plaintiffs failed to allege that defendants had the motive to commit fraud, and turned to the recklessness inquiry. Strong circumstantial evidence of recklessness can be alleged in two ways: (i) where a complaint alleges a set of facts in which defendants knew or had access to non-public information that was in conflict with their own public statements or (ii) where defendants failed to sufficiently check information they had a duty to monitor. In this case, the plaintiffs alleged that the defendants failed to follow an internal policy by routinely disregarding their own publicly stated underwriting guidelines which rendered many of their own statements false and misleading. Plaintiffs also adequately alleged scienter based on reports provided to senior management that purportedly contradicted defendants' public statements. Then, the court turned to the analysis in *Tellabs v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), which requires that for scienter to be sufficiently pled, the inference of fraudulent intent on the face of the pleading must be at least as cogent and compelling as other, perhaps innocent inferences of intent. Holistically, the court found that a cogent story of securities fraud could be revealed from the defendants' actions. Ultimately, the court denied the motion to dismiss with regard to some of the statements in the defendants' offering documents and certain statistics regarding the bond collateral, but granted the motion with regard to other statements made.

4. Loss Causation

a. *Police and Fire Ret. Sys. v. Safenet, Inc.*, 645 F. Supp. 2d 210 (S.D.N.Y. 2009).

Plaintiffs allege that defendants—an issuer and its officers and directors—violated the Exchange Act by issuing materially false financial, proxy and registration statements. Plaintiffs allege that defendants fraudulently used stock option backdating and improper revenue recognition to inflate the value of the issuer's shares. The price of the issuer's shares fell upon

the public disclosure of the alleged improper accounting practices. Defendants moved to dismiss, arguing that plaintiffs failed to allege loss causation. The court found that while the losses from two of defendants' corrective disclosures were significant, the losses were not out of line with previous stock movements and were therefore insufficient to establish loss causation. However, the court found that a third alleged corrective disclosure—a press release announcing receipt of an SDNY subpoena related to the defendant corporation's stock-options program—showed a causal connection between the material misrepresentation regarding the stock options program and the loss. The court therefore denied defendants' motion to dismiss with respect to this corrective disclosure. The court found plaintiffs failed to meet their pleading requirements with respect to allegations relating to defendants' alleged non stock-options fraudulent revenue recognition accounting practices. The court found that the information included in the press release—that the SEC sent the defendant corporation a formal inquiry into certain accounting policies and practices—was too vague to satisfy the pleading requirements under *Dura*. The court further found that plaintiffs had adequately alleged violations of Sections 11, 12(a)(2) and 15 of the Securities Act.

5. Class Certification

a. *In re Flag Telecom Holdings, Ltd. Sec. Litig*., 574 F.3d 29 (2d Cir. 2009).

Defendants appealed an order of the district court certifying a proposed class and appointing class representatives. The class representatives comprised individuals and entities with complaints under both the Securities Act (the "'33 Act Plaintiffs") and the Exchange Act (the "'34 Act Plaintiffs"). The '33 Act Plaintiffs' complaints centered primarily on statements made during initial public offerings ("IPO"), while the '34 Act Plaintiffs' allegations were based on allegedly false and misleading statements made after the IPO. On appeal, the defendants argued that a "fundamental conflict" existed between the '33 Act Plaintiffs (who were subject to a negative causation affirmative defense) and the '34 Act Plaintiffs (who are required to prove loss causation) which violated the "typicality" requirement of Rule 23(a). Defendants argued that the Supreme Court's holding in *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336 (2005) controlled, and argued that the loss causation required to be proven by the '34 Act Plaintiffs would preclude the '33 Act Plaintiffs from overcoming defendants' "negative causation" defense, thus adding up to a "zero-sum game." In other words, by establishing loss causation, the '34 Act Plaintiffs undermined the '33 Act Plaintiffs' ability to show that it was actually the alleged misstatements in the prospectus and registration statement that were the cause of the drop in the stock price.

The court disagreed with this challenge by holding that the defendants overlooked the possibility that the decline in the value of the stock might have been caused by both statements in the registration statement as well as statements made after the IPO. Furthermore, *Dura* requires plaintiffs to disaggregate losses caused by events aside from those disclosures of truth behind alleged misstatements; thus the jury could decide which portion of the plaintiffs' harm was caused by each misstatement—whether in the registration statement and prospectus or made after the IPO. Next, the court turned to the defendants' claim that the class should not include people who sold their stock before the alleged corrective disclosures were made, namely as "in-and-out traders." The court agreed with the defendants that the lower court relied on a lesser standard of

proof in determining that the in-and-out traders could "conceivably" overcome the defendants' negative causation; the lower court was required to find by the preponderance of the evidence that the in-and-out trader as class representatives were adequate and typical of the class and not subject to any unique defenses. The court found that the plaintiffs had failed to offer enough evidence to prove that the in-and-out traders could demonstrate loss causation as a matter of law, because they could not show that any of the material that leaked to the market before the ultimate disclosures revealed the truth with respect to the specific misrepresentations alleged. Therefore, the in-and-out trader could not serve as a class representative.

6. Other

a. *United States v. Kelley*, 551 F.3d 171 (2d Cir. 2009).

This appeal addressed a disputed evidentiary issue on appeal following defendant's conviction for wire fraud and securities fraud, including a violation of Section 10(b) of the Exchange Act. The 2d Circuit held that in a criminal action, the district court did not abuse its discretion in admitting as evidence fraudulent account statements sent to the defendant's clients two to four years after the clients' purchase of the securities. The court noted that the statements were not by themselves proof of a violation of Section 10(b) because they were not provided in connection with the purchase or sale of a security. However, the court found that the statements were admissible because they indicated that defendant's actions were not mistakes, but instead were part of a broader alleged scheme to defraud.

b. *Waldman v. Wachovia Corp.*, No. 08-2913, 2009 WL 86763 (S.D.N.Y. Jan. 12, 2009).

Plaintiffs in a class action alleging violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 moved to lift the PSLRA discovery stay. The documents sought by plaintiffs had already been produced to state and federal authorities in connection with regulatory investigations. These investigations ultimately led to a settlement between defendants and the authorities which would afford some compensation to the plaintiff class. The court granted plaintiff's motion, finding that the burden placed on defendants in connection with the production of the documents would be slight because defendants had already found, reviewed and organized the documents. At the same time, the court found that lead plaintiffs had to determine whether to continue prosecuting the case despite the settlement reached between defendants and the SEC, and the unavailability of the documents burdened plaintiffs' ability to make that determination.

c. *In re Take-Two Interactive Software, Inc. Deriv. Litig.*, No. 06-5279, 2009 WL 1066251 (S.D.N.Y. Apr. 21, 2009).

Plaintiffs brought a derivative action on behalf of the company alleging violations of Sections 10(b), 14(a) and 20(a) of the Exchange Act and related state law claims. The company's board of directors authorized the Special Litigation Committee (SLC) to investigate the alleged violations. After issuing its final report, the SLC moved to dismiss plaintiffs' claims against all but four defendants and recommended that the remaining claims be assigned to the company for prosecution or other disposition. Plaintiffs moved to strike the SLC's motion to

dismiss, arguing that there were genuine issues of fact as to whether the SLC conducted a reasonable investigation and whether it was conducted in good faith. The court denied plaintiffs' motion in its entirety, and granted the SLC's motion.

d. *DeBlasio v. Merrill Lynch & Co., Inc.*, No. 07 Civ 318, 2009 WL 2242605 (S.D.N.Y. July 27, 2009).

Plaintiffs brought a class action under the Investment Advisors Act ("IAA"), the Sherman Antitrust Act, and state law alleging that five groups of banking entities engaged in deceptive and misleading practices relating to a series of "cash sweep" programs that were offered as part of the plaintiffs' brokerage accounts. Defendants moved to dismiss, and the court granted the motion. Specifically, the court held that plaintiffs had failed to adequately plead fraudulent misstatements or omissions as required under Rule 9(b). The court also found that plaintiffs failed to allege that they received investment advisory services from defendants or had investment advisory contracts with defendants. Without an investment contract, there can be no cause of action under the IAA.

e. *Koncelik v. Savient Pharms., Inc.*, No. 08 Civ. 10262 (GEL), 2009 WL 2448029 (S.D.N.Y. Aug. 10, 2009).

In a securities class action suit, plaintiffs sought a partial lifting of the stay of discovery under Section 21(D)(b)(3)(B) of the Exchange Act, as amended by the PSLRA. Plaintiffs alleged that defendants failed to disclose that the clinical trial results for a new drug showed that 5% of the patients provided with the drug suffered cardiovascular events. Plaintiffs alleged that once this information was disclosed, the price of defendant shares fell by more than 60%. Plaintiffs sought to compel identification by defendants of certain third party corporations and the global pharmaceutical company that offered to acquire defendant and to serve preservation subpoenas on those corporations. The third party corporations were companies with which the defendant communicated in an attempt to find a licensing partner for the new drug. The court found plaintiffs' request particularized and that it only sought the identity of the third party corporations. The court noted that while the subpoenas were broad, they only required the preservation of documents and not the actual production. The court found that plaintiffs' request was necessary to prevent them from being prejudiced by the loss of evidence, since the third party corporations in possession of potentially relevant information were free to destroy it without the preservation subpoenas. The court granted plaintiffs' motion.

f. *In re Fannie Mae 2008 Sec. Litig.*, No. 08 Civ. 7831, 2009 WL 4067259 (S.D.N.Y. Nov. 24, 2009).

Plaintiffs alleged, among other claims, violations of Sections 12(a)(2) and 15 of the Securities Act against defendant Fannie Mae and certain individuals and underwriters. The plaintiffs alleged that the economic downturn beginning in 2007 and 2008 rendered Fannie Mae undercapitalized and overexposed to subprime and other credit markets and that this was not disclosed in Fannie Mae's offering materials for certain securities offered in 2007 and 2008. Defendants moved to dismiss because Fannie Mae securities are exempt from Securities Act liability under the terms of that statute and Fannie Mae's federal charter and because Fannie Mae

is a government instrumentality. The court granted the motion to dismiss as to the Securities Act claims, as to all defendants, on both grounds.

III. THIRD CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

The 3d Circuit handed down three noteworthy cases during 2009. In *In re Lord Abbett Mutual Funds Fee Litigation*, the court found that where SLUSA preempts some but not all claims in a complaint, only the preempted claims should be dismissed, and not the entire action. In *Alaska Electrical Pension Fund v. Pharmacia Corporation*, the court reversed the district court's finding that the plaintiff's action was barred by the two-year statute of limitations because a scientific study did not provide "storm warnings" that would begin to run the clock on the statute of limitations. In *Institutional Investors Group v. Avaya, Inc.*, the 3d Circuit held that "motive and opportunity" is no longer an independent means to plead scienter, thus deepening a circuit split on this issue.

The district courts of the 3d Circuit also issued important decisions in 2009. For instance, the District of New Jersey in *SEC v. Lucent Technologies., Inc.* found that scienter was lacking for allegations of aiding and abetting the sale of "switches" in violation of Section 13 of the Exchange Act, but found that, despite the lack of any allegation of motive, the SEC's claim against one defendant for certain oral assurances could proceed. The court also found that the SEC's claims of a principle violation of section 13 could proceed because no allegation of scienter is required for such claims. In *Trustcash Holdings, Inc. v. Moss*, the court held that non-purchasers lack standing to assert claims under Sections 12(a) and 17(a) of the Securities Act.

The Eastern District of Pennsylvania in *In re Herley Industrial Inc. Securities Litigation* granted plaintiffs' motion for class certification, holding that the lead plaintiff—an investment advisor—had standing because, although it suffered no injury-in-fact, several funds with standing had assigned their claims to the investment advisor. In *SEC v. Anton*, the court rejected the SEC's claims against the defendant for insider trading, holding that the evidence failed to establish that the defendant knew of the relevant information at the time he spoke with the alleged tippee, that the information allegedly provided was not material in light of other publicly available information, and that the "personal benefit" test was not satisfied.

B. NOTEWORTHY CASES IN 2009

1. Pleading Standards for Securities Fraud

a. *Institutional Investors Group v. Avaya, Inc.*, No. 06-4595, 2009 WL 1151943 (3d Cir. Apr. 30, 2009).

Plaintiff-shareholders brought suit alleging violations of Sections 10(b) and 20(a) of the Exchange Act arising out of statements by the company's officers. Plaintiffs alleged that defendants (1) denied the existence of unusual price competition that was hurting profit margins during the class period despite knowing that the company was offering widespread discounts to clients; and (2) issued baseless financial projections and positive portrayals to the market. In support, plaintiffs offered information from confidential sources (former company employees). Plaintiffs appealed after the district court granted the defendants' motion to dismiss. The 3d Circuit reversed as to the pricing-pressure statements, but affirmed with respect to the financial projections. As to the former, a corporate officer repeatedly denied the existence of unusual

discounting when asked pointed questions by analysts about pricing pressure. Confidential witnesses remarked on the widespread discounting for many of the company's products and services during the class period. The same corporate officer later acknowledged the existence of discounting. Based on that evidence, the court found that plaintiffs adequately pled falsity. For those same reasons, the court concluded that plaintiffs adequately pled that the corporate officer's statements were made with reckless disregard for their falsity. The court reached a different conclusion regarding the projection-related statements, however. Positive financial results that followed the projections undercut any assertion that the projections were false when made. Moreover, the projections were forward-looking statements accompanied by extensive cautionary language. Plaintiffs failed to provide any basis to conclude that corporate officers knew that the established goals were unobtainable when they issued the relevant statements. Finally, the court held that "motive and opportunity" is no longer an independent means to plead scienter.

b. *SEC v. Lucent Techs., Inc.*, No. 04-2315, 2009 WL 1111234 (D.N.J. Apr. 27, 2009).

The SEC brought a civil enforcement action against, *inter alia*, a telecommunications corporation and four of its former senior executives and managers for violations of Sections 10 and 13 of the Exchange Act, and for aiding-and-abetting those violations. Two defendants were charged with giving oral extra-contractual assurances to distributors in five transactions that led to improper revenue recognition. The other defendants were charged with providing four "switches" to a client without a purchase order and recognizing revenue pursuant to a retroactive verbal agreement. All defendants moved for summary judgment.

The court initially held that, applying the "bright line" test, none of the defendants was primarily liable under Rule 10b-5(b). No defendant was "integrally involved" in the drafting or signing of any financial report or issued statements used in any report. The court rejected the SEC's recasting of the misrepresentation claim as a "scheme" for the purpose of avoiding application of the "bright line" test. The court next concluded that the aiding-and-abetting claim against one of the defendants could proceed because the evidence suggested that the defendant knew that she could not give oral assurances without informing the company's finance personnel but did so nonetheless. With respect to the defendants charged with aiding and abetting in connection with the sale of the switches, however, the court found scienter lacking, emphasizing that outside auditors approved of the accounting for the switches. For that same reason—the absence of scienter—the court held that those defendants were entitled to summary judgment on the claim that they aided or abetted a Section 13 violation. However, because a principal violation under Section 13 does not require proof of scienter, the court denied summary judgment on that count.

2. Scienter

a. *In re Radian Sec. Litig.*, No. 07-3375, 2009 WL 974324 (E.D. Pa. Apr. 09, 2009).

Plaintiffs brought a class action against defendant credit enhancement corporation and its officers alleging securities fraud in violation of Sections 10(b) and 20(a) of the Exchange Act

and Rule 10b-5. Plaintiffs alleged that defendants made false and misleading statements and concealed information related to their interest in a subprime mortgage investment company in order to consummate a corporate merger. Defendants moved to dismiss the class action complaint based upon, among other things, the assertion that plaintiffs' allegations of fraud did not satisfy the heightened pleading requirements of the PSLRA. The court granted defendants' motion, holding that the complaint did not allege that defendants had the motive and opportunity to engage in securities fraud or that they engaged in conscious misbehavior or recklessness. Specifically, the court explained that: (1) motives that are generally possessed by most corporate directors and officers are inadequate to satisfy the scienter requirement under the Exchange Act; and (2) the standard for "conscious misbehavior or recklessness," as a means of pleading scienter under the Exchange Act requires misrepresentations to be made so recklessly that culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception.

3. SLUSA

a. *In re Lord Abbett Mut. Funds Fee Litig.*, No. 07-1112, 2009 WL 117002 (3d Cir. Jan. 20, 2009).

The plaintiffs filed a class action complaint alleging that the defendants violated federal and state securities laws. The district court initially dismissed with prejudice the state law claims, concluding that those claims were preempted by the Securities Litigation Uniform Standards Act of 1998 (SLUSA). The defendants later moved to dismiss the plaintiffs' amended complaint, alleging that where SLUSA preempted some, but not all, of the claims asserted by the plaintiffs, the statute required dismissal of the entire action. After the district court accepted that argument and dismissed the complaint, the plaintiffs appealed. The 3^{d} Circuit reversed, holding that where SLUSA operates to bar some, but not all, of the claims alleged in a complaint, a court should only dismiss the preempted claims and not the entire action.

4. Class Certification

a. *In re Herley Indus. Inc. Sec. Litig.*, No. 06-2596, 2009 WL 3169888 (E.D. Pa. Sep. 30, 2009).

Plaintiff investors brought an action against defendant manufacturer and its officers, alleging violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. The court concluded that the putative lead plaintiff, an investment advisor, did not have standing to sue on behalf of the class because it did not suffer injury-in-fact. However, by virtue of two funds (who did have standing) assigning their claims to the investment advisor, the lead plaintiff cured its standing problem (even though the assignment took place after the investment advisor had been appointed as lead plaintiff). Plaintiff then moved for class certification, and defendants objected that the typicality and adequacy elements were not met. The court held that the supposed "unique defenses" that defendants claimed applied to the putative lead plaintiff (and which could destroy the existence of the typicality element) were either not available or not likely to play a significant role at trial. The court also held that the investors' supposed "market manipulation" did not present any conflict that could defeat the adequacy element. Accordingly, the court granted the lead plaintiff's motion for class certification.

5. Confidential Witnesses

a. *In re Par Pharm. Sec. Litig.*, No. 06-cv-3226, 2009 WL 3234273 (D.N.J. Sept. 30, 2009).

Shareholders filed a class action against an issuer, a drug manufacturer, its distributor, and present and former directors and officers of the issuer, alleging violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Plaintiffs' claims were based on significant restatements to the company's accounts receivable reserves and inventory. Defendants moved to dismiss, primarily arguing that the complaint failed to allege scienter with particularity and failed to plead loss causation. Except as to one defendant, the court denied defendants' motion, finding that the confidential informants and trading allegations in the complaint sufficiently pled scienter. The court also found that loss causation had been pled based on the drop in the company's stock price the day after it announced that its financial statements could no longer be relied upon because of accounting errors. The court also denied defendants' Rule 11 motion, which was based on an affidavit from one of the confidential witnesses who claimed that plaintiffs' private investigator misquoted her, took information out of context, and ignored other information she had provided. While noting that defendants could renew their Rule 11 motion after discovery, the court found that the most appropriate course was to discount, but not ignore, the confidential informant's allegations.

6. Insider Trading

a. *SEC v. Anton*, No. 06-2274, 2009 WL 1109324 (E.D. Pa. Apr. 23, 2009).

The SEC alleged that defendant violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 by providing material, nonpublic inside information to a shareholder who subsequently sold his stock. The SEC alleged that defendant informed the shareholder that the corporation would be increasing its loss reserves and planned to suspend its dividend. The court rejected the SEC's insider trading claims, holding that the evidence failed to establish that defendant knew of the relevant information at the time he spoke with the shareholder, that the information about increasing loss reserves was not material given publicly available information, and that the "personal benefit" test was not satisfied. The evidence showed that defendant, who was in the process of retiring, did not know the corporation intended to suspend the dividend and was only generally aware that loss reserves would be increased. Moreover, the loss reserves information was not material because the corporation increased its reserves in previous quarters, informed shareholders of the possibility of further increases, and Credit Suisse had published a report on the decrease of the corporation's credit rating. Finally, defendant did not personally benefit from the shareholder's sale. He did not receive any proceeds, and the relationship between the two individuals belied the notion that the information was a gift. After trial of this matter to the bench, the court entered judgment in favor of defendant and against plaintiff.

7. Other

a. *Alaska Elec. Pension Fund v. Pharmacia Corp.*, Nos. 07-4500, 07-4564, 2009 WL 213095 (3d Cir. Jan. 30, 2009).

Plaintiffs filed a Rule 10b-5 claim against pharmaceutical company defendants, alleging that defendants had fraudulently misrepresented scientific data from a study on the gastrointestinal side effects of their anti-inflammatory drug. Defendants moved for summary judgment on statute of limitations grounds, based on a previous finding of the district court that investor reliance was not reasonable after the complete results of the study had been published, which had occurred on a date beyond the two-year statute of limitations. The district court granted the motion for summary judgment. Plaintiffs appealed, and the 3d Circuit reversed, holding that storm warnings were not present at the time the study results were published.

b. *In re Nutrisystem Inc. Derivative Litig.*, No. 07-4565, 2009 WL 3443401 (E.D. Pa. Oct. 26, 2009).

The court dismissed a derivative suit filed against ten of the company's officers and directors alleging state fiduciary duty claims and federal securities laws violations, because plaintiff failed to make a demand on the company's board of directors or its shareholders and plaintiff did not adequately plead demand futility. The court found that merely naming directors as defendants in a derivative suit is not sufficient to make them interested parties; rather, a plaintiff must plead particularized facts showing a "substantial likelihood" that a majority of the board will face personal liability. The court found that plaintiff did not meet that burden.

c. *Trustcash Holdings, Inc. v. Moss*, No. 08-5284, 2009 WL 3767552 (D.N.J. Nov. 12, 2009).

Defendant CEO received a loan from defendant financial advisory firm that was collateralized by shares of plaintiff company's common stock. The CEO defaulted on the loan, enabling defendant firm to take ownership of those shares of stock and sell them on the open market. Plaintiffs sued the defendants, alleging the loan was a "sham" and that the defendant firm's sale of the shares in the market resulted in the devaluing of the common stock of plaintiff's company. The court granted defendants' motion to dismiss, holding that non-purchasers (such as the plaintiffs here) do not have standing to bring a private cause of action under Section 12(a) of the Securities Act. Similarly, the court dismissed plaintiffs' Section 17(a) claims because, even though the 3d Circuit has not definitively ruled on the issue, a clear majority of other Circuits and district courts in the 3d Circuit have held that Section 17(a) does not provide non-purchasers with a private right of action. Finally, the court dismissed plaintiffs' Rule 10b-5 claims because a non-purchasing or non-selling plaintiff does not have standing to request injunctive relief for a 10b-5 violation.

IV. FOURTH CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

During 2009, the 4th Circuit issued a significant decision in *Public Employees' Retirement Association of Colorado v. Deloitte & Touche LLP*, holding that plaintiffs failed to allege that an auditor acted with the requisite scienter. The 4th Circuit also affirmed the district court's decision in *SEC v. Pirate Investor LLC*, finding that the defendants' representation that the information in an investor report was based on inside information was false and misleading where no inside information was ever obtained. Finally, in *Wiggins v. Janus Capital Group*, the court reversed the dismissal of claims against a mutual fund's investment advisor even though the advisor did not make the allegedly fraudulent statements, because investors could infer that the advisor played a role in preparing or approving the statements. In *Wiggins*, the investment advisor has filed a petition for certiorari with the Supreme Court, and the Court recently sought the views of the Solicitor General's Office.

The district courts of the 4th Circuit issued a number of notable decisions in 2009. On the subject of pleading standards for securities fraud, the court dismissed a complaint based on alleged misrepresentations regarding the release of a new pharmaceutical product by the issuer, where the issuer had warned investors that preclinical testing had raised safety concerns about the drug and that FDA approval could be delayed. The court granted a motion for summary judgment in *In re Mutual Funds Investor Litigation*, holding that defendant mutual funds' actions did not amount to intentional misconduct or recklessness under the Exchange Act where the record showed that defendants made extensive efforts to limit activities of market timers.

In addition, the courts in both *In re Mills Corp. Securities Litigation* and *In re Red Hat, Inc.* rejected the argument that plaintiffs must establish loss causation in order to certify a class, in conflict with 5th Circuit precedent. *Mills* and *Red Hat* thus join the majority of courts addressing the issue that have rejected the 5th Circuit's approach to loss causation at the class certification stage.

The district courts also handed down decisions on a variety of additional securities-related topics. In *Iman v. Hall*, the court held that plaintiffs' condominium purchases did not qualify as "securities" under the Securities Act and the Exchange Act. In *Saratoga Advantage Trust v. ICG, Inc.*, the court appointed lead plaintiffs and rejected defendants' argument that the case could not proceed as a class action where the court had previously appointed another lead plaintiff in a factually similar action that was dismissed prior to class certification. In *Lefkoe v. Jos. A. Bank Clothiers*, the court granted a motion to compel the identification of confidential witnesses identified in the complaint after the denial of a motion to dismiss. Finally, in *Latham v. Matthews*, the court found that the existence of two lawsuits brought by the defendant company's former CEOs was sufficient to put plaintiffs on inquiry notice as to certain claims implicated in the prior lawsuits. Accordingly, these claims were barred under the statute of limitations.

B. NOTEWORTHY CASES IN 2009

1. Misrepresentations and Omissions

a. *Johnson v. Pozen Inc.*, Case No. 1:07CV599, 2009 WL 426235, (M.D.N.C. Feb. 19, 2009).

Plaintiffs asserted claims against an issuer and certain of its officers pursuant to Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Plaintiffs alleged that the defendants misrepresented the date on which a new drug would be approved and omitted material information regarding test results. The court held that plaintiffs failed to plead that defendants made false or misleading statements or failed to disclose material information because defendants had warned that preclinical testing had raised safety concerns and that FDA approval could be delayed. Moreover, defendants' statements fell under the PSLRA's Safe Harbor provision. Finally, the court held that the stock sales by the individual defendants did not give rise to a strong inference of scienter because the amounts and timing of the sales were not unusual and suspicious.

2. Scienter

a. *Pub. Employees' Ret. Ass'n of Colo. v. Deloitte & Touche LLP*, 551 F.3d 305 (4th Cir. 2009).

After their first complaint against defendant auditor was dismissed for failure to state a claim, plaintiffs brought a motion for leave to file a second amended complaint alleging claims under Rule 10b-5 for the defendant's alleged role in fraud committed by a company and its subsidiary. The district court denied the motion for leave to amend on the grounds that the proposed amendment was futile because it failed to allege facts giving rise to a strong inference of scienter as required by the PSLRA. The 4th Circuit affirmed, holding that the plaintiffs failed to allege adequately that the defendant acted with scienter.

b. *In re Mut. Funds Inv. Litig.*, 626 F. Supp. 2d 530 (D. Md. 2009).

Plaintiffs filed a putative class action complaint against a mutual fund and its subsidiary for violations of Section 10(b) of the Exchange Act and Rule 10b-5. The court granted summary judgment to defendants, finding that no rational trier of fact could find that they acted with scienter. The record showed that defendants were policing market timers and made extensive efforts in warning and restricting accounts it identified as market timers. Although the court found that defendants might have done more to restrict the accounts identified as market timers, the court concluded that a rational fact finder could not find that their actions amounted to intentional misconduct or recklessness.

3. Appointment of Lead Plaintiff

a. *Saratoga Advantage Trust v. ICG, Inc.*, Case No. 2:08-0011, 2009 WL 777865 (S.D. W. Va. Mar. 20, 2009).

Plaintiff moved for appointment as lead plaintiff. Defendants argued against appointment of a lead plaintiff on the grounds that the case could not proceed as a class action because the court had previously appointed another lead plaintiff in a factually similar action that was dismissed. The court rejected defendants' argument because the prior action had been dismissed prior to class certification, and therefore the appointment of a lead plaintiff in that case did not bar plaintiff's appointment as lead plaintiff in the new action. The court further held that plaintiff was not collaterally estopped from seeking to serve as lead plaintiff simply because it lost the lead plaintiff contest in the prior action.

4. Class Certification

a. *In re Mills Corp. Sec. Litig.*, 257 F.R.D. 101 (E.D. Va. 2009).

Lead plaintiffs moved for class certification in a case involving claims for control person liability under Section 20(a) of the Exchange Act and violations of Section 15 of the Securities Act. The court applied a preponderance of the evidence standard to the Rule 23 inquiry and found that lead plaintiffs had met their burden of establishing numerosity, commonality, typicality, and adequacy, as well as the requirements of Rule 23(b)(3). The court rejected defendants' argument that plaintiffs must show economic loss and loss causation at class certification, reasoning that imposing such a burden on plaintiffs risks converting class certification into a hearing on the merits. Because the lead plaintiffs had met the requirements of Rule 23, the court granted the motion for class certification.

b. *In re Red Hat, Inc.,* No. 5:04-CV-473-BR, 2009 WL 2993735 (E.D.N.C. Aug. 28, 2009).

Plaintiffs asserted claims under Section 10(b) of the Exchange Act arising from defendants' allegedly improper revenue recognition and misleading financial reports. Plaintiffs filed a motion for class certification and defendants objected on grounds that plaintiffs failed to establish adequacy or predominance. The court found that plaintiff Gilbert was an adequate class representative because he was sufficiently credible, able to vigorously represent the class, and did not have interests antagonistic to the class. The court found that the predominance requirement was met by presuming reliance under the fraud-on-the-market theory. There was no dispute that defendants made the alleged misrepresentations publicly or that the stock was traded on an efficient market. The court found that the alleged misrepresentations were material as they would be important to a reasonable investor's decision and that the class representative purchased stock after the alleged misrepresentations but before the truth was revealed. The court declined to follow 5th Circuit precedent requiring the plaintiff to establish loss causation to invoke the fraud-on-the-market presumption at the class certification stage, reasoning that it improperly added an additional element to plaintiffs' burden. The court further refused to determine whether defendants successfully rebutted the fraud-on-the-market presumption at this

stage, reasoning that a *Daubert* analysis of each side's experts was premature where no merits discovery had been conducted.

5. Confidential Witnesses

a. *Lefkoe v. Jos. A. Bank Clothiers*, No. WMN-06-1892, 2009 WL 3003247 (D. Md. May 1, 2009).

Plaintiffs filed a class action complaint alleging that an issuer and its senior management issued false statements during the class period that reassured investors that the issuer's gross profit margins would increase significantly in the following fiscal year. After losing its motion to dismiss, defendants moved to compel the identification of confidential witnesses identified in the complaint. The court granted the motion, but denied the motion as to attorney work product regarding plaintiffs' communications with defendants' representatives and third parties.

6. Other

a. *Wiggins v. Janus Capital Group*, 566 F.3d 111 (4th Cir. 2009).

Plaintiffs brought a putative class action against a mutual fund and its investment advisor alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5. The 4th Circuit affirmed dismissal of the claims against the fund, but reversed as to the advisor. The advisor had advised subsidiary fund companies of the mutual fund, but no statements in the prospectuses issued by those companies were attributed to the advisor. The court adopted a standard requiring plaintiffs to allege facts from which a court could plausibly infer that interested investors would have known that the advisor was responsible for the statements at the time they were made, even if the statements on their face were not directly attributed to the advisor. Under this standard, the court held that plaintiffs had stated a claim against the advisor because it was reasonable for investors to infer that the advisor played a role in preparing or approving the alleged misstatements.

b. *SEC v. Pirate Investor LLC*, 580 F.3d 233 (4th Cir. 2009).

The district court found defendants liable in an SEC enforcement action for securities fraud arising from misstatements in an investor report and e-mail solicitation. The 4th Circuit affirmed, holding that: (i) defendants' representations that the information in the report was based on inside information was false where no inside information was actually obtained; (ii) the representations were material as they would be important to reasonable investors; (iii) defendants acted with scienter where they published the statements knowing that the representations were false; and (iv) the representations were made "in connection with" the purchase or sale of securities where the securities purchase was necessary to complete defendants' fraudulent scheme, defendants made the misrepresentations with the intent to induce securities transactions, and defendants directed the misrepresentations to investors that they knew were likely to rely upon them. The 4th Circuit further held that the First Amendment does not protect fraudulent speech in the form of securities fraud.

c. *SEC v. Resnick*, 604 F. Supp. 2d 773 (D. Md. 2009).

Defendant officer of a company was accused of participating in a fraudulent scheme to inflate and overstate the financial results of the company and its parent. He was convicted by a jury on six counts of criminal conspiracy and securities law violations arising out of this scheme. The SEC filed the present action charging the officer with four equivalent civil counts of securities laws violations. The SEC sought (i) a permanent injunction against Kaiser, enjoining him from further violations of securities laws or regulations; (ii) disgorgement of the bonus he received resulting from the inflation of the financial results, as well as his salary for the relevant period; (iii) an officer and director bar preventing him from ever serving as an officer or director of a public company in the future; and (iv) a third tier civil monetary penalty. The SEC moved for summary judgment, arguing that his conviction on all counts in the criminal case collaterally estopped him from litigating the civil charges against him. The district court granted the motion. As to the relief requested by the SEC, the court held that all of the relief sought was warranted except for disgorgement of the officer's salary because the salary was not causally linked to the unlawful conduct.

d. *Iman v. Hall*, Case No. 7:08cv00567, 2009 WL 960474 (W.D. Va. Apr. 7, 2009).

Plaintiffs claimed that defendants defrauded them in their purchases of condominium units in a South Florida development project. In addition to claims under the Interstate Land Sales Full Disclosure Act and state-law claims, plaintiffs alleged violations of the Securities Act and the Exchange Act. The court granted defendants' motion to dismiss plaintiffs' securities claims because the plaintiffs' condominium purchases were not securities, and because the complaint failed to plead the claims with particularity as required by Federal Rule of Civil Procedure 9(b).

e. *Latham v. Matthews*, Nos. 6:08-cv-2995-RBH, 6:08-cv-3183-RBH, 2009 WL 3052223 (D.S.C. Sept. 4, 2009).

Defendants moved to dismiss a putative class action complaint on the grounds that certain claims were barred by the statute of limitations and that plaintiffs failed to meet the PSLRA's pleading requirements. The court found that the existence of two lawsuits brought by the defendant company's former CEOs was sufficient to put plaintiffs on inquiry notice as to certain claims implicated in the prior lawsuits. Accordingly, these claims were barred under the statute of limitations. The court held that plaintiffs adequately pled falsity, materiality, and loss causation on the Section 10(b) and Rule 10b-5 claims. The court found that plaintiffs adequately alleged scienter as to the defendant corporation and two individual defendants who made inconsistent statements and/or signed SEC filings with notice of the irregularities contained within the filings by virtue of their involvement in certain company activities. The court found that plaintiffs' general allegations as to the remaining three individual defendants failed to allege scienter with sufficient particularity. Accordingly, the Section 10(b) and Rule 10b-5 claims against the three individual defendants were dismissed, but the other claims survived the motion to dismiss.

V. FIFTH CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

In 2009 the 5th Circuit Court of Appeals handed down three noteworthy securities decisions. In *Lormand v. U.S. Unwired, Inc.*, the court held that the PSLRA safe harbor provisions are inapplicable when defendants know that their alleged misrepresentations are misleading. The *Lormand* court also held that plaintiffs adequately alleged loss causation based on truths revealed to the market by third parties which resulted in the alleged loss. In *Alaska Electric Pension Fund v. Flowserve Corporation*, the appeals court reversed a district court's denial of class certification and held that a plaintiff class need only demonstrate loss causation at the class certification stage by a preponderance of the evidence. In *Affiliated Computer Services, Inc. v. Wilmington Trust Co*., the court held that Section 314(a) of the Trust Indenture Act does not impose an independent obligation on issuers to file reports with the SEC.

In addition, the district courts of the 5th Circuit issued decisions relating to scienter, duties to disclose, the Investment Advisors Act, and insider trading. In a stock options backdating case, the court in *Engel v. Sexton* distinguished claims against directors and officers who approved the backdated stock options from those who merely received them. Regarding the former, scienter was sufficiently pled because the directors and officers had a duty to monitor the exercise date of stock option grants; as to the latter, mere receipt of the options award was insufficient to establish scienter. In *In re Enron Corp. Securities and Derivative & ERISA Litigation*, the district court held that under the Supreme Court's decision in *Stoneridge*, an entity cannot be held liable for involvement in a deceptive scheme unless the plaintiffs demonstrate actual reliance on the defendants' conduct. In *Dommert v. Raymond James Financial Services, Inc.*, the court held that the limitations period under the Investment Advisors Act is the same as the limitations period under the Securities Act. Finally, the court in *SEC v. Cuban* held that while a fiduciary may accept both an obligation of confidentiality and a duty of non-use through the very existence of a fiduciary relationship, a non-fiduciary defendant must separately undertake both duties through express or implied agreements. Since the defendant in this case did not undertake both agreements, there was no deception in his trading, and therefore no insider trading.

B. NOTEWORTHY CASES IN 2009

1. Scienter

a. *Engel v. Sexton*, No. 06-10447, 2009 WL 361108 (E.D. La. Feb. 11, 2009).

Plaintiffs filed a derivative action, alleging that named directors and officers of defendant corporation engaged in a scheme of backdating stock options which amounted to violations of Section 14(a) of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5. After finding that the plaintiffs were not required to make a demand on the corporation's board prior to filing their derivative action due to futility, the court drew a distinction between directors and officers that approved the backdated stock options and those that merely received such options. The court found that scienter had been sufficiently pled as to the members of the compensation committee who had approved the backdated option grants, as those defendants had

a duty to monitor the exercise dates of the grants which they approved and failure to do so amounted to severe recklessness. Mere receipt of backdated grants, however, without more, was ruled insufficient to support an inference of scienter. As a result, the motion to dismiss was granted as to the defendants that only received backdated grants, and denied as to the defendants who served on the approving committee. Plaintiffs' Section 14(a) claim was dismissed under the Securities Act's statute of repose, and their Section 20(a) claim was likewise dismissed due to failure to plead that any of the named defendants controlled those who violated Section 10(b).

b. *In re Enron Corp. Sec. Deriv. & ERISA Litig.*, No. 01-3624, 2009 WL 565512 (S.D. Tex. Mar. 5, 2009).

Plaintiffs, who were investors in Enron, named three financial institutions as defendants in the Enron securities litigation, alleging violations of Section 10(b) of the Exchange Act. The plaintiffs claimed that the financial institutions' involvement in deceptive transactions involving Enron gave rise to a duty to disclose their alleged knowledge of the falsity of Enron's financial statements. The court granted the defendants' motion for summary judgment, relying on the 5th Circuit's decision in *Regents of University of California v. Credit Suisse First Boston (USA)*, 482 F.3d 372 (5th Cir. 2007), and the Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlantic, Inc.*, 128 S.Ct. 761 (2008). First, the 5th Circuit held in *Regents* that these same financial institutions did not have a duty of disclosure and, therefore, relitigation of this matter was barred under the mandate rule. Second, because the financial institutions were not in a fiduciary relationship with the investors, no duty to disclose could exist. Third, the Supreme Court held in *Stoneridge* that an entity is not liable under Section 10(b) for its involvement in a deceptive scheme unless the plaintiffs are shown to have actually relied on the defendants' conduct. Plaintiffs here had no contact with the financial institutions and testified that they never relied on anything the defendants did.

2. PSLRA Safe Harbor

a. *Lormand v. U.S. Unwired, Inc.*, No. 07-30106, 2009 WL 941505 (5th Cir. Apr. 9, 2009).

Plaintiffs filed a class action complaint alleging that defendant made material misrepresentations and omissions regarding its contractual arrangement with a telephone company, amounting to violations of Section 10(b), Rule 10b-5, and Section 20(a) of the Exchange Act. Defendant implemented a "no-deposit" program to attract sub-prime customers. Though defendant's executives privately expressed the view that this "no-deposit" program would lead to enormous losses, defendant publicly touted the program as a necessary and profitable step to reach new customers. Eventually, public disclosures were made about the detrimental effects of the "no-deposit" program, and the stock price dropped. In reversing the district court's dismissal of plaintiffs' claim related to these misrepresentations, the court made two relevant holdings. First, the court held that the PSLRA safe harbor provision is inapplicable where defendants know that their alleged misrepresentations are in fact misleading when they are made. Specifically, the generic disclaimer used by defendants was insufficient because it only warned the public of a vague risk regarding customer satisfaction, and failed to provide meaningful caution about the clear dangers that were materializing as a result of the "no-deposit" program. Second, the court held that a plaintiff sufficiently pleads loss causation where the

alleged loss occurs after the truth is disclosed to the market by a third party. Though it was a disclosure from the telephone company's third-party affiliates that first revealed the truth about the telephone company's "no-deposit" program to the market, the law does not bar a plaintiff from pleading loss causation based on truths revealed to the market by other parties.

3. Class Certification

a. *Alaska Elec. Pension Fund v. Flowserve Corp.*, No. 07-11303, 2009 WL 1740648 (5th Cir. June 19, 2009).

Plaintiffs filed a class action complaint alleging that defendants made false statements concerning earnings forecasts, past financial performance, and integration costs and savings related to acquisitions, amounting to violations of Sections 10(b) and 20(a) of the Exchange Act and Sections 11 and 15 of the Securities Act. Plaintiffs moved to certify the class, and defendants moved for summary judgment, arguing that the plaintiffs failed to allege loss causation. The 5th Circuit vacated the district court's denial of plaintiffs' motion for class certification and reversed in part its grant of defendants' motion for summary judgment, remanding the case for further proceedings. Specifically, the court held that while the 5th Circuit does require a plaintiff class to demonstrate some loss causation to gain certification, such causation need only be demonstrated by "a preponderance of all admissible evidence." The district court, in determining that plaintiffs failed to prove loss causation and were therefore not entitled to the rebuttable presumption of class-wide reliance, erred by applying an overly burdensome standard which only found loss causation to be proven where defendant released a "fact-for-fact" disclosure admitting to and fully correcting all prior false statements. In correcting this error, the 5th Circuit held that loss causation can be shown where the corrective disclosure did not precisely mirror an earlier misrepresentation, but simply reflected the relevant truths previously obscured by defendant. The 5th Circuit also found error in the district court's grant of defendant's summary judgment motion, as the lower court failed to apply the correct standard to its determination on the Exchange Act claims, and failed to give the plaintiffs the benefit of a presumption, as required by the case law, for the Securities Act claims.

4. Insider Trading

a. *SEC v. Cuban*, No. 3:08-CV-2050-D, 2009 WL 2096166 (N.D. Tex. July 17, 2009).

The SEC filed a complaint alleging that defendant received material, non-public information about a planned investment by a public corporation in which he invested, agreed to maintain the confidentiality of that information, then sold his shares based on the information thereby avoiding substantial losses. The SEC claimed that these actions amounted to violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, and sought a permanent injunction against future violations as well as a civil penalty and disgorgement of losses avoided. Defendant moved to dismiss the complaint, and the court granted the motion. Specifically, the court held that in order to successfully plead a claim under the misappropriation theory of insider trading, a plaintiff must demonstrate that the defendant (a) made an express or implied promise to keep the relevant information confidential, and (b) undertook a legal duty to refrain from trading on that information for personal gain. Further,

these agreements may be entered into by the defendant either through creation of a fiduciary relationship, or through an express or implied agreement. Defendant did enter a confidentiality agreement with respect to the material, non-public information he received, but did not accept a legal duty to refrain from trading on that information. While a fiduciary may, by operation of law, accept both an obligation of confidentiality and a duty of non-use through the very existence of a fiduciary relationship, a non-fiduciary defendant must separately undertake both duties through express or implied agreements. Since defendant did not undertake both agreements, there was no deception in his trading on the relevant information, and therefore no misappropriation.

5. Other

a. *Affiliated Computer Servs., Inc. v. Wilmington Trust Co*., 565 F.3d 924 (5th Cir. 2009).

Under an indenture governing certain of plaintiff's debt securities, plaintiff agreed that it would comply with the provisions of Section 314(a) of the Trust Indenture Act, which requires an issuer of bonds to file with the indenture trustee "copies of the annual reports . . . which such obligor is required to file with the Commission." Plaintiff delayed in filing its 2006 Form 10-K with the SEC and therefore also delayed providing a copy of its 2006 10-K to the indenture trustee. As a result, the trustee called an event of default under the indenture. Plaintiff thereafter brought a declaratory judgment action against defendant seeking a determination that it had not breached the Indenture.

In a matter of first impression, the 5th Circuit affirmed the district court's judgment and held that Section 314(a) does not impose an independent obligation on issuers to file reports with the SEC. Rather, it merely requires issuers to provide their indenture trustees with copies of reports that they in fact filed with the SEC. The court expressly "agree[d] with the reasoning of the Eight Circuit" in *UnitedHealth Group Inc. v. Wilmington Trust Co.*, 548 F.3d 1124 (8th Cir. 2008), which held that Section 314(a) "merely identifies *which* reports must *eventually* be forwarded to the trustee" and does not impose "any particular timetable for filing nor does it incorporate the SEC's regulatory deadlines." *Id.* at 1130 (second emphasis added).

b. *Dommert v. Raymond James Fin. Servs, Inc.*, No. 06-102, 2009 WL 275440 (E.D. Tex. Feb. 3, 2009).

Plaintiffs filed a complaint alleging that defendant financial services firms made statements omitting material facts, thereby violating the Investment Advisers Act ("IAA"). Defendants moved for summary judgment, arguing that the statute of limitations barred plaintiffs' claim. The court granted defendants' motion. The court found that although the remedial provision of the IAA does not explicitly provide a statute of limitations, the limitations period from the Securities Act should be imputed. Therefore, an action for rescission under the IAA must be brought either within one year of the wrong, or within one year of discovery of the wrong provided the wrong occurred within the past three years. The court did not address the question of whether the extended limitations period provided under the Sarbanes-Oxley Act should apply to claims under the IAA because the plaintiffs' claim would have failed to satisfy even this longer limitations period.

VI. SIXTH CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

In 2009, the 6th Circuit issued a significant securities opinion in *Segal v. Fifth Third Bank, N.A.*, holding that courts should employ a broad construction of the phrase "in connection with" in determining whether a state law claim involves "an untrue statement or omission of a material fact in connection with" buying or selling a covered security, and therefore should be dismissed under SLUSA.

In addition, the district courts of the 6th Circuit issued three notable securities-related opinions in 2009. In *Clayton, Jr. v. Heartland Resources, Inc.*, the court held that misrepresentations and omissions in offering documents were sufficient to establish scienter when combined with the defendant attorney's experience in the securities industry. *SEC v. Sierra Brokerage Services, Inc.* was a case brought by the SEC for an alleged "pump and dump" scheme. The court granted the SEC's motion for summary judgment because the defendant failed to establish a safe harbor or Section 4(1) protection. In addition, the court found that the defendants violated Sections 13(d) and 16(a) for failing to disclose ownership to the SEC. Finally, *Indiana State District Council v. Omnicare, Inc.*, found that plaintiffs had failed to plead loss causation with respect to alleged misstatements premised on non-compliance with GAAP, where there had been no restatement and the auditors continued to certify compliance with GAAP. The court also discounted statements of confidential witnesses where plaintiffs did not present sufficient information about the witnesses.

B. NOTEWORTHY CASES IN 2009

1. Pleading Standards for Securities Fraud

a. *Clayton, Jr. v. Heartland Res., Inc.,* No. 08-00094, 2009 WL 790175 (W.D. Ky. Mar. 24, 2009).

Plaintiffs alleged that an attorney for a securities seller made false representations in violation of Sections 10(b) of the Exchange Act and 12(a)(2) of the Securities Act. The defendant moved to dismiss, arguing that plaintiff had failed to allege scienter and that he owed no duty to plaintiffs. With respect to the Section 10(b) claim, the court rejected the motion to dismiss for lack of scienter, finding that misrepresentations and omissions in the offering documents combined with the defendant's experience working for the securities seller could plausibly lead to the inference that the defendant had knowledge or acted recklessly. The court also held that an attorney who substantially participates in the preparation of offering documents can be primarily liable to investors who relied upon misrepresentations made in those documents. The court dismissed the Section 12(a)(2) claim because attorneys who draft offering documents do not qualify as an "offeror" or "seller" of a security under Section 12(a)(2).

2. Misstatements and Omissions

a. *Indiana State District Council v. Omnicare, Inc.*, 583 F. 3d 935 (6th Cir. Oct. 21, 2009).

Plaintiff class of investors brought an action against the defendant pharmaceutical company and individual officers under Section 10(b) of the Exchange Act and Section 11 of the Securities Act, alleging that defendants made misrepresentations and omissions with respect to the company's securities. The 6th Circuit affirmed dismissal of the Exchange Act claims but remanded the district court's decision not to dismiss the Securities Act claims, holding that Securities Act claims "sounding in fraud" must be pleaded with particularity. The court also held that loss causation was inadequately pleaded as to certain alleged misstatements premised on non-compliance with GAAP. In the absence of any financial restatement and given the continued willingness of defendant's auditors to certify the company's GAAP compliance, the court concluded that "the complaint does not suggest that the alleged GAAP violations were ever recognized or revealed to the market." Finally, the court reaffirmed its willingness to "steeply discount" the statements of confidential witnesses where plaintiffs provided little information about a key confidential witness "except the title of his position," and where there was a disconnect between what the witness knew and the alleged subject matter of the fraud.

3. Section 5 Registration

a. *S.E.C. v. Sierra Brokerage Servs., Inc.*, No. 03-326, 2009 WL 828242 (S.D. Ohio Mar. 31, 2009).

The SEC brought claims under Sections (5)(a), 5(c), 10(b), 13(d), 15(c)(1), 16(a), and 17(a)(1) of the Securities Act alleging a "pump and dump" scheme. Both parties moved for summary judgment. The court denied defendants' motion and granted the SEC's motion. With respect to the Section 5 claims, the court rejected defendants' argument that their unregistered sales of securities were protected under the Rule 144(k) safe harbor because the defendants were in common control, and the appropriate time had not elapsed. The court also denied Section 4(1) protection for the defendants because they were not issuers or underwriters. The court granted judgment to the SEC under Sections 5(a) and (c) because defendants offered to sell unregistered securities. Moreover, the defendants violated Sections 13(d) and 16(a) because they did not disclose ownership of the securities to the SEC. The court further concluded that the SEC established scienter under Sections 15(c)(1), 17(a)(1), and 10(b) since the defendants orchestrated a successful scheme to artificially inflate the stock price.

4. SLUSA

a. *Segal v. Fifth Third Bank, N.A.*, No. 08-3576, 2009 WL 2958438 (6th Cir. Sept. 17, 2009).

A trust beneficiary's state-law class action claims for breach of fiduciary duty, breach of contract, and unjust enrichment were dismissed by the district court as barred under SLUSA. The district court held that SLUSA barred these claims because the beneficiary's allegations did not merely coincide with but depended on securities transactions. The 6th Circuit, on an issue of first impression in the Circuit, upheld the district court's dismissal, finding that all four necessary

factors for SLUSA's application were present: (1) The class action must be "covered", which means *inter alia* that it involves more than fifty members; (2) the claims must be based on state law; (3) the action must involve a "covered security," which means *inter alia* a nationally listed security; and (4) the complaint must allege "an untrue statement or omission of a material fact in connection with" buying or selling a covered security or a "manipulative or deceptive device or contrivance in connection with" buying or selling a covered security. The only issue contested in this matter was with respect to the fourth factor. Before the passage of SLUSA, courts had construed the "in connection with" clause "flexibly," not "technically and restrictively," *S.E.C. v. Zandford*, 535 U.S. 813, 819 (2002), requiring only that "the fraud alleged coincide with a securities transaction—whether by the plaintiff or by someone else," *Merrill Lynch v. Dabit*, 547 U.S. 71, 85 (2006). Because Congress could "hardly have been unaware" of this broad construction when it chose to use the same phrase in SLUSA, *Dabit* held that the same meaning applies to both sets of laws. *Id.* In light of this broad statutory interpretation, the 6th Circuit found that dismissal was proper.

VII. SEVENTH CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

The 7th Circuit Court of Appeals handed down two noteworthy securities decisions in 2009. The first, *Stark Trading v. Falconbridge Ltd.*, affirmed a district court's dismissal of a Section 10(b) claim for failure to allege reliance. The second, *Beck v. Dobrowski*, affirmed a decision by the district court dismissing a Section 14(a) claim against defendant board members in connection with alleged misrepresentations in a proxy statement. The *Beck* court found that Section 14(a) does not require plaintiffs to plead a strong inference of scienter.

The district courts of the 7th Circuit issued several decisions relating to pleading requirements. In *Western Pennsylvania Electrical Employees Pension Trust v. Plexus Corp.* the court held that the plaintiffs failed to meet the PSLRA's heightened pleading standards. In *Greer v. Advanced Equities, Inc.*, the court granted a motion to dismiss based on plaintiffs' failure to adequately plead scienter and on plaintiffs' failure, in part, to identify misrepresentations with particularity. The court in *Zerger v. Midway Games, Inc.* held that plaintiffs failed to adequately allege a false and misleading statement because they alleged no contemporaneous facts suggesting the alleged misstatements lacked a reasonable basis when made. The court also found that plaintiffs failed to plead a strong inference of scienter because the complaint contained no factual allegations suggesting that the issuer's executives knew about the alleged fraud at the relevant time.

The district courts also handed down notable decisions regarding class certification. *Silverman v. Motorola, Inc.* certified a class that included "in-and-out" traders. The district courts in *Makor Issues & Rights, Ltd. v. Tellabs, Inc.* and *Schleicher v. Wendt* also granted motions for class certification, in each case with certain caveats.

B. NOTEWORTHY CASES IN 2009

1. Pleadings Standards for Securities Fraud

a. *W. Pa. Elec. Employees Pension Trust v. Plexus Corp.*, No. 07C0582, 2009 WL 604276 (E.D. Wis. Mar. 6, 2009).

Plaintiffs asserted claims under Section 10(b) of the Exchange Act against a corporation and several of its officers. Plaintiffs claimed that the corporation's forecasts were materially misleading and the result of an intent to deceive, alleging management knew its forecasted growth in defense contracts lacked a reasonable basis since the company only had a single defense contract. The defendants moved to dismiss, arguing that the complaint failed to plead a strong inference of scienter and that the forecasts were forward-looking statements protected by the PSLRA safe harbor. The district court agreed with the defendants and dismissed the complaint with leave to replead. The court ruled that the complaint failed to demonstrate that the individual defendants knew that the company could not meet its forecasts, particularly when the complaint's allegations showed that the company expected additional defense business. The court found no support for scienter based on confidential witness allegations, finding they related to the status of the current contract rather than the prospects for additional contracts. The court also found nothing suspicious in the individual defendants' stock sales, reasoning that it was

natural for the defendants to sell substantial portions of their stock due to the fact that the stock was trading at a four-year high during the class period and because certain defendants increased their holdings during the class period. Alternatively, the court held that the PSLRA safe harbor protected the allegedly misleading statements as each was either a forward-looking statement or an assumption underlying a forward-looking statement and was surrounded by adequate cautionary language.

b. *Greer v. Advanced Equities, Inc.*, No. 08 C 4958, 2009 WL 1748410 (N.D. Ill. June 19, 2009).

Plaintiffs alleged that defendants violated Section 12(a)(2) of the Securities Act by employing a false and incomplete placement memorandum to induce plaintiffs to purchase shares. Plaintiffs further alleged that defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 by making fraudulent statements and omitting crucial information in connection with the sale of securities. Defendants moved to dismiss on grounds that the statute of limitations barred plaintiffs' claims and, alternatively, plaintiffs failed to meet the PSLRA's pleading standards. The court denied the motion based on statute of limitations, holding that it would not require plaintiffs to establish equitable estoppel at the motion to dismiss stage. The court, however, granted the motion (with leave to replead) based on plaintiffs' failure to adequately plead scienter and on plaintiffs' failure, in part, to identify misrepresentations with particularity.

c. *Zerger v. Midway Games, Inc.*, No. 07 C 3797, 2009 WL 3380653 (N.D. Ill. Oct. 19, 2009).

Plaintiffs filed a federal securities fraud action against defendant issuer based on the defendant's year-end result and its failure to meet forecasts. The court dismissed the complaint, finding first that the lead plaintiffs lacked standing to challenge any statement made after their last purchase of Midway stock. The court further held that plaintiffs failed to adequately allege a false and misleading statement because the complaint alleged no facts contemporaneous to the statements that might suggest the statements lacked a reasonable basis when made. Finally, the court held that plaintiffs failed to plead a strong inference of scienter because the complaint contained no factual allegations suggesting that the issuer's executives knew about the alleged fraud when they issued the public statements.

d. *Spears v. Metro. Life Ins. Co.*, No. 2:07-cv-88 JVB, 2009 WL 2408928 (N.D. Ind. Aug. 4, 2009).

Plaintiffs claimed that they were fraudulently induced to purchase a company's financial products, arguing that the company lured plaintiffs into purchasing their products even though such purchases were not in their best interest. The company filed a motion to dismiss, which the court granted. The court held, first, that plaintiffs failed to plead the actual purchase of securities during the class period; second, that the alleged misrepresentations were insufficiently pleaded under the PSLRA; third, that the amended complaint's generic and conclusory allegations of knowledge did not create a strong inference of scienter; fourth, that the failure to purchase securities during the class period prevented plaintiffs from establishing reliance; and, fifth, that the amended complaint did not demonstrate plaintiffs' economic harm from the placement of the company's financial products.

2. Reliance

a. *Stark Trading v. Falconbridge Ltd.*, 552 F.3d 568 (7th Cir. 2009).

The 7th Circuit affirmed the dismissal of a claim brought by plaintiff hedge funds under Section 10(b) of the Exchange Act. The court found that plaintiffs could not demonstrate reliance when they were aware of purportedly fraudulent information underlying the tender offer at issue before the expiration of the period for tendering their shares. The court also affirmed the dismissal of plaintiffs' claim under Section 11 of the Securities Act because the complaint failed to allege that plaintiffs sustained a loss.

3. Class Certification

a. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, No. 02-4356, 2009 WL 448895 (N.D. Ill. Feb. 23, 2009).

Plaintiffs proposed a class consisting of purchasers of the defendant's common stock between December 11, 2000 and June 19, 2001—the respective start and end dates of alleged deceptive statements and inflated earnings guidance in violation of federal securities laws. Defendants argued that the proposed class was overbroad and should exclude (1) individuals who purchased after a corrective disclosure on April 18, 2001, (2) in and out traders, (3) individuals involved in a co-pending case, and (4) employees of the defendant. The court certified the class, refusing to consider defendants' argument on the grounds that it went to the merits of the case and was therefore inappropriate at the class certification stage. Further, defendants claimed that several of the named plaintiffs lacked typicality and adequacy. The court disqualified one of these plaintiffs because his situation presented a unique standing claim in that he experienced a net profit during the Class Period.

b. *Schleicher v. Wendt*, No. 1:02-cv-1332, 2009 WL 761157 (S.D. Ind. Mar. 20, 2009).

Plaintiffs asserted claims under Sections 10(b) and 20(a) of the Exchange Act and moved to certify a class of all persons or entities who purchased or acquired defendant company's securities during the period from April 24, 2001 through August 9, 2002. Defendants contested: (1) the adequacy of each lead plaintiff under Rule 23(a)(4); (2) plaintiffs' fraud on the market theory of reliance; (3) plaintiffs' contention that short sellers should be included; (4) plaintiffs' ability to prove loss causation and (5) plaintiffs' assertion that damages determinations would not be individualized. The court certified the class in part, holding that the company's common stock was trading in an efficient market throughout the class period and that plaintiffs did not have to establish loss causation at the class certification stage. Further, the court held that while individualized damages assessments would need to be made at some point during the litigation, the merits of the securities fraud claim were best resolved by a class action. The court, however, refused to allow one of the lead plaintiffs to serve as a class representative, holding that his felony fraud conviction made him an inadequate lead plaintiff. The court further excluded from the class purchasers of the company's debt securities and preferred stock, holding that plaintiffs failed to show that these securities traded in an efficient market.

c. *Silverman v. Motorola, Inc.*, No. 07 C 4507, 2009 WL 2704588 (N.D. Ill. Aug. 25, 2009).

Investors asserted claims under Section 10 of the Exchange Act arising from defendant issuer's allegedly false statements concerning the rollout of a new line of mobile phones. Plaintiffs alleged that defendants were aware that the product line would likely face production delays but stated to investors that they expected the product launch to proceed on schedule. Over defendants' objections, the court certified a class and adopted an approach for determining loss causation that included "in-and-out" traders in the proposed class when those traders suffered damage as a result of their purchase of stock during the class period. Additionally, the court held that the purchase of shares after a corrective disclosure has no bearing on whether or not the proposed class representative relied on the integrity of the market during the class period. Further, the court held that an institutional investor's reliance on an investment manager to make financial decisions does not prevent that institutional investor from establishing reliance. Moreover, the court held that a lead plaintiff can meet the adequacy requirement even if, as a "professional plaintiff," it is extensively relying on the expertise of counsel to navigate the complicated litigation waters of a securities class action complaint. Finally, the court held that lead plaintiffs' claims predominated over the action, as their argument that the issuer's alleged misstatements caused plaintiffs' loss was common to the entire class.

4. Other

a. *Beck v. Dobrowski*, No. 07-3967, 2009 WL 723172 (7th Cir. Mar. 20, 2009).

The 7th Circuit affirmed the dismissal of plaintiff shareholder's claims under Section 14(a) against defendant board members in which plaintiffs alleged material misrepresentations or omissions in proxy solicitations following a bidding war for the entity at issue. The court ruled that, while the PSLRA applies to suits under Section 14(a) of the Exchange Act, plaintiff need not plead a strong inference of scienter as there is no required state of mind for a Section 14(a) violation. The court nevertheless rejected plaintiff's misrepresentation allegations, ruling that the buyer's termination fee in the deal was irrelevant and that plaintiff's claim that the solicitation was mailed too close to the shareholders' meeting was inactionable. The court also rejected plaintiff's loss causation allegations, ruling that the losing bid was not superior to the winning bid.

b. *In re Northfield Labs., Inc. Sec. Litig.,* No. 06 C 1493, 2009 WL 4639678 (N.D. Ill. Dec. 8, 2009).

Investors filed a securities fraud class action alleging that the company, which develops and tests blood substitutes for the treatment of patients who face life-threatening blood losses, made misleading statements about the success of its clinical trials. After the court bifurcated discovery on the issues of class certification and liability, defendants moved to compel plaintiffs to produce copies of their trading records in the defendant issuer's securities and other securities. Defendants further claimed that they were entitled to know what information in the corrective disclosures was "new" to the market. The court granted in part and denied in part defendant's motion to compel, finding first that defendants were entitled to test the accuracy and

completeness of plaintiffs' trade confirmations and therefore the more complete account statements for the issuer's securities were required to be produced. The court denied the motion to compel relating to other types of securities, holding that plaintiffs had not objected to having their depositions taken, or to answering detailed questions regarding their specific investments, and thus they would be able to provide adequate answers on the relevant investment topics. Finally, the court held that plaintiffs had no obligation to answer an interrogatory asking them to identify what information they believed was "new" in each of the purported corrective disclosures. Specifically, the court held that plaintiffs had already identified the corrective disclosures at issue in this case and had no obligation at the class certification stage to identify the "new" information in each of the disclosures.

VIII. EIGHTH CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

Courts in the 8th Circuit issued two securities-related decisions of interest in 2009. In *McAdams v. McCord*, the court of appeals affirmed the district court's dismissal of securities fraud claims, finding that to adequately plead loss causation, plaintiffs must state the value of the defendant issuer's stock prior to and immediately following the announcement of the issuer's need for a restatement. In addition, the District of Minnesota in *In re Medtronic, Inc.* declined to apply the theory of "collective scienter" to plaintiffs' allegations of fraudulent intent, finding that the Eighth Circuit had implicitly rejected the doctrine.

B. NOTEWORTHY CASES IN 2009

1. Pleading Standards for Securities Fraud

a. *In re Medtronic Inc.,* No. 07-4564, 2009 WL 649688 (D. Minn. Mar. 10, 2009).

Plaintiffs brought a federal securities fraud class action pursuant to Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 against the issuer and three of its officers and directors. The complaint alleged that defendants made material and fraudulent misrepresentations and omissions about a product which was ultimately recalled. Defendants moved to dismiss the complaint for failure to allege the defendants' fraudulent acts and scienter with particularity. The court granted the defendants' motion to dismiss and dismissed the complaint with prejudice. First, the court held that plaintiffs failed to sufficiently plead materiality of the challenged statements and omissions because the information allegedly possessed was not statistically significant and because other indications, when viewed separately or in their totality, were insufficient to show materiality. Second, the court held that the plaintiffs did not establish a strong inference of scienter. With respect to the individual defendants, the court found that plaintiffs had not established a strong inference of scienter for any of the individuals because plaintiffs could not rely on an inference that defendants must have been aware of information based on their positions within the company or on a general allegation of access to information. In addition, although a court may infer that individuals in top management are aware of matters central to the business' operation, the plaintiffs in this case did not sufficiently allege that the relevant product was central to the issuer's business. With respect to plaintiffs' argument that a strong inference of scienter could be imputed to the issuer without adequately pleading scienter against an individual defendant, the court stated that the 8th Circuit had not directly addressed the doctrine of "collective scienter," but had already implicitly rejected the doctrine in *Kushner v. Beverly Enterprises*, 317 F.3d 820 (8th Cir. 2003). Accordingly, the court stated it would not apply the doctrine and held that because plaintiffs had not adequately pled scienter against any individual defendant or employee of the issuer, corporate scienter could not be established.

2. Loss Causation

a. *McAdams v. McCord*, 584 F.3d 1111 (8th Cir. 2009).

The 8th Circuit affirmed the district court's dismissal of plaintiffs' securities fraud claims for failure to adequately plead loss causation. The court found that "conclusory" allegations that the company and its auditors made material misstatements—and therefore caused plaintiffs' loss—do not establish loss causation when the complaint fails to state the value of the company's stock when the investors made their investments, or its value right before, or right after, the need for a restatement was announced.

IX. NINTH CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

In 2009, the Ninth Circuit Court of Appeals issued noteworthy securities-related decisions on a variety of issues. In *In re Peregrine Systems., Inc. Securities Litigation*, the 9th Circuit affirmed a district court decision holding that the defendant was not primarily liable under Section 10(b) for assisting a corporation in meeting its revenue projections by purchasing products at the end of the quarter because the plaintiffs failed to establish reliance. In *In re Shoretel Inc. Securities Litigation*, the court held that defendant successfully established a "negative causation" defense to a Section 11 claim because the alleged disclosure of the misstatements simply disclosed that the company's results fell short of expectations, and did not reveal what was misrepresented in or omitted from the registration statement. In addition, the 9th Circuit held in *Proctor v. Vishay Intertechnology Inc.*, that SLUSA provided an independent basis for federal court jurisdiction and that, where the single claim on which federal jurisdiction was based was precluded under the statute, other non-precluded claims should be remanded to state court rather than being dismissed along with the precluded action.

Two of the significant district court decisions addressed the requirements for pleading falsity and scienter. First, in *In re Washington Mutual, Inc. Securities, Derivative & ERISA Litigation*, the Western District of Washington addressed a motion to dismiss claims under the Exchange Act against a banks' officers and outsider directors, and claims under the Securities Act against the bank's underwriters and auditor. The court denied the officer defendants' motion to dismiss plaintiffs' Section 10(b) claim because—with the exception of two insufficiently definitive statements—plaintiffs had successfully alleged falsity and scienter as to statements regarding the bank's risk management, appraisals, underwriting, financial statements and internal controls. The court also found that with respect to claims under Section 11 of the Securities Act, plaintiffs were not required to allege subjective falsity as to the auditor's certification of the bank's internal controls, because whether the auditor complied with auditing standards was a verifiable and, therefore, actionable fact. Second, the Western District of Washington found scienter allegations sufficient in *South Ferry LP # 2 v. Killinger*, applying the "core operations" theory to hold that plaintiffs had provided particularized allegations demonstrating actual knowledge of the bank's risk management deficiencies and insufficient hedging against interest rate fluctuation.

The district courts split on the question of whether the group pleading doctrine remained a viable means of alleging scienter in the Ninth Circuit, with the Southern and Central Districts of California finding that it did not in *In re DotHill Systems Corp. Securities Litigation* and *In re Downey Securities Litigation*, respectively, while the Western District of Washington held that the doctrine could form the basis of a scienter allegation in *In re Northwest Biotherapeutics Inc. Securities Litigation*.

B. NOTEWORTHY CASES IN 2009

1. Pleading Standards for Securities Fraud

a. *In re Peregrine Sys., Inc. Sec. Litig.*, No. 06-55197, 2009 WL 186165 (9th Cir. Jan. 23, 2009).

Plaintiff alleged that defendants were liable as primary violators under Section 10(b) of the Exchange Act because of their involvement in a fraudulent scheme in which they received service contracts from companies to whom the corporation ultimately would sell their software products. In exchange, the defendants allegedly agreed to serve as intermediary purchasers and buy software from the corporation at the end of fiscal quarters to enable the corporation to meet specific quarterly projections, which the corporation would not have been able to do otherwise. In total, plaintiff alleged that defendants helped the corporation improperly recognize $32.1 million in revenue. Although the court stated that there was no question as to the fraud perpetrated by the corporation, the issue was whether plaintiff-appellant could hold the non-speaking defendants liable as primary violators of Section 10(b) for participating in a scheme to defraud the corporation's investors. Plaintiff used the fraud-on-the-market presumption to contend that reliance was demonstrated through press releases issued to the investing public that discussed the partnership between the corporation and defendants. The court held that the defendants' allegedly deceptive acts were not placed in issue by the corporation's press releases, and therefore, the presumption of reliance was not triggered. Accordingly, the Ninth Circuit affirmed the district court's dismissal of the complaint.

b. *Huberman v. Tag-It Pacific Inc.*, 314 F. App'x 59 (9th Cir. 2009).

Plaintiff brought claims under Sections 10(b) and 20(a) of the Exchange Act and Rule 10(b)(5) against the defendant issuer and individual defendants alleging material misrepresentations in press releases and SEC filings as well as improper accounting practices. The district court granted summary judgment in favor of defendants and denied plaintiff's motion for class certification. Plaintiff appealed both rulings. First, the Ninth Circuit found that when considered all together, the internal communications, defendant company's accounting practices and public announcements suggested that the individual defendants failed to disclose the corporation's deteriorating financial condition. Moreover, the court found that defendant company's accounting practices may have constituted "egregious deficiencies" based on alleged inadequate monitoring of its inventory, inadequate reserves, and inaccurate reporting of accounts receivable and payable. Therefore, the court held that the evidence raised a genuine issue of material fact and concluded that the district court clearly erred in determining that there was insufficient evidence of scienter. Second, the court held that there was sufficient evidence to loss causation, noting that "[t]he misrepresentation need not be the *sole* reason for the decline in value of the securities, but it must be a substantial cause." The court held that the evidence presented—press releases discussing negative information about defendant company's business, and a stock chart reflecting defendant company's corresponding significant losses in stock value—reasonably could establish loss causation. Accordingly, the court reversed the grant of summary judgment and remanded for trial. Next, the Ninth Circuit reviewed the district court's denial of class certification and noted that although the existence of a unique defense could support an atypicality finding, such a finding was not warranted in this case because the basis for

the purported atypicality was rooted in unsubstantiated speculation. Noting that typicality only requires that the representative claims are "reasonably coextensive with those of absent class members [but] they need not be substantially identical," the court held that the district court's denial of class certification on atypicality grounds was an abuse of discretion. Finally, the court held that the superiority requirement under Rule 23(b)(3) was satisfied by the "evidence that [defendant company] traded on an efficient market." Accordingly, common questions of fact and law predominated over individual questions, and the court remanded with instructions to grant class certification.

c. *In re Shoretel Inc., Sec. Litig.*, No. 08-00271, 2009 WL 248326 (N.D. Cal. Feb. 2, 2009).

Plaintiffs asserted claims under the Securities Act, alleging that the company filed a registration statement that contained material misstatements and omissions. These alleged misrepresentations and omissions were disclosed on January 7, 2008, when the company reported its results for the second quarter. In considering defendants' motion to dismiss, the court found that because the complaint did not "sound in fraud," the heightened pleading standard under Federal Rule of Civil Procedure 9(b) was not applicable. The court then examined plaintiffs' allegations under Rule 8, and found that they had offered sufficient facts to state a claim as to the company's purportedly false statements regarding its growth, revenue recognition practices and credit extension policies. However, the court held that defendants successfully established the "negative causation" defense because the January 7 press release simply disclosed that the company's results fell short of expectations; it did not reveal what was misrepresented in or omitted from the registration statement. Consequently, plaintiffs failed to allege that any damage caused by the subsequent stock drop was due to misrepresentations or omissions disclosed in the press release.

d. *In re Downey Sec. Litig.*, No. 08-3261, 2009 WL 736802 (C.D. Cal. Mar. 18, 2009).

Plaintiffs brought a federal securities fraud class action pursuant to Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 against the issuer and several individuals, its CEO, its board chairman, and its CFO. The complaint alleged that the decline in the issuer's share price resulted from alleged misrepresentations made by the individual defendants. The district court granted the individual defendants' motions to dismiss. The court held that plaintiff failed to plead that the individual defendants made a material misstatement or omission and failed to sufficiently plead scienter and loss causation. First, the court found that the alleged misrepresentations and omissions were not actionable because they were too vague under the PSLRA's particularity requirement or not actionable when viewed in the context of other statements made, and lacked the required specificity or particularized facts demonstrating that the statement was false and that the individual defendant knew it was false when made. The purportedly false statements in the issuer's SEC filings could not be attributed to the individual defendants merely because they had signed or certified the filings where there were no allegations that the individual defendant played a role in the preparation or dissemination of the allegedly false statements. In addition, the general allegations against the issuer could not be attributed to the individual defendants because the group pleading doctrine did not survive the PSLRA. Second, the court found that plaintiffs had failed to plead a strong inference of scienter.

High ranking corporate positions, signatures on public filings, and resignations and terminations do not give rise to such an inference without particularized facts suggesting the individual defendant either knew of the falsity of the statements or participated in falsifying them. Moreover, GAAP violations by themselves, the issuance of a restatement by itself, or allegations that defendants violated a "laundry list of generic GAAP requirements" are insufficient to support a strong inference of scienter. Additionally, the court found that the statements of the confidential witnesses lacked the requisite specificity to give rise to a strong inference of scienter. The court also found that the absence of any stock sales by the individual defendants during the class period negated a strong inference of scienter. Third, the court held that plaintiffs failed to adequately plead loss causation because the complaint did not allege any disclosure of wrongdoing.

e. *In re DotHill Sys. Corp. Sec. Litig.*, No. 06-CV-228, 2009 WL 734296 (S.D. Cal. Mar. 18, 2009).

Plaintiffs asserted claims under Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 against the issuer and certain of its officers and directors. The district court granted defendants' motion to dismiss the complaint because plaintiffs failed to sufficiently plead falsity, scienter and loss causation. The court held that falsity was lacking as to certain of the statements at issue, and some were comprised of mere puffery or were too vague to be actionable. In addition, the court held that the complaint's generalized scienter allegations were deficient because general "hands-on management" allegations are insufficient to plead a strong inference of scienter, and plaintiffs failed to sufficiently bolster them or adequately plead factual misrepresentations. Although noting that the Ninth Circuit had yet to decide the issue, the court ruled that the group pleading doctrine is no longer valid. Citing cases from four circuits and the Southern District of California, the court explained that it found this "weight of authority" against the group pleading doctrine persuasive, and thus rejected the argument that it ought to apply the doctrine in this case. Regarding loss causation, the court found the complaint was inadequate because, with respect to various of the alleged misrepresentations, plaintiffs failed to show that a disclosing event actually disclosed the falsity of the alleged misstatements.

f. *In re Northwest Biotherapeutics Inc. Sec. Litig.*, No. C07-1254RAJ, 2008 WL 6822401 (W.D. Wash. July 2, 2008).

Plaintiffs, a putative class of purchasers of an issuer's stock, filed a securities fraud action against the issuer, its former CEO, former chairperson, and a private investment company for violation of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Plaintiffs alleged that defendants made false statements in three press releases about the issuer's authorization to commercialize and market a vaccine. Defendants moved to dismiss, and the court denied the motion. The court held that plaintiffs sufficiently pled falsity by establishing that the issuer's press releases misleadingly suggested that the issuer was authorized to "commercialize" and "market" its vaccine in Switzerland, when the scope of its authorization was much more limited. Next, the court held that plaintiffs pleaded scienter by alleging that the CEO and chairperson would have been, as high-ranking officers, privy to the facts related to the Swiss authorization. The court also imputed their scienter to the issuer. The court further found that plaintiffs adequately pleaded loss causation, having alleged that the issuer's share price dropped after a press release revealed that earlier press releases were fraudulent. The court also held that the

group pleading doctrine was viable, but not adequately pled against the private investment company defendant.

g. *In re Wash. Mut., Inc. Sec., Derivative & ERISA Litig.*, No. 2:08-md-1919 MJP, 2009 WL 3517630 (W.D. Wash. Oct. 27, 2009).

Plaintiffs filed a class action under Sections 11 and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5, against the officers and outside directors of a bank. Plaintiffs also asserted Securities Act claims against the bank's underwriters and auditor. Plaintiffs alleged that defendants: (1) decreased the efficacy of the bank's risk management policies; (2) corrupted the bank's appraisal process; (3) abandoned appropriate underwriting standards; and (4) misrepresented the bank's financial results and internal controls.

The court granted in part and denied in part defendants' motions to dismiss. The court denied the officer defendants' motion to dismiss the Section 10(b) claim because—with the exception of two insufficiently definitive statements—plaintiffs had successfully alleged falsity and scienter as to statements regarding the bank's risk management, appraisals, underwriting, and financial statements and internal controls. With respect to the bank's financial statements specifically, the court found sufficient allegations that the bank's allowance for loan losses ("ALL") had been understated, and that the bank's internal controls were ineffective at containing risk.

The court granted defendants' motion to dismiss the Section 11 claim only as to those offerings for which plaintiffs did not have standing—those for which no named plaintiff was a purchaser. The court denied the auditor's motion as to the remainder, finding sufficient plaintiffs' allegations of understated ALL and ineffective internal controls. Specifically, the court held that plaintiffs were not required to quantify the amount by which the Bank's ALL was understated, and alleged the bank was operating without internal controls in place to ensure compliance with underwriting, appraisal standards, and proper calculation of the ALL. Further, the court held that plaintiffs were not required to allege subjective falsity as to the auditor's certification of the bank's internal controls; whether the auditor complied with auditing standards was a verifiable and, therefore, actionable fact. The court also denied the underwriters' motion to dismiss, as they had failed to negate causation.

The court granted in part the underwriters' motion to dismiss the Section 12(a)(2) claim, as plaintiffs had not linked their 2006 purchases directly to a misleading prospectus. However, the court held that plaintiffs sufficiently alleged a direct purchase as to the 2007 offering.

h. *In re Jones Soda Co. Sec. Litig.*, 2009 WL 1794278 (W.D. Wash. June 22, 2009).

Individual plaintiffs purchased shares of defendant soft drink company between March 2007 and March 2008 ("the class period"). Plaintiffs alleged that defendant's share price was inflated during the class period because two individual defendants, the company's president and CEO, and its CFO and secretary, made statements that were intended to, and did, create a false impression about the company's financial results and business prospects. Plaintiffs alleged violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. The court denied

plaintiffs' request for leave to amend and dismissed the complaint because the proposed amendment was futile and lacked the requisite particularity under the PSLRA. With respect to falsity, plaintiffs failed to plead any facts supporting their assertion that defendants' statements regarding agreements to place its sodas in 25% of all retail outlets were false. Instead, the court found that defendants merely reported what they had done and expressed hope that they would be able to capitalize on their new investment opportunities. Regarding scienter, the court held that plaintiffs failed to allege facts that would give rise to a strong inference that defendants lied or were deliberately reckless about the company's expected revenue.

2. Misstatements and Omissions

a. *New York State Teachers' Ret. Sys. v. Fremont Gen. Corp.,* No. 2:07-CV-5756, 2009 WL 3112574 (C.D. Cal. Sept. 25, 2009).

Defendant company is a financial services holding company whose lending operations included national subprime residential real estate loans, with a wholly owned subsidiary operating in the United States. After the company's stock price declined sharply, plaintiff investors brought a class action lawsuit, alleging that the company and several of its and its subsidiary's former officers had violated Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Specifically, plaintiffs alleged that defendants made a series of materially false and misleading statements in press releases, conference calls with investors and analysts, and in SEC filings regarding the company's underwriting practices, and its GAAP compliance and internal controls. The court granted defendants' motion to dismiss, holding that plaintiffs had failed to plead falsity and scienter with sufficient particularity. The general allegations of falsity did not contain factual allegations supporting defendants' knowledge of how the allegedly false statements were misleading at the time the statements were made. Further, that the company publicly disclosed its problems and attempted to address them, and that only one of the defendants stood to personally profit from the alleged scheme to defraud investors, weighed against a finding of scienter. In addition, the court held that the complaint failed to provide any facts demonstrating that the allegedly misleading statements were made knowingly or recklessly. Finally, allegations relying on confidential witnesses were lacking in specificity, and did not establish that the confidential witnesses were in positions to gain personal knowledge of what defendants knew at the time they made the allegedly fraudulent statements.

b. *South Ferry LP # 2 v. Killinger*, No. C04-1599-JCC, 2009 WL 3153067 (W.D. Wash. Oct. 1, 2009).

Plaintiffs brought a class action alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5. The court granted in part and denied in part defendants' motion to dismiss. The court dismissed those defendants against whom plaintiffs had not alleged any misstatements. The court denied the remaining defendants' motion to dismiss, holding that—under the core operations theory—plaintiffs had identified material misstatements by those defendants regarding the issuer's ability to effectively hedge against interest rate fluctuation risk.

c. *In re CellCyte Genetics Sec. Litig*, No. C08-0047RSL, 2009 WL 3103892 (W.D. Wash. Sept. 24, 2009).

Plaintiff shareholders brought an action alleging that a company, with the aid of a stock promoter, misled investors in violation of Sections 10(b) and 20(a) of the Exchange Act via the publication of a brochure containing false information about the company's regenerative therapy technology. Defendants moved to dismiss on the following grounds: (1) plaintiffs failed to allege misstatements attributable to defendants, and (2) plaintiffs failed to plead facts sufficient to establish a strong inference of scienter. The court granted the motion, finding that: (1) statements alleged against defendants were "immaterial puffery," not false, or not attributable to defendants; and (2) defendants had no duty to determine the veracity of the alleged statements, and the mere fact of defendants' possible access to contradictory information was legally insufficient to demonstrate scienter. In addition, the court denied leave to amend the complaint with respect to "control person" allegations. Because the stock promoter was not an officer, director or majority shareholder, did not otherwise exert control over the company, and plaintiffs had not attributed any other false statements to him, amendment would be futile.

d. *In re Atlas Mining Co.*, No. 07-428-N-EJL, 2009 WL 3151135 (D. Idaho Sept. 25, 2009).

Plaintiff shareholders alleged that defendant auditor's clean audit opinion was a material misstatement in violation of Section 10(b) of the Exchange Act and Rule 10b-5. The court granted defendant's motion to dismiss. It held that plaintiffs failed to allege a material misstatement because: (1) plaintiffs alleged only one $250,000 misstatement in the audited financial statements; (2) the proper accounting treatment of the $250,000 was ambiguous; and (3) subsequent restated financial statements did not constitute admissions by defendant that the originally filed statements were materially false. In addition, the district court held that the mere failure to adhere to GAAP was insufficient to create an inference of scienter.

3. Materiality

a. *Siracusano v. Matrixx Initiatives, Inc.*, No. 06-15677, 2009 WL 3448282 (9th Cir. Oct. 28, 2009).

Plaintiff shareholders alleged that defendant company's press releases and SEC filings contained material misstatements in violation of Section 10(b) of the Exchange Act. The 9th Circuit reversed the district court's dismissal of the complaint. The court held that assessing the element of materiality required a case-by-case analysis best left to the trier of fact. It also held that plaintiffs pled facts sufficient to create an inference of scienter by alleging: (1) defendant was aware of a possible connection between its pharmaceutical product and anosmia, the loss of the sense of smell; (2) defendant issued press releases endorsing the drug and denying any link between the drug and anosmia; and (3) defendant filed a Form 10-Q that mentioned a generalized risk of product liability litigation but failed to disclose the specific anosmia-related lawsuits that had been filed.

4. Scienter

a. *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981 (9th Cir. 2009).

Defendant company announced that it had erroneously accounted for internal software expenditures and that due to these accounting errors it had likely overestimated earnings for the previous six quarters. Plaintiffs alleged that the company and the individual defendants engaged in manipulative accounting methods, in violation of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. The district court granted defendants' motion to dismiss with prejudice. On appeal, the 9th Circuit considered the impact of the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* on the requirements for pleading scienter set forth in the 9th Circuit's prior case law. The court concluded that *Tellabs* did not materially alter that standard, and only had the effect of adding a "holistic" component to the analysis. That is, following *Tellabs*, courts in the 9th Circuit will conduct a dual scienter inquiry: first, they will determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter; second, if none of the individual allegations is sufficient, the courts will conduct a "holistic" review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness. Here, the court concluded that the plaintiffs' individual allegations were insufficient, standing alone, to create a strong inference of scienter. The court then considered all allegations holistically, concluding that even taken together, the allegations failed to support a strong inference of scienter. The court thus affirmed the district court's dismissal of the action with prejudice.

b. *Rubke v. Capitol Bancorp, Ltd.*, 551 F.3d 1156 (9th Cir. 2009).

The Ninth Circuit affirmed the district court's dismissal of plaintiffs' claim under Section 11 of the Securities Act. The court found that the complaint failed to sufficiently allege that defendants' registration statement contained false statements or misleading omissions consistent with the heightened pleading requirements of Rule 9(b). In reaching this conclusion, the court held that Section 11 claims based on allegedly misleading fairness opinions must allege with particularity that the defendant corporation and its officers and directors actually believed that the fairness opinions were unreliable and that the underlying stock offer was unfair. Additionally, the court held that Section 11 claims cannot be based on omitted information that is publicly available, that "Section 11 does not require the disclosure of all information a potential investor might take into account when making his [investment] decision," that "[a] claim under Section 11 based on the omission of information must demonstrate that the omitted information existed at the time the registration statement became effective," and that "there is no duty to disclose income projections in a prospectus."

c. *Pittleman v. Impac Mortgage Holdings, Inc.*, 2009 WL 648983 (C.D. Cal. Mar. 9, 2009).

Defendant is a publicly traded mortgage lender that specializes in Alt-A loans. Plaintiff, a public investor who lost money on defendant's common stock, brought a class action lawsuit against defendant, its CEO and president, claiming that the defendants fraudulently inflated the

issuer's stock price in violation of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. The district court granted defendants' motion to dismiss for failure to plead a strong inference of scienter. The complaint relied primarily on statements by five anonymous former employees (FEs). The court focused on the additional statements by FE1 and FE4, concluding that the statements were too vague to support a strong inference of scienter. Further, because the statements were so vague, plaintiff could not rely on the core operations inference for pleading scienter, by which the knowledge of facts critical to a company's core operations or transactions is imputed to the company and its key officers.

d. *McCasland v. FormFactor Inc.*, No. C 07-5545 SI, 2009 WL 2086168 (N.D. Cal. July 14, 2009).

Lead plaintiff brought suit against defendant issuer and certain of its officers under Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Plaintiff alleged that defendants had made misleading, optimistic comments regarding the development of new technology to reduce the risk of damage to computer chips during processing. Plaintiff contended that defendants' optimistic statements that the technology would be on-time prevented plaintiff from selling its shares during the class period, until the issuer ultimately disclosed that the technology would not meet the expected timeline and profitability. The court granted defendants' motion to dismiss on the grounds that plaintiff failed to provide sufficient detail to allege a strong inference of scienter as required by the PSLRA. Specifically, the court held that plaintiff did not meet the PSLRA's requirements because it failed to allege that defendants had actual exposure to the ultimately misleading information. The court did not grant plaintiff leave to amend because it had granted such leave previously, and plaintiff had failed to provide substantive updates to its complaint.

e. *In re Metawave Commc'ns. Corp. Sec. Litig*., 629 F. Supp. 2d 1207 (W.D. Wash. 2009).

Plaintiffs, purchasers of the defendant issuer's stock during the class period, alleged that the issuer and three of its executives made material misrepresentations about the quality of its product, the revenue recognized from the product's sale, and the value of the inventory, in violation of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Plaintiffs alleged that defendants admitted that the issuer had falsely booked $7.1 million of revenue associated with the failed product, and announced a restatement of its financials, resulting in a sharp decline of the stock price. Individual defendants moved to dismiss, arguing that plaintiffs had not satisfied the heightened pleading standard for scienter established by the PSLRA. Although plaintiffs had adequately pled loss causation, the court granted individual defendants' motion to dismiss with prejudice, holding plaintiffs failed to adequately plead scienter. Plaintiffs put forward the statements of numerous confidential witnesses regarding the alleged failed product tests, the weak market for the product, and the behavior of the individual defendants. However, the court found that none of the allegations established a strong inference that the individual defendants knew the product was a failure at the time they made public statements to the contrary. Moreover, the court noted the absence of a viable motive for misrepresentation, as the individual defendants did not sell their own stock at the allegedly inflated price.

5. Loss Causation

a. *In re Maxim Integrated Prods., Inc. Sec. Litig.*, 2009 WL 2136939 (N.D. Cal. July 16, 2009).

Plaintiffs brought a purported class action against Maxim Integrated Products, Inc. ("Maxim") and several of Maxim's former officers alleging violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Plaintiffs asserted that Maxim's financial statements were false and misleading because they failed to record a compensation expense for stock options allegedly granted below fair market value. Defendants moved to dismiss plaintiffs' Section 10(b) claim and an officer defendant moved to dismiss plaintiffs' Section 20(a) claim. The court granted in part and denied in part the motions to dismiss. It ruled that public disclosures about the risk or potential of fraud were not sufficient to support allegations of loss causation. Nor was there a specific corrective disclosure that was followed by an immediate stock increase. However, the court ruled that a revelation about the magnitude of Maxim's restatement of earnings could support an allegation of loss causation because it contained new information about Maxim's accounting of stock options and was followed by an immediate stock decline. The court denied the individual defendant's motion to dismiss the Section 20(a) claim because plaintiffs stated sufficient facts to allege his control at Maxim.

6. Confidential Witnesses

a. *In re Gilead Sciences Sec. Litig.*, No. C 03-4999, 2009 WL 3320492 (N.D. Cal. Oct. 13, 2009).

Plaintiff shareholders asserted violations of Section 10(b) and 20(a) of the Exchange Act, claiming that defendants engaged in the off-label marketing of a drug which supposedly resulted in the overstatement of the defendant issuer's sales. Defendants moved to dismiss, and the court denied the motion. Specifically, the court found that the allegations of off-label marketing based on statements by confidential witnesses were sufficient to state a claim. The witnesses' job descriptions and responsibilities were described with particularity and the allegations were supported by the probability that someone in their positions would possess the information alleged. The court also declined to dismiss plaintiffs' Section 20(a) claim. Although it was a "close call," the court agreed that control person liability was adequately pled in light of allegations of a company-wide strategy of marketing the drug for off-label purposes. The court did, however, grant the motion to dismiss claims against certain "non-speaking" individual defendants. The court rejected plaintiffs' assertion that these defendants engaged in insider trading, finding that the complaint contained no allegations of insider trading.

7. Class Certification

a. *Desai v. Deutsche Bank Sec. Ltd.*, No. 08-55081, 2009 WL 2245223 (9th Cir. July 29, 2009).

Plaintiffs allege that defendant violated Section 10(b) of the Exchange Act by taking part in a sophisticated scheme to manipulate the stock price of an issuer to create the appearance of greater market demand than actually existed. The district court denied class certification because the requirements of Federal Rule of Civil Procedure 23(b) were not met. In particular, individual

issues relating to the reliance element of Section 10(b) predominated over common ones. The 9th Circuit affirmed. The court held that the presumption of reliance afforded by *Affiliated Ute Citizens v. United States*, 406, U.S. 128, 153-153 (1972), is only applicable in cases that can be characterized as primarily alleging omissions, and not this case, which concerns only manipulative conduct. The court also rejected plaintiffs' invitation to recognize a new presumption of reliance based on the "integrity of the market"—*i.e.*, that investors, when purchasing stock, generally assume that no one has destroyed the efficiency of the market by manipulating it.

8. Lead Plaintiff

a. *Cunha v. Hansen Natural Corp.*, Nos. ED CV 08-01249-SGL (JCX), ED CV 08-01278-SGL (JCX), 2009 WL 2029797 (C.D. Cal. Jul 13, 2009).

Before the court were two motions for lead plaintiff in a consolidated securities class action. Through PSLRA section 78u-4(a) and *In re Cavanaugh*, 306 F. 3d 726 (9th Cir. 2002), a three-step process has developed to identify an appropriate lead plaintiff. The first step is to publicize the pendency of the action, the claims made and the purported class period by posting notice to the putative class. In step two, "the district court must consider the losses allegedly suffered by the various plaintiffs" to select the "presumptively most adequate plaintiff," *i.e.*, the one who "has the largest financial interest in the relief sought by the class." Third, the court must allow other plaintiffs the opportunity to rebut the presumptive lead plaintiff's showing that it satisfies these requirements. Here, one plaintiff was challenging the presumptive lead plaintiff's status as to adequacy, arguing that the presumptive lead plaintiff was stretched too thin by the numerous other class action lawsuits in which it was involved. The PSLRA's "5-in-3" rule provides that, absent the exercise of discretion by the court, a person may not serve as lead plaintiff in more than five securities class actions within a three-year period. One of the proposed lead plaintiffs already had served as lead plaintiff in seven securities class actions in the past three years, thus falling afoul of the 5-in-3 rule. In this instance, the court opted not to exercise its discretion to deviate from the 5-in-3 rule because there was an alternative institutional investor plaintiff that could adequately assume the lead plaintiff role. Accordingly, the court denied the presumptive lead plaintiff's motion to be appointed.

9. Statute of Limitations

a. *Roth v. Reyes*, 567 F.3d 1077 (9th Cir. 2009).

Plaintiff, shareholder of the issuer defendant, brought an action against the issuer and its top officers pursuant to Section 16(b) of the Exchange Act to recover short-swing profits allegedly realized by defendants. In affirming the district court's dismissal of the action, the 9th Circuit held that the action was time-barred because it was brought more than two years after defendants' profits were realized. The court rejected plaintiff's argument that the Section 16(b) limitations period should have been tolled because defendants claimed inaccurate exemptions on their Section 16(a) filings. The court held that Congress intended the two-year limitations period to be tolled "when the pertinent Section 16(a) reports are not filed," not when an insider files Section 16(a) reports but falsely claims an exemption for the disclosed transactions. Expanding

the equitable tolling rule in this manner would be inconsistent with Section 16 because it would effectively eliminate the two-year limitations period in any case that turned on the applicability of an exemption. Therefore, the court declined to read Section 16(b) in a manner that would eliminate the limitations period whenever an insider engaged in an exempt transaction.

10. SLUSA

a. *Proctor v. Vishay Intertechnology, Inc.*, No. 07-16527, 2009 WL 3260535 (9th Cir. Oct. 9, 2009).

In an action asserted in state court, plaintiffs brought shareholder derivative and class action claims for breach of fiduciary duty. Defendant removed to federal court under SLUSA, and the district court dismissed the complaint. On appeal, the 9th Circuit held that SLUSA provides an independent basis for federal court jurisdiction and requires removal of an entire case provided a single claim therein is precluded under the statute. Upon dismissing claims precluded under SLUSA, any remaining claims should be remanded to state court.

X. TENTH CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

While relatively quiet in 2009, the 10th Circuit court of appeals and district courts addressed a handful of pertinent issues. In *In re Williams Securities Litigation,*, the court applied *Dura* in affirming the district court's award of summary judgment for failure to show loss causation. In addition, the court in *In re Thornburg Mortgage, Inc. Securities Litigation* held that there was no requirement to republish class notice where plaintiffs amended their complaint to add new claims and enlarged the class period by seven months.

B. NOTEWORTHY CASES IN 2009

1. Loss Causation

a. *In re Williams Sec. Litig.*, 558 F.3d 1130 (10th Cir. 2009).

Plaintiffs brought claims against the defendant issuer, individual defendants and an auditor under Sections 10(b) and Section 20(a) of the Exchange Act. The court affirmed the district court's award of summary judgment in favor of defendants. Citing *Dura Pharmaceuticals., Inc. v. Broudo*, 544 U.S. 336 (2005), the court held that "[a]ny reliable theory of loss causation that uses corrective disclosures will have to show both that corrective information was revealed and that this revelation caused the resulting decline in price." Further, "[t]o be corrective, the disclosure need not precisely mirror the earlier misrepresentation, but it must at least relate back to the misrepresentation and not to some other negative information about the company." Under this standard, the court found that the plaintiffs' expert's theories of loss causation failed to distinguish between losses attributable to the alleged fraud and other types of losses. As such, the court held that the expert's testimony was properly excluded under Fed. R. Evid. 702, as the expert's methods could not "reliably link the class' losses to the revelation of the alleged misrepresentations," and summary judgment was properly granted in favor of defendants.

2. Notice Provisions of the PSLRA

a. *In re Thornburg Mortg., Inc. Sec. Litig.*, 2009 U.S. Dist. LEXIS 47149 (D.N.M. Apr. 20, 2009).

The court held there was no requirement to republish the class notice where plaintiffs amended their complaint to add new claims and enlarged the class period by seven months. In reaching this holding, the court noted that the PSLRA requires only one notice at the beginning of litigation, so long as the complaints are "substantially the same." In finding no notice was required regarding the expanded class period, the court reasoned that "[l]itigation is an ongoing process, and it is not surprising that new time periods might come under the umbrella of a particular case as time passes." The court thus found that the original notice fulfilled its purpose, as the underlying allegations were sufficiently related to the earlier claims.

XI. ELEVENTH CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

The 11th Circuit handed down several securities-related decisions in 2009. In *Puterman v. Lehman Brothers, Inc.*, the 11th Circuit affirmed the district court's dismissal of plaintiffs' claims as time-barred because the participation of one of the plaintiffs in an earlier lawsuit relating to the same conduct at issue in the instant action put him on notice of the alleged fraud more than two years before the instant action was filed. In *In re CP Ships Ltd. Sec. Litig.*, the court of appeals found that the district court had subject matter jurisdiction over a securities fraud class action against a company that was headquartered and organized outside the U.S. because acts related to the company's alleged accounting fraud occurred in the company's U.S. office. Finally, in *W.R. Huff Asset Management Co., LLC v. Kohlberg, Kravis, Roberts & Co. LLP*, the court declined to review the district court's decision granting plaintiff's motion to remand a securities fraud action because it was not a "final" order.

The district courts of Florida also handed down decisions on a variety of securities-related topics, including the pleading standards for securities fraud in *Slayter, et al. v. DC 701, LLC, et al.*, the PLSRA's safe harbor for forward-looking statements in *Hoffman v. AuthenTec, Inc.*, class certification in *In re HealthSouth Corp. Securities Litigation*, and the definition of a security in *Tippens v. Round Island Plantation, L.L.C.*

B. NOTEWORTHY CASES IN 2009

1. Pleading Standards for Securities Fraud

a. *Slayter, et al. v. DC 701, LLC, et al.*, No. 07-1903, 2009 WL 223838 (M.D. Fla. Jan. 29, 2009).

Plaintiffs alleged that they were induced to invest in converted condominium units through material misrepresentations and omissions in violation of Section 10(b) and Rule 10b-5 of the Exchange Act and Florida state law. The defendant moved to dismiss, and the court denied the defendant's motion. The court held that Section 10(b) did not require that the alleged violator directly communicate misrepresentations to each investor for primary liability to attach. Therefore, it was irrelevant that the defendant did not make misrepresentations to each of the plaintiffs directly; it was sufficient to allege that the defendant made misrepresentations to some plaintiffs, with the knowledge that these plaintiffs would pass along the misrepresentations to other plaintiffs with whom the defendant had no direct communication.

b. *Eastwood Entes., LLC v. Farha*, No. 8:07-cv-1940-T-33EAJ, 2009 WL 3157668 (M.D. Fla. Sept. 28, 2009).

Plaintiff investors filed securities fraud claims against a managed healthcare provider and three of its officers, alleging that defendants executed a fraud involving the company's accounting for refunds and compliance with governmental regulations. The court denied defendants' motion to dismiss, finding that plaintiffs' allegations, supported by the guilty plea of a company employee, an admission in its restatement that the company falsely inflated its income and first-hand accounts of employees, among other things, pled the existence of the fraud

with particularity under the PSLRA. Additionally, confidential witness accounts, allegations of insider trading, and the existence of investigations into the Company by various governmental agencies were sufficient to support a strong inference of scienter.

c. *Cole v. Health Mgmt. Assocs., Inc.*, No. 2:07cv00484-Ftm-UA-DNF, 2009 WL 2713178 (M.D. Fla. July 17, 2009).

Shareholders sued a hospital operating company and its management for issuing allegedly misleading statements regarding its provision for bad debt expense. The court dismissed the complaint with prejudice, finding that defendants had adequately disclosed the potential for increased bad debt expense. The court also held that plaintiffs had failed to allege scienter because they could not point to any facts showing that defendants had information that contradicted that which they disclosed. The lack of an alleged GAAP violation and a restatement of the company's financials further undermined the sufficiency of the scienter allegations. Further, the court held that because there was no material omission or misstatement, plaintiffs could not demonstrate loss causation.

2. Scienter

a. *In re Pegasus Wireless Corp. Sec. Litig.*, No. 07-81113-CIV-MARRA/JOHNSON, 2009 WL 2997006; 2009 WL 3055205; 2009 WL 3055210 (S.D. Fla. Sept. 21, 2009).

Shareholders sued a wireless networking software and hardware designer, its officers and directors and its auditor for failing to disclose the prior litigation and business history of the company's president and for issuing false financial statements. The court dismissed the complaint with prejudice with respect to the CEO and an outside director because plaintiffs did not adequately allege that defendants had knowingly misled investors about the president's past. The court also dismissed the action against the company's auditor because plaintiffs' allegations that the auditor knew about the fraud by virtue of its relationship with the company and its knowledge of management's previous improprieties at other companies were insufficient to survive a motion to dismiss.

b. *Durgin v. Mon*, No. 06-61844-CIV, 2009 WL 3055216 (S.D. Fla. Sept. 21, 2009).

Plaintiff investors filed securities fraud claims against officers and directors of a homebuilder and financial services company, alleging that defendants were personally liable for misrepresentations and omissions contained in public filings and press releases relating to defendants' obligations with a real estate joint venture. Although it found that plaintiffs had alleged actionable misstatements and/or omissions and loss causation, the court dismissed the complaint, finding that plaintiffs failed to plead scienter and failed to show that each defendant was directly involved in controlling the content of the statements at issue. The court granted leave to replead, instructing plaintiffs to include allegations of defendants' specific functions and roles in the company and allegations that established scienter. The court stated it would reconsider plaintiffs' Section 20(a) claim for control person liability once they had re-pled their Section 10(b) claims.

c. *Durham v. Whitney*, No. 06-CV-00687, 2009 WL 3783375 (M.D. Fla. Nov. 10, 2009).

The court dismissed plaintiff shareholder's suit against a provider of real estate and financial markets educational courses and training, in which plaintiff alleged the company, four of its individual officers, and its outside auditor committed securities fraud through a series of misleading statements in the company's public filings, press releases, and website about the company's business model, educational courses and financial results. The court found that plaintiff failed to allege scienter with any particularity, finding that allegations of ordinary conduct, an employee email revealing the true nature of the company's business, uncorroborated statements of opinions by confidential witnesses, and isolated stock sales failed to state an inference of scienter. Additionally, plaintiff failed to plead loss causation because there was no nexus between statements in two press releases—announcing the pendency of an investigation by the SEC and the receipt of a grand jury subpoena—and any of plaintiff's liability theories. Finally, plaintiff failed to plead even the expected minimum allegations, such as a single GAAP violation or the presence of red flags, to state a claim against the auditor defendant.

3. Safe Harbor for Forward Looking Statements

a. *Hoffman v. AuthenTec, Inc.*, No. 6:08-cv-1741-Orl-28DAB, 2009 WL 3109860 (M.D. Fla. Sep. 24, 2009).

Shareholders sued a semi-conductor company as well as its CEO and CFO for alleged material misstatements regarding revenue expectations and customer relationships in the company's public filings and on investor conference calls. The court dismissed the complaint with prejudice, finding that the majority of the statements were protected by the PSLRA's safe harbor for forward-looking statements because they consisted of projections of financial performance and new business opportunities and were accompanied by detailed cautionary language. The court also found that the single statement that was not forward-looking, concerning a customer's adoption of the company's design into its product, was inactionable because plaintiffs could not allege that the disclosure of the statement's falsity caused the company's share price to decline.

4. Class Certification

a. *In re HealthSouth Corp. Sec. Litig.*, Nos. CV-03-BE-1500-S, CV-03-BE-1501-S, CV-03-BE-1502-S, 2009 WL 3152226 (N.D. Ala. Sept. 30, 2009).

Defendants (an investment bank and an audit firm) challenged class certification of the bondholder plaintiffs, who brought securities claims arising out of an alleged accounting fraud scheme in connection with the purchase of bonds. Defendants asserted, *inter alia*, that the bondholder plaintiffs did not qualify for a presumption of reliance for their Section 10(b) claims and thus failed to satisfy the predominance requirement of Rule 23(b)(3). The court disagreed and certified the class for purposes of the Section 10(b) claims, finding that the secondary market purchasers were entitled to a presumption of reliance under the fraud on the market theory, the primary market purchasers were entitled to a presumption of reliance under the fraud created the

market theory, and both groups of purchasers qualified for a presumption of reliance under the common fraudulent scheme theory. The court slightly modified the class definition for purposes of bondholder plaintiffs' Section 11 claims, excluding primary market purchasers from the class as to any bonds that were not traceable to a registration statement (*i.e.*, unregistered bonds exchanged for registered bonds through a voluntary Rule 144A/Exxon exchange).

5. Jurisdiction

a. *W. R. Huff Asset Mgmt. Co., LLC v. Kohlberg, Kravis, Roberts & Co. LLP*, No. 07-13114, 2009 WL 1148026 (11th. Cir. Apr. 29, 2009).

In an attempt to avoid SLUSA preclusion and to obtain a remand to state court, plaintiffs sought leave to file an amended complaint. The district court granted plaintiffs leave to file the complaint and subsequently remanded the case to state court. Defendants appealed the order granting plaintiffs leave to file an amended complaint. The 11th Circuit found that it lacked appellate jurisdiction to review the order because such an order was not "final" under the meaning of 28 U.S.C. § 1291 and the collateral order doctrine. Rather, the order was reviewable by a state appellate court following a final judgment from the state trial court.

b. *In re CP Ships Ltd. Sec. Litig.*, No. 08-16334 (RLA), 2009 WL 2462367 (11th Cir. Aug. 13, 2009).

A shipping company headquartered and organized outside the U.S. settled a securities fraud class action alleging violations of Sections 10(b) and 20(a) of the Exchange Act stemming from the company's alleged accounting fraud. The 11th Circuit found that (1) the district court had subject matter jurisdiction over the action because substantial acts in furtherance of the fraud were committed in the company's U.S. office; and (2) the settlement was not unfair or unreasonable despite foreign class members' potential for greater recovery in foreign class actions because they could opt out of the U.S. settlement in favor of pursuing those claims.

6. Statute of Limitations

a. *Puterman v. Lehman Bros., Inc.*, No. 08-10189, 2009 WL 1492256 (11th Cir. May 29, 2009).

Plaintiff investors filed a securities fraud action against multiple financial institution defendants, alleging that they participated in a fraud perpetuated by a pension fund, in violation of Section 10(b) of the Exchange Act and Rule 10b-5. The 11th Circuit affirmed the district court's dismissal of plaintiffs' claims as time-barred because the participation of one of the plaintiffs in an earlier lawsuit relating to the same conduct at issue here put him on notice of the alleged fraud more than two years before this action was filed.

b. *Sewell v. D'Alessandro & Woodyard, Inc.*, No. 2:07-cv-343-FTM-29SPC, 2009 WL 2913505 (M.D. Fla. Sept. 10, 2009).

Plaintiff investors filed securities fraud claims against two companies and their executives, alleging that they perpetrated a real estate investment scam by inducing plaintiffs to

enter into purchase agreements by misrepresenting important facts about the investments. Although it found the purchase agreements to be "investment contracts," the court granted defendant's motion to dismiss plaintiffs' federal securities law claims. The court dismissed the majority of plaintiffs' federal securities claims as time-barred, finding that plaintiffs' purchase agreements placed them on inquiry notice of their claims more than one year before they filed the Complaint. The court dismissed plaintiffs' remaining 10b-5 claims because plaintiffs failed to plead scienter under Rule 9(b) and the PSLRA. Finally, because plaintiffs failed to allege primary liability with respect to the corporate defendants, there was no control person liability under Section 20(a) for the individual defendant executives.

7. Insider Trading

a. *Klein v. Cent. Florida Invs., Inc*., 642 F. Supp. 2d 1374 (S.D. Fla. 2009).

Defendant was forced to sell plaintiff corporation's stock pursuant to a settlement agreement that resolved litigation stemming from the defendant's attempted takeover of the corporation. To offset the losses associated with the stock sale, defendant also issued call options for the corporation that expired within six months of being written. Plaintiff moved for partial summary judgment on the grounds that defendant had violated Section 16(b) of the Exchange Act for making short-swing profits from transactions in the corporation's stock. Defendants, while acknowledging that they were statutory insiders who had engaged in the transactions at issue, argued that the unorthodox transaction exception for involuntary transactions applied to their issuing of the call options because the options had been written to offset losses associated with the stock sale required by the settlement. The court found that the issuance of call options was not an involuntary action because (1) the decision to enter the settlement was made voluntarily; (2) the settlement was structured to allow defendant to dispose of its stock without violating Section 16(b); and (3) the call options could also have been structured to avoid liability by expiring at a date later than six months after they were issued.

8. Bar Orders

a. *In re HealthSouth Corp. Sec. Litig.*, No. 07-10701, 2009 WL 1675398 (11th Cir. June 17, 2009).

The 11th Circuit rejected the challenges of former CEO and non-settling defendant to the scope of a Bar Order, which extinguished his contractual rights to indemnification and advancement of his defense costs. First, the 11th Circuit held that the PSLRA's mandatory contribution bar was not exclusive and therefore did not preclude a Bar Order from extinguishing contractual indemnification rights. Further, the fact that the Bar Order provided the former CEO with a judgment credit to offset the loss of his indemnification rights coupled with the public policies in favor of settling class actions and against indemnification in the context of securities fraud weighed in favor of upholding the Bar Order. Second, the court rejected the former CEO's claim that advancement of fees was an independent claim, reasoning that the advancement of fees was effectively measured by the non-settling defendant's liability to the underlying plaintiffs. Finally, the court rejected the argument that the Bar Order did not adequately compensate the defendant for the loss of his contractual right to the advancement of legal fees.

9. Other

a. *In re HealthSouth Corp. Sec. Litig.*, No. 07-11908, 2009 WL 1684422 (11th Cir. Jun. 17, 2009).

A member of the settling bondholder class appealed the district court's denial of its untimely request to opt out of the bondholder class and the denial of its motion for reconsideration. The 11th Circuit held that the district court did not commit clear error in finding that a plaintiff class member had actual and constructive notice of a settlement when the class member received copies of the settlement notice and the notice was published in prominent newspapers. In addition, the court held that the district court did not abuse its discretion in denying the class member's untimely opt out request because the notice expressly informed class members that the plan of allocation would be determined at a later date.

b. *Tippens v. Round Island Plantation L.L.C.*, No. 09-CV-14036, 2009 WL 2365347 (S.D. Fla. Jul. 31, 2009).

Plaintiff investors filed securities fraud claims against developers, a financial institution, and individual officers, alleging that they perpetuated a real estate scam in which they induced plaintiffs to buy investment condominium properties that defendants knew would not be completed or sold. The court denied defendants' motion to dismiss these claims, holding that the real estate contracts at issue were "investment contracts" within the meaning of the Securities Act and that plaintiffs' allegations were sufficient to state a cause of action under Section 12. However, the court dismissed plaintiffs' conclusory allegations of control person liability against one of the individual defendant officers.

XII. DISTRICT OF COLUMBIA CIRCUIT

A. SUMMARY OF DEVELOPMENTS IN 2009

In 2009, the D.C. Circuit issued two important securities-related decisions. In *Zacharias v. SEC*, the court affirmed an SEC order holding that officers and directors of a company and a third party participated in a "scheme" to sell securities in violation of Section 5 of the Securities Act, even though the securities at issue were freely tradable shares sold by the third party. In addition, in *Liberty Property Trust v. Republic Properties Corporation*, the appeals court found that interests in a limited partnership were "securities" under the meaning of the Exchange Act.

The District Court for the District of Columbia also handed down several notable securities decisions. In *SEC v. Johnson*, the district court rejected the SEC's request to fine and permanently enjoin a former executive found liable of aiding and abetting securities fraud violations from serving as an officer of a public company. In *Ross v. Walton*, the court granted defendants' motion to dismiss a Section 10(b) claim, finding that a loan provider's knowledge of government probes into one of its portfolio companies did not constitute compelling evidence that the loan provider was aware of the fraudulent activities of an executive at the portfolio company, particularly where the indicted executive did not implicate the loan provider in his defense.

B. NOTEWORTHY CASES IN 2009

1. Scienter

a. *Ross v. Walton*, No. 1:07-CV-004202, 2009 WL 3754136 (D.D.C. Nov. 4 2009).

Shareholders brought suit against a business loan provider and its officers and directors for violations of Sections 10(b) and 20(a) of the Exchange Act, alleging that the company's financial statements misled investors by failing to inform them of fraud perpetrated by a former executive at one of its portfolio companies. The loan provider, which had a 95 percent stake in the portfolio company at the time, issued a press release revealing the executive's indictment. The loan provider's stock price immediately declined following the revelation, and plaintiffs filed suit.

The court granted defendants' motion to dismiss for failure to adequately plead scienter, finding that plaintiffs had failed to show that the loan provider knew of the executive's fraud when they issued the relevant financial statements. Plaintiffs had cited several "red flags" that they said should have alerted the loan provider to the fraud, including that the loan provider was notified of several government probes into the portfolio company, and that the loan provider was named as a defendant in an earlier shareholder lawsuit against the portfolio company. The court found that the so-called "red flags" did not constitute compelling evidence that the defendants must have known of the fraud while it was happening. The court also pointed out that the executive had not implicated the loan provider or its executives in his criminal prosecution, despite having every motivation to do so, and that the sentencing court ultimately ordered the executive to pay the portfolio company restitution of $30 million, implicating the portfolio company as a victim of the fraud rather than a co-conspirator. The court also granted

defendants' motion to dismiss on the grounds that investors had failed to allege facts demonstrating actual economic loss resulting from the alleged concealment of the fraud. The court found that the stock value returned to pre-disclosure prices and that the stock could have been sold at a profit just after the end of the class period.

2. Definition of a "Security"

a. *Liberty Prop. Trust v. Republic Properties Corp.*, 577 F.3d 335 (D.C. Cir. 2009).

In 2004, defendant real estate development company ("Republic") and its owners had agreed to pay a West Palm Beach, Florida official for consultancy services allegedly pertaining to projects outside the city limits of West Palm Beach. A month before the contract began, however, Republic entered into a contract with the city to construct a $100 million mixed-use development, an agreement the official had voted in favor of approving. In December 2005 defendants formed the Republic Property Trust, a real estate investment trust ("REIT") which subsequently established the Republic Property Limited Partnership for tax planning purposes, 88 percent of which was owned by the trust, its sole general partner. Defendants and Republic Property Limited Partnership signed a contribution agreement in which Republic sold its rights in the city development contract to the limited partnership in exchange for units in the limited partnership. The REIT was subsequently spun off in an initial public offering.

In 2006, plaintiffs Liberty Property Trust ("Liberty REIT") and Liberty Property Limited Partnership ("Liberty Partnership"), successors in interest to the Republic Property Trust and Republic Property Limited Partnership, respectively, discovered that the official under consultancy agreement with Republic had pled guilty to the charge of accepting bribes for other, unrelated transactions. The fallout from the scandal led to the termination of the contract between the city and Liberty Partnership. Liberty filed suit under Section 10 of the Exchange Act against Republic and its owners, asserting that the relationship between Republic and the Florida official was material information that should have been disclosed in the contribution agreement. The district court dismissed the claim, finding that the limited partnership interests the defendants acquired were not "investment contracts" and therefore were not securities. The district court based its finding on the fact that the defendants, who were owners of Republic, were parties on both sides of the transaction because they also owned 9 percent of the REIT, and that they could not be held liable for failing to disclose information to themselves.

The Court of Appeals reversed, finding that such a holding would effectively pierce two corporate veils. The appellate court faulted the district court for disregarding the organizational forms of both the corporation and the limited partnership to view the transaction as between the same parties. The court also found that even if it were proper to disregard the corporate forms, the developers did not exercise sufficient control of the limited partnership as owners of 9 percent of the trust to disqualify their units as securities.

3. Section 5(a) violations

a. *Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009).

Defendants, two former executives of a company, appealed an administrative ruling that they participated in the sale of unregistered securities in violation of Section 5 of the Securities Act. Defendants sold their options to a group of foreign entities which in turn sold them to the public. The administrative ruling found that the defendants were not exempt from registration simply because the foreign entities distributed the shares for them. The ruling instead found that both the defendants and the foreign entities were "underwriters" under the Securities Act, thereby collapsing the two transactions (the sale by defendants to the foreign entities and the sale by the entities to the public) and considering them to be one transaction for purposes of Securities Act liability. The 1st Circuit agreed, holding that the foreign entities were underwriters because the sales to the foreign entities would have to be totally separate from the sales to the public for them to be considered "private," and "the record provides ample evidence that all of the sales were connected."

4. Sanctions

a. *In re Fannie Mae Sec. Litig.*, 552 F.3d 814 (D.C. Cir. 2009).

This case involved an appeal of a district court order holding a governmental investigative agency in contempt for failing to comply with an agreed-upon discovery deadline. The defendants claimed that over 20,000 documents remained unaccounted for when they moved to hold the agency in contempt. Although the district court recognized that the agency undertook extensive efforts to comply, it deemed those efforts "not only legally insufficient, but too little too late." As a sanction, the district court ordered that the agency turn over certain documents that the agency claimed were privileged. The D.C. Circuit upheld the district court's contempt ruling, finding that the lower court was within its rights to issue a contempt citation. The court held that when the agency entered into a stipulated order for the production of documents, it waived any right to challenge information requests.

b. *SEC v. Johnson*, 595 F. Supp. 2d 40 (D.D.C. 2009).

After a jury found the former executive of a defunct issuer liable for aiding and abetting the issuer's securities fraud violations, the SEC filed a request for a permanent injunction against the executive that would prevent him from serving as an officer for a public company or from violating securities laws. The SEC also sought the maximum fine against the executive ($120,000). The district court rejected those remedies as "far too Draconian," because the violation was an isolated incident in the executive's career. In addition, the executive's current position was with a nonpublic company, and therefore he no longer faced disclosure obligations.

XIII. DELAWARE COURTS

A. SUMMARY OF DEVELOPMENTS IN 2009

In January 2009, the Supreme Court of Delaware held in *Gantler v. Stephens* that the shareholder ratification doctrine is limited to circumstances where a fully informed shareholder vote approves director action that does not require shareholder approval in order to become legally effective.

The Delaware Chancery courts also issued securities-related decisions on a variety of topics in 2009. These include *In re Citigroup, Inc. Shareholder Derivative Litigation*, an action related to subprime mortgage lending, in which the court held that plaintiffs failed to show that defendant board of directors breached its fiduciary duty in allegedly failing to heed "red flags" related to subprime lending. In *In re Affiliated Computer Services, Inc. Shareholders Litigation*, the court dismissed the plaintiffs' derivative claims for fiduciary misconduct on demand futility grounds. In *Beiser v. PMC-Sierra, Inc.*, the court granted the defendants' motion to dismiss the plaintiff's inspection request, finding that the request was an improper attempt to avoid the PSLRA discovery stay in a federal lawsuit. Finally, in *Norfolk County Retirement Systems. v. Jos. A. Bank Clothiers, Inc.*, the court rejected a plaintiff's argument that denial of a motion to dismiss and motion for judgment on the pleadings was sufficient to demonstrate that additional documentation was required to assess the independence of a special litigation committee.

B. NOTEWORTHY CASES IN 2009

1. Fiduciary Duty

a. *Gantler v. Stephens*, No. 2392, 2009 WL 188828 (Del. Jan. 27, 2009).

The Delaware Supreme Court held that the shareholder ratification doctrine is limited to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective.

b. *In re Citigroup, Inc. S'holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009).

Plaintiffs alleged that since at least 2006, defendant's board of directors caused and allowed defendant to engage in subprime lending, ultimately leaving the company exposed to massive losses relating to those loans, especially as a result of repackaging those loans into collateralized debt obligations (CDOs). By late 2007, defendant was facing billions of dollars of write-downs related to CDOs and other losses associated with subprime lending. Plaintiffs alleged that defendant's board ignored numerous "red flags" in the form of news articles and other occurrences related to the subprime mortgage industry and committed waste in connection with a letter agreement granting a $68 million severance package to an executive in exchange for a non-disparagement agreement, non-compete agreement, non-solicitation agreement, and a release of claims against the company. The court rejected claims for "reckless and gross mismanagement," noting that Delaware law instead treats such allegations as claims for breach of fiduciary duty. The court granted the motion to dismiss the breach of fiduciary duty claims

regarding subprime exposure, holding that the "red flags" alleged by plaintiffs were "little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally," and did not amount to particularized facts suggesting that the board was aware or should have been aware of wrongdoing within the company. The allegations with respect to the severance agreement were sufficient to survive a motion to dismiss because there was reasonable doubt as to whether the agreement was "so one sided" as to be beyond the "outer limit" of the board's discretion regarding executive compensation in light of the unknown value of the agreements and release agreed to by the executive.

c. *Louisiana Mun. Police Employees' Ret. Sys. v. Fertitta*, C.A. No. 4339-VCL, 2009 WL 2263406 (Del. Ch. July 28, 2009).

The court denied a motion to dismiss a claim against a corporation's board for breach of fiduciary duties relating to abandonment of an acquisition by the controlling stockholder because of (1) the board's failure to act "in the face of an obvious threat to the corporation and the minority stockholders" and (2) the board's failure to enforce a $15 million termination fee against the controlling shareholder.

d. *Latesco, L.P. v. Wayport, Inc.*, C.A. No. 4167-VCL, 2007 WL 2246793 (Del. Ch. July 24, 2009).

A board has a fiduciary disclosure obligation (1) when it seeks collective shareholder action and (2) when it is involved in a transaction with a minority shareholder that occurs outside the scope of an independent right of first refusal and the board is aware of material information not known by the shareholder.

e. *Xu Hong Bin v. Heckmann Corp.*, C.A. No. 4637-CC, 2009 WL 3440004 (Del.Ch. Oct. 26, 2009).

In circumstances when a fiduciary is negotiating a general release with the corporation and the corporation does not suspect fraud by the fiduciary, the fiduciary owes a duty to disclose material facts relating to that release, including the fraud; however, when a director negotiates a general release with his corporation "amid corporate suspicions or allegations that the director committed fraud," a director has no fiduciary duty to disclose any fraudulent conduct, even if the fraud is greater than that suspected by the corporation.

2. Demand Futility

a. *Beiser v. PMC-Sierra, Inc.*, C.A. No. 3893-VCL, 2009 WL 483321 (Del. Ch. Feb. 26, 2009).

After amending its twice-dismissed federal complaint in a federal derivative action, plaintiff made a demand for books and records under Delaware law for documents relating to defendant company's stock option granting practices. Defendant denied plaintiff's inspection request, and plaintiff filed suit seeking to compel the inspection. Plaintiff admitted in briefing that its purpose for the demanded inspection was to acquire information needed to successfully replead demand futility. Defendant moved to dismiss, arguing that plaintiff's purpose for

inspection was improper. The Court of Chancery granted the motion to dismiss, distinguishing *Romero v. Career Educ. Corp.*, 2005 WL 1798042 (Del. Ch. July 19, 2005) and *Cohen v. El Paso Corp.*, 2004 WL 2340046 (Del. Ch. Oct. 18, 2004), holding that because plaintiff was subject to the mandatory stay of discovery in his federal derivative action imposed by the PSLRA, his purpose for seeking the statutory inspection of books and records was an improper attempt to circumvent that stay. The court therefore granted the motion to dismiss.

b. *In re Affiliated Computer Servs., Inc. S'holders Litig.*, C.A. No. 2821-VCL, 2009 WL 296078 (Del. Ch. Feb. 6, 2009).

Plaintiffs failed to plead demand futility in connection with failed merger negotiations because there was no inference of misconduct in either (1) the board's decision to wait to form a special committee until a definitive offer was received or (2) the special committee's choice to negotiate with the chairman and his buyer group regarding a waiver of their exclusivity agreement.

3. Special Litigation Committees

a. *Norfolk County Ret. Sys. v. Jos. A. Bank Clothiers, Inc.*, C.A. No. 3443-VCP, 2009 WL 353746 (Del. Ch. Feb. 12, 2009).

The court held that the documents produced by the company were sufficient for plaintiff to determine whether the SLC was independent and had conducted its investigation in good faith. Plaintiff argued that the denial of the motion to dismiss and motion for judgment on the pleadings was sufficient to demonstrate that additional investigation was appropriate, but the court rejected this argument, holding that alone did not suffice to demonstrate a credible basis to suspect wrongdoing. Inasmuch as plaintiff had failed to articulate a need for additional documents beyond those already produced by the company, the company's motion for summary judgment was granted.

4. Shareholder Ratification

a. *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

The shareholder ratification doctrine is limited to circumstances in which a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to take legal effect. Additionally, directors and officers of Delaware corporations owe identical fiduciary duties to their corporations.

5. Books and Records Inspection

a. *Beiser v. PMC-Sierra, Inc.*, C.A. No. 3893-VCL, 2009 WL 483321 (Del. Ch. Feb. 26, 2009).

The court granted a motion to dismiss in a federal derivative action because plaintiff was subject to the mandatory stay of discovery imposed by the PSLRA, and his purpose for seeking a statutory inspection of books and records was an improper attempt to circumvent that stay.

b. *Norfolk County Ret. Sys. v. Jos. A. Bank Clothiers, Inc.*, C.A. No. 3443-VCP, 2009 WL 353746 (Del. Ch. Feb. 12, 2009).

An SLC report and other related documents produced by a corporation in response to a books and records demand were sufficient for a shareholder to determine whether the SLC was independent and had conducted its investigation in good faith; the denial of a motion to dismiss a securities fraud did not, on its own, demonstrate that additional investigation was appropriate.

c. *City of Westland Police v. Axcelis Technologies, Inc.*, C.A. No. 4473-VCN, 2009 WL 3086537 (Del. Ch. Sept. 28, 2009).

The court dismissed an action to compel inspection of books and records in connection with a board's consideration of an acquisition proposal and its refusal to accept resignations submitted by directors because plaintiffs failed to demonstrate a "credible basis" to suspect wrongdoing.

6. Stockholder Proposal

a. *Kistefos AS v. Trico Marine Serv., Inc*., C.A. No. 4497-CC, 2009 WL 1124477 (Del. Ch. April 14, 2009).

A corporation was required to include a stockholder proposal on the annual meeting ballot because a challenge to the validity of that proposal was not ripe until after it was approved by the shareholders at the annual meeting, since the proposal may not be approved.

7. Merger-Related Challenges

a. *Wayne County Employees' Ret. Sys. v. Corti*, C.A. No. 3534-CC, 2009 WL 2219260 (Del. Ch. July 24, 2009).

Applying *Lyondell*, the court dismissed an action challenging a business combination, concluding that the plaintiff could not state a claim that the directors acted in bad faith because they did not "utterly fail[] to attempt to obtain the best sale price" or "knowingly and completely fail[] to undertake their responsibilities."

b. *In re NYMEX S'holder Litig.*, C.A. No. 3621-VCN, 2009 WL 3206051 (Del.Ch. Sept. 30, 2009).

The court dismissed a challenge to the adequacy of a merger negotiation process alleging that the disinterested directors compromised their independence by deferring to its chairman, an interested party, as plaintiffs failed to demonstrate bad faith and it was well within the business judgment of the board to determine how merger negotiations were to be conducted.

8. Other

a. *Am. Int'l Group v. Greenberg*, C.A. No. 769-VCS (Del. Ch. June 17, 2009)

A derivative lawsuit against an outside auditor was barred by the *in pari delicto* doctrine; in contrast, *in pari delicto* does not bar a derivative lawsuit against a corporation's insiders who were involved in the alleged conspiracy.

b. *Berger v. Pubco Corp.*, C.A. No. 509, 2008 (Del. 2009).

The "quasi-appraisal" remedy for deficient disclosure in a short-form merger does not require minority shareholders to opt into a class-action suit or escrow part of the cash they received from the company.

c. *In re Nat'l City Corp. S'holders Litig.*, C.A. No. 4123-CC, 2009 WL 2425389 (Del. Ch. July 31, 2009).

The court made a reduced award of attorneys' fees to plaintiffs' counsel for settlement of a class action relating to a merger because the "meager" additional disclosures were made in an 8-K instead of a supplemental proxy statement.

XIV. AUDITOR AND ACCOUNTING-RELATED CASES

Federal courts issued a number of noteworthy decisions in securities cases involving auditors or alleged accounting improprieties. For example, the 9th Circuit in *Huberman v. Tag-It Pacific Inc.* reversed the district court's award of summary judgment, finding that there may have been "egregious deficiencies" in the defendant company's accounting practices, including inadequate monitoring of inventory, inadequate reserves, and inaccurate reporting of accounts receivable and payable. In *In re Washington Mutual, Inc. Securities, Derivative & ERISA Litigation*, the Western District of Washington refused to dismiss investors' Section 11 claims against the issuer's outside auditors. The court found that plaintiffs had adequately pleaded that the bank's allowance for loan losses was understated (even though plaintiffs did not allege the amount of the understatement), and that the bank was operating without internal controls to ensure compliance with underwriting and appraisal standards. The court also held that plaintiffs were not required to allege subjective falsity as to the auditor's certification of the bank's internal controls; according to the court, whether the auditor complied with auditing standards was a verifiable and, therefore, actionable fact. In *In re Atlas Mining Co*., the District of Idaho dismissed claims under the Exchange Act that defendant auditor's unqualified audit opinion was a material misstatement, because (1) plaintiffs alleged only one $250,000 misstatement in the audited financial statements; (2) the proper accounting treatment of the $250,000 was ambiguous; and (3) subsequent restated financial statements did not constitute admissions by defendant that the originally filed statements were materially false.

Other accounting-related decisions addressed the sufficiency of plaintiffs' allegations of scienter. In *Zucco Partners, LLC v. Digimarc Corp*., the 9th Circuit granted a motion to dismiss claims that an issuer had erroneously accounted for internal software expenditures, holding that plaintiffs failed to plead scienter. In *In re Pegasus Wireless Corp. Securities Litigation*, shareholders alleged in the Southern District of Florida that a software designer, its officers and directors and its outside auditor violated the Exchange Act by issuing or participating in the issuance of false financial statements. Defendants moved to dismiss, and the court granted the motion as to all defendants, including the auditor. The court found that plaintiffs' allegations that the auditor knew about the fraud by virtue of its longstanding relationship with the company and its knowledge of management's previous improprieties at other companies were insufficient to survive a motion to dismiss.

Finally, in *American International Group v. Greenberg*, the Delaware Court of Chancery applied the doctrine of *in pari delicto* to dismiss a derivative lawsuit against an outside auditor.

1. Pleading Standards for Securities Fraud

a. *Huberman v. Tag-It Pacific Inc.*, 314 F. App'x 59 (9th Cir. 2009).

Plaintiff brought claims under Sections 10(b) and 20(a) of the Exchange Act and Rule 10(b)(5) against the defendant issuer and individual defendants alleging material misrepresentations in press releases and SEC filings as well as improper accounting practices. The district court granted summary judgment in favor of defendants and denied plaintiff's motion for class certification. Plaintiff appealed both rulings. First, the 9th Circuit found that when considered all together, the internal communications, defendant company's accounting

practices and public announcements suggested that the individual defendants failed to disclose the corporation's deteriorating financial condition. Moreover, the court found that defendant company's accounting practices may have constituted "egregious deficiencies" based on alleged inadequate monitoring of its inventory, inadequate reserves, and inaccurate reporting of accounts receivable and payable. Therefore, the court held that the evidence raised a genuine issue of material fact and concluded that the district court clearly erred in determining that there was insufficient evidence of scienter. Second, the court held that there was sufficient evidence to loss causation, noting that "[t]he misrepresentation need not be the *sole* reason for the decline in value of the securities, but it must be a substantial cause." The court held that the evidence presented—press releases discussing negative information about defendant company's business, and a stock chart reflecting defendant company's corresponding significant losses in stock value—reasonably could establish loss causation. Accordingly, the court reversed the grant of summary judgment and remanded for trial. Next, the 9th Circuit reviewed the district court's denial of class certification and noted that although the existence of a unique defense could support an atypicality finding, such a finding was not warranted in this case because the basis for the purported atypicality was rooted in unsubstantiated speculation. Noting that typicality only requires that the representative claims are "reasonably coextensive with those of absent class members [but] they need not be substantially identical," the court held that the district court's denial of class certification on atypicality grounds was an abuse of discretion. Finally, the court held that the superiority requirement under Rule 23(b)(3) was satisfied by the "evidence that [defendant company] traded on an efficient market." Accordingly, common questions of fact and law predominated over individual questions, and the court remanded with instructions to grant class certification.

b. *In re Wash. Mut., Inc. Sec., Derivative & ERISA Litig.*, No. 2:08-md-1919 MJP, 2009 WL 3517630 (W.D. Wash. Oct. 27, 2009).

Plaintiffs filed a class action under Sections 11 and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5, against the officers and outside directors of a bank. Plaintiffs also asserted Securities Act claims against the bank's underwriters and auditor. Plaintiffs alleged that defendants: (1) decreased the efficacy of the bank's risk management policies; (2) corrupted the bank's appraisal process; (3) abandoned appropriate underwriting standards; and (4) misrepresented the bank's financial results and internal controls.

The court granted in part and denied in part defendants' motions to dismiss. The court denied the officer defendants' motion to dismiss the Section 10(b) claim because—with the exception of two insufficiently definitive statements—plaintiffs had successfully alleged falsity and scienter as to statements regarding the bank's risk management, appraisals, underwriting, and financial statements and internal controls. With respect to the bank's financial statements specifically, the court found sufficient allegations that the bank's allowance for loan losses ("ALL") had been understated, and that the bank's internal controls were ineffective at containing risk.

The court granted defendants' motion to dismiss the Section 11 claim only as to those offerings for which plaintiffs did not have standing—those for which no named plaintiff was a purchaser. The court denied the auditor's motion as to the remainder, finding sufficient plaintiffs' allegations of understated ALL and ineffective internal controls. Specifically, the

court held that plaintiffs were not required to quantify the amount by which the Bank's ALL was understated, and alleged the bank was operating without internal controls in place to ensure compliance with underwriting, appraisal standards, and proper calculation of the ALL. Further, the court held that plaintiffs were not required to allege subjective falsity as to the auditor's certification of the bank's internal controls; whether the auditor complied with auditing standards was a verifiable and, therefore, actionable fact. The court also denied the underwriters' motion to dismiss, as they had failed to negate causation.

2. Misstatements and Omissions

a. *In re Atlas Mining Co.*, No. 07-428-N-EJL, 2009 WL 3151135 (D. Idaho Sept. 25, 2009).

Plaintiff shareholders alleged that defendant auditor's clean audit opinion was a material misstatement in violation of Section 10(b) of the Exchange Act and Rule 10b-5. The court granted defendant's motion to dismiss. It held that plaintiffs failed to allege a material misstatement because: (1) plaintiffs alleged only one $250,000 misstatement in the audited financial statements; (2) the proper accounting treatment of the $250,000 was ambiguous; and (3) subsequent restated financial statements did not constitute admissions by defendant that the originally filed statements were materially false. In addition, the district court held that the mere failure to adhere to GAAP was insufficient to create an inference of scienter.

3. Scienter

a. *Pub. Employees' Ret. Ass'n of Colo. v. Deloitte & Touche LLP*, 551 F.3d 305 (4th Cir. 2009).

After their first complaint against defendant auditor was dismissed for failure to state a claim, plaintiffs brought a motion for leave to file a second amended complaint alleging claims under Rule 10b-5 for the defendant's alleged role in fraud committed by a company and its subsidiary. The district court denied the motion for leave to amend on the grounds that the proposed amendment was futile because it failed to allege facts giving rise to a strong inference of scienter as required by the PSLRA. The 4th Circuit affirmed, holding that the plaintiffs failed to allege adequately that the defendant acted with scienter.

b. *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981 (9th Cir. 2009).

Defendant company announced that it had erroneously accounted for internal software expenditures and that due to these accounting errors it had likely overestimated earnings for the previous six quarters. Plaintiffs alleged that the company and the individual defendants engaged in manipulative accounting methods, in violation of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. The district court granted defendants' motion to dismiss with prejudice. On appeal, the 9th Circuit considered the impact of the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* on the requirements for pleading scienter set forth in the 9th Circuit's prior case law. The court concluded that *Tellabs* did not materially alter that standard, and only had the effect of adding a "holistic" component to the analysis. That is, following *Tellabs*, courts in the 9th Circuit will conduct a dual scienter inquiry: first, they will determine

whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter; second, if none of the individual allegations is sufficient, the courts will conduct a "holistic" review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness. Here, the court concluded that the plaintiffs' individual allegations were insufficient, standing alone, to create a strong inference of scienter. The court then considered all allegations holistically, concluding that even taken together, the allegations failed to support a strong inference of scienter. The court thus affirmed the district court's dismissal of the action with prejudice.

c. *In re Pegasus Wireless Corp. Sec. Litig.*, No. 07-81113-CIV-MARRA/JOHNSON, 2009 WL 2997006; 2009 WL 3055205; 2009 WL 3055210 (S.D. Fla. Sept. 21, 2009).

Shareholders sued a wireless networking software and hardware designer, its officers and directors and its auditor for failing to disclose the prior litigation and business history of the company's president and for issuing false financial statements. The court dismissed the complaint with prejudice with respect to the CEO and an outside director because plaintiffs did not adequately allege that defendants had knowingly misled investors about the president's past. The court also dismissed the action against the company's auditor because plaintiffs' allegations that the auditor knew about the fraud by virtue of its relationship with the company and its knowledge of management's previous improprieties at other companies were insufficient to survive a motion to dismiss.

4. Loss Causation

a. *In re Williams Sec. Litig.*, 558 F.3d 1130 (10th Cir. 2009).

Plaintiffs brought claims against the defendant issuer, individual defendants and an auditor under Sections 10(b) and Section 20(a) of the Exchange Act. The court affirmed the district court's award of summary judgment in favor of defendants. Citing *Dura Pharmaceuticals., Inc. v. Broudo*, 544 U.S. 336 (2005), the court held that "[a]ny reliable theory of loss causation that uses corrective disclosures will have to show both that corrective information was revealed and that this revelation caused the resulting decline in price." Further, "[t]o be corrective, the disclosure need not precisely mirror the earlier misrepresentation, but it must at least relate back to the misrepresentation and not to some other negative information about the company." Under this standard, the court found that the plaintiffs' expert's theories of loss causation failed to distinguish between losses attributable to the alleged fraud and other types of losses. As such, the court held that the expert's testimony was properly excluded under Fed. R. Evid. 702, as the expert's methods could not "reliably link the class' losses to the revelation of the alleged misrepresentations," and summary judgment was properly granted in favor of defendants.

5. Derivative Lawsuits

a. *Am. Int'l Group v. Greenberg*, C.A. No. 769-VCS (Del. Ch. June 17, 2009)

A derivative lawsuit against an outside auditor was barred by the *in pari delicto* doctrine; in contrast, *in pari delicto* does not bar a derivative lawsuit against a corporation's insiders who were involved in the alleged conspiracy.

XV. SECURITIES & EXCHANGE COMMISSION ENFORCEMENT CASES

Several significant decisions in SEC enforcement actions were issued during 2009. Three of these decisions involved allegations of insider trading. In *SEC v. Dorozhko*, the 2d Circuit held that a breach of fiduciary duty is not required to state a claim under Section 10(b) of the Exchange Act, and that misrepresenting one's identity to gain access to an issuer's confidential information is a "deceptive" practice under the Act. In *SEC v. Anton*, the Eastern District of Pennsylvania rejected the SEC's claims against the defendant for insider trading, holding that the evidence failed to establish that the defendant knew of the relevant information at the time he spoke with the alleged tippee, that the information allegedly provided was not material in light of other publicly available information, and that the "personal benefit" test was not satisfied. In *SEC v. Cuban*, the Northern District of Texas held that a fiduciary may automatically have an obligation of confidentiality and a duty of non-use, but non-fiduciaries must separately undertake both duties through express or implied agreements. Since the defendant in this case did not undertake both agreements, there was no deception in his trading, and therefore no insider trading.

Several courts addressed civil penalties sought by the SEC against individual defendants. In *SEC v. Resnick*, the District of Maryland granted the SEC's request for a permanent injunction, an officer and director bar and a third tier civil monetary penalty against an individual convicted of securities fraud, but denied the SEC's request for disgorgement. In *SEC v. Johnson*, the District Court for the District of Columbia denied the SEC's request for a permanent injunction and a large fine as "too Draconian" under the circumstances.

In addition, the 4th Circuit in *SEC v. Pirate Investor LLC* affirmed the determination by the district court that the defendant had violated Section 10(b) and Rule 10b-5. In *SEC v. Lucent Technologies., Inc.*, the District of New Jersey found that defendants were not primarily liable under the "bright line test," but permitted claims to proceed against one defendant under an aiding and abetting theory of liability.

1. Insider Trading

a. *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009).

Plaintiff appealed a decision by the district court denying plaintiff's request for a preliminary injunction in an action under Section 10(b) of the Exchange Act. Plaintiff alleged that defendant violated Section 10(b) by "hacking" material information of a company and using that information to purchase and sell the company's stock. Plaintiff alleged that defendant—a corporate outsider with no special relationship to the company—hacked the server of the entity responsible for maintaining the online release of the company's earnings reports. The district court found that a breach of fiduciary duty of disclosure is a required element of any "deceptive" device under Section 10(b). The court concluded that because defendant was an outsider, he owed no fiduciary duty to the company. On appeal, plaintiffs further clarified their allegations, arguing that computer hackers either 1) engage in false identification and masquerade as another user, or 2) exploit a weakness in an electronic code within a program to cause the program to malfunction in a way that grants the user greater privileges. On appeal, the 2d Circuit found that precedent has not established that a breach of fiduciary duty is a required element of an

actionable securities claim under Section 10(b). The 2d Circuit further noted that plaintiff's allegations were not based on defendant's alleged failure to disclose, but rather the allegation that defendant affirmatively misrepresented himself in order to gain access to material, nonpublic information, which was then used for trading. The 2d Circuit found that misrepresenting one's identity in order to gain access to information that is otherwise off limits is deceptive within the ordinary meaning of the word. The 2d Circuit stated that it was "unclear" whether exploiting a weakness in an electronic code to gain unauthorized access is "deceptive" rather than theft. The 2d Circuit vacated the district court's order denying plaintiff's motion for a preliminary injunction, for further findings as to whether defendant's computer hacking involved a fraudulent misrepresentation that was deceptive within the meaning of Section 10(b).

b. *SEC v. Anton*, No. 06-2274, 2009 WL 1109324 (E.D. Pa. Apr. 23, 2009).

The SEC alleged that defendant violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 by providing material, nonpublic inside information to a shareholder who subsequently sold his stock. The SEC alleged that defendant informed the shareholder that the corporation would be increasing its loss reserves and planned to suspend its dividend. The court rejected the SEC's insider trading claims, holding that the evidence failed to establish that defendant knew of the relevant information at the time he spoke with the shareholder, that the information about increasing loss reserves was not material given publicly available information, and that the "personal benefit" test was not satisfied. The evidence showed that defendant, who was in the process of retiring, did not know the corporation intended to suspend the dividend and was only generally aware that loss reserves would be increased. Moreover, the loss reserves information was not material because the corporation increased its reserves in previous quarters, informed shareholders of the possibility of further increases, and Credit Suisse had published a report on the decrease of the corporation's credit rating. Finally, defendant did not personally benefit from the shareholder's sale. He did not receive any proceeds, and the relationship between the two individuals belied the notion that the information was a gift. After trial of this matter to the bench, the court entered judgment in favor of defendant and against plaintiff.

c. *SEC v. Cuban*, No. 3:08-CV-2050-D, 2009 WL 2096166 (N.D. Tex. July 17, 2009).

The SEC filed a complaint alleging that defendant received material, non-public information about a planned investment by a public corporation in which he invested, agreed to maintain the confidentiality of that information, then sold his shares based on the information thereby avoiding substantial losses. The SEC claimed that these actions amounted to violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, and sought a permanent injunction against future violations as well as a civil penalty and disgorgement of losses avoided. Defendant moved to dismiss the complaint, and the court granted the motion. Specifically, the court held that in order to successfully plead a claim under the misappropriation theory of insider trading, a plaintiff must demonstrate that the defendant (a) made an express or implied promise to keep the relevant information confidential, and (b) undertook a legal duty to refrain from trading on that information for personal gain. Further, these agreements may be entered into by the defendant either through creation of a fiduciary

relationship, or through an express or implied agreement. Defendant did enter a confidentiality agreement with respect to the material, non-public information he received, but did not accept a legal duty to refrain from trading on that information. While a fiduciary may, by operation of law, accept both an obligation of confidentiality and a duty of non-use through the very existence of a fiduciary relationship, a non-fiduciary defendant must separately undertake both duties through express or implied agreements. Since defendant did not undertake both agreements, there was no deception in his trading on the relevant information, and therefore no misappropriation.

2. Pleading Requirements for Securities Fraud

a. *SEC v. Pirate Investor LLC*, 580 F.3d 233 (4th Cir. 2009).

The district court found defendants liable in an SEC enforcement action for securities fraud arising from misstatements in an investor report and e-mail solicitation. The 4th Circuit affirmed, holding that: (i) defendants' representations that the information in the report was based on inside information was false where no inside information was actually obtained; (ii) the representations were material as they would be important to reasonable investors; (iii) defendants acted with scienter where they published the statements knowing that the representations were false; and (iv) the representations were made "in connection with" the purchase or sale of securities where the securities purchase was necessary to complete defendants' fraudulent scheme, defendants made the misrepresentations with the intent to induce securities transactions, and defendants directed the misrepresentations to investors that they knew were likely to rely upon them. The 4th Circuit further held that the First Amendment does not protect fraudulent speech in the form of securities fraud.

3. Aiding and Abetting

a. *SEC v. Lucent Techs., Inc.*, No. 04-2315, 2009 WL 1111234 (D.N.J. Apr. 27, 2009).

The SEC brought a civil enforcement action against, *inter alia*, a telecommunications corporation and four of its former senior executives and managers for violations of Sections 10 and 13 of the Exchange Act, and for aiding-and-abetting those violations. Two defendants were charged with giving oral extra-contractual assurances to distributors in five transactions that led to improper revenue recognition. The other defendants were charged with providing four "switches" to a client without a purchase order and recognizing revenue pursuant to a retroactive verbal agreement. All defendants moved for summary judgment.

The court initially held that, applying the "bright line" test, none of the defendants was primarily liable under Rule 10b-5(b). No defendant was "integrally involved" in the drafting or signing of any financial report or issued statements used in any report. The court rejected the SEC's recasting of the misrepresentation claim as a "scheme" for the purpose of avoiding application of the "bright line" test. The court next concluded that the aiding-and-abetting claim against one of the defendants could proceed because the evidence suggested that the defendant knew that she could not give oral assurances without informing the company's finance personnel but did so nonetheless. With respect to the defendants charged with aiding and abetting in

connection with the sale of the switches, however, the court found scienter lacking, emphasizing that outside auditors approved of the accounting for the switches. For that same reason—the absence of scienter—the court held that those defendants were entitled to summary judgment on the claim that they aided or abetted a Section 13 violation. However, because a principal violation under Section 13 does not require proof of scienter, the court denied summary judgment on that count.

4. Civil Liability

a. *SEC v. Resnick*, 604 F. Supp. 2d 773 (D. Md. 2009).

Defendant officer of a company was accused of participating in a fraudulent scheme to inflate and overstate the financial results of the company and its parent. He was convicted by a jury on six counts of criminal conspiracy and securities law violations arising out of this scheme. The SEC filed the present action charging the officer with four equivalent civil counts of securities laws violations. The SEC sought (i) a permanent injunction against Kaiser, enjoining him from further violations of securities laws or regulations; (ii) disgorgement of the bonus he received resulting from the inflation of the financial results, as well as his salary for the relevant period; (iii) an officer and director bar preventing him from ever serving as an officer or director of a public company in the future; and (iv) a third tier civil monetary penalty. The SEC moved for summary judgment, arguing that his conviction on all counts in the criminal case collaterally estopped him from litigating the civil charges against him. The district court granted the motion. As to the relief requested by the SEC, the court held that all of the relief sought was warranted except for disgorgement of the officer's salary because the salary was not causally linked to the unlawful conduct.

b. *SEC v. Johnson*, 595 F. Supp. 2d 40 (D.D.C. 2009).

After a jury found the former executive of a defunct issuer liable for aiding and abetting the issuer's securities fraud violations, the SEC filed a request for a permanent injunction against the executive that would prevent him from serving as an officer for a public company or from violating securities laws. The SEC also sought the maximum fine against the executive ($120,000). The district court rejected those remedies as "far too Draconian," because the violation was an isolated incident in the executive's career. In addition, the executive's current position was with a nonpublic company, and therefore he no longer faced disclosure obligations.

XVI. DEVELOPMENTS WITH THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD IN 2009

A. NOTABLE RELEASES IN 2009

1. Board Issues Statement on PCAOB Registration Process for Auditors of Non-Public Broker-Dealers

On January 8, 2009, the PCAOB issued a statement providing information for auditors of non-public broker-dealers about the PCAOB's registration process. Until recently, registration of such auditors was unnecessary pursuant to an SEC order, but that order recently expired. Financial statements of non-public broker-dealers for fiscal years ending after December 31, 2008 must now be certified by a registered public accounting firm.

2. PCAOB Re-proposes Auditing Standard on Engagement Quality Review

On March 4, 2009, the PCAOB voted to re-propose for comment an auditing standard on Engagement Quality Review (EQR), also known as "concurring partner review." The Board first proposed a new EQR standard on February 26, 2009. In an EQR, a "qualified reviewer takes a fresh, objective look at the engagement, and, based on that review, evaluates whether it is appropriate for the firm to issue its report." This re-proposal would supersede the Board's quality control standard, SECPS Requirements of Membership, Section 1000.08(f), and would be applicable to all registered firms. The changes in the new proposal generally relates to:

- *Applicability* – The new proposal would require an EQR for audits and reviews of interim financial information, but not for other engagements performed according to the standards of PCAOB.
- *Objective* – The new proposal includes an explicit objective for the engagement quality reviewer "to perform an evaluation of the significant judgments made by the engagement team and the conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report . . . in order to determine whether to provide concurring approval of issuance."
- *Reviewer Qualifications* – The new proposal refines requirements in response to comments suggesting that only partners would have sufficient authority to conduct the review.
- *Scope* – The new proposal revises the description of procedures required in an EQR and includes separate requirements for reviewing different types of engagements, such as an audit and an interim review.
- *Concurring Approval of Issuance* – The new proposal revises the proposed provision on concurring approval by replacing the "knows, or should know based upon the requirements of this standard" formulation with a formulation grounded in auditor's duty to exercise due professional care.
- *Documentation* – The new proposal clarifies the scope of the documentation requirements.

3. PCAOB Discloses Information Related to its International Inspections Program

On April 7, 2009, the PCAOB published the list of non-U.S. jurisdictions in which there are registered firms that the Board intends to inspect in 2009. The list was published to "provide transparency." If it later removes a jurisdiction from the list, it will make a public announcement explaining why plans have changed for that jurisdiction. The Board also published the list of non-U.S. jurisdictions in which there are registered firms that the Board has already inspected. As reports are finalized, they will be made available to the public.

4. PCAOB Issues Concept Release on Possible Revisions to the Standard on Audit Confirmations

On April 14, 2009, the PCAOB voted to issue for comment a concept release on possible revisions to the standard on audit confirmation, AU sec. 330, The Confirmation Process. According to the PCAOB, confirmation is "an audit process by which an auditor obtains and evaluates a direct communication from a knowledgeable third party in response to a request for information regarding account balances, transactions or other items that comprise a company's financial statements." The PCAOB issued the concept release for comment because "it is important today to update the standard on confirmations given the significant advances in technology and methods of communication."

5. PCAOB Adopted Rule Amendment on Timing of Certain Non-U.S. Inspections

On June 25, 2009, the PCAOB voted to adopt an amendment to a rule on the timing of certain inspections of registered non-U.S. public accounting firms. The amendment to PCAOB Rule 4003(g) gives the Board the ability to postpone, for up to three years, the first inspection of any foreign registered public accounting firm that the Board is otherwise required to conduct before the end of 2009 and that is in a jurisdiction in which the Board has not conducted an inspection prior to 2009. The Board will post a list of registered firms that have not yet had their first PCAOB inspection, even though more than four years have passed since the end of the calendar year in which they first issued an audit report while registered with the Board.

6. PCAOB Adopted New Auditing Standard on Engagement Quality Review and Issues Concept Release on Requiring the Engagement Partner to Sign the Audit Report

On July 28, 2009, the PCAOB voted to adopt Auditing Standard No. 7, Engagement Quality Review (EQR), and to issue a Concept Release on requiring the engagement partner to sign the audit report. The EQR standard provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. AS No. 7 applies to all audit engagements and engagements to review interim financial information conducted pursuant to the standards of the PCAOB.

7. PCAOB Announced Formation of Investor Advisory Group

On July 31, 2009, the PCAOB announced the formation of the Investor Advisory Group to advise the Board in carrying out its responsibilities. The Group will provide an additional opportunity for the Board to hear from investors on a broad range of issues affecting investor protection through the oversight of registered audit firms. On September 17, 2009, the PCAOB announced the 19 members of the inaugural group.

8. PCAOB Rules Requiring Reporting by Registered Firms Took Effect

On October 12, 2009, PCAOB rules requiring reporting by registered public accounting firms took effect. The rules implement a provision of the Sarbanes-Oxley Act of 2002 and constitute the first reporting obligations imposed on registered firms by the Board. The new rules require (i) the reporting within 30 days of certain "reportable events" on Form 3 (ranging from administrative matters to more substantive matters); (ii) the filing of annual reports on Form 2; (iii) the payment of an annual fee; and (iv) the optional filing of a Form 4, that allows, in certain circumstances, for a firm to succeed to the registration status of a predecessor firm without a break in the registration status and without the need to file a new registration application on Form 1.

9. PCAOB Reproposed Auditing Standards on Auditor Risk Assessment

On December 17, 2009, the PCAOB voted to repropose for comment seven auditing standards and related amendments that collectively would revise the requirements for assessing risk in an audit. These reproposed standards include changes made in response to comments received on the original proposal and other refinements. They would establish requirements for audit procedures performed throughout the audit, from the initial planning stages through the evaluation of the audit results in forming the opinion in the auditor's report.

B. NOTABLE GUIDANCE IN 2009

1. PCAOB Publishes Staff Guidance on Auditing Internal Control Over Financial Reporting in Smaller Public Companies

On January 23, 2009, the PCAOB published "Staff Views—An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies." Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements," provides direction to auditors on scaling an audit based on a company's size and complexity. The newly-issued guidance explains how auditors can apply the principles in Auditing Standard No. 5 to audits of smaller, less complex public companies.

2. PCAOB Issues Staff Questions and Answers on the Registration Process for Auditors of Non-Public Broker-Dealers

On February 19, 2009, the PCAOB issued Staff Questions and Answers concerning registration of auditors of non-public broker-dealers. The newly-issued guidance addresses (i) the registration process, including timing and fees; (ii) the extent to which applications are public

and the process for seeking confidential treatment; and (iii) obligations associated with being registered, including periodic reporting and annual fee requirements. This guidance supplements guidance issued by the SEC and FINRA on the same topic.

C. NOTABLE DISCIPLINARY PROCEEDINGS IN 2009

1. *In the Matter of Clancy and Co., P.L.L.C.*, PCAOB Release No. 105-2009-001 (Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions)

In a March 29, 2009 order instituting disciplinary proceedings, the PCAOB revoked the registration of an Arizona public accounting firm. In addition, the PCAOB barred one of the firm's partners and imposed a one-year suspension on another of its partners from being associated persons of a registered public accounting firm. The sanctions were based on findings that all three violated PCAOB rules and auditing standards in the audits of the 2003, 2004 and 2005 financials of an issuer. The PCAOB found that in adopting the auditing work of a third party, the firm failed to properly coordinate with the third party, to perform necessary follow up on that work and to conform the work to applicable auditing standards.

2. *In the Matter of Lawrence Scharfman CPA PA*, PCAOB Release No. 105-2009-0005 (Order Making Findings and Imposing Sanctions)

In an August 11, 2009 order, the PCAOB revoked the registration of Lawrence Scharfman CPA PA and barred Lawrence Scharfman CPA from being an associated person of a registered accounting firm for violations of Section 10A(b) of the Exchange Act, PCAOB rules, and PCAOB auditing and independence standards in auditing the financial statements of three issuer clients. With respect to the first issuer, respondents failed to plan the audit work, perform sufficient procedures, address material inconsistencies between information contained in 10KSB and the financial statements, and assess whether a significant stock issuance was properly valued, disclosed and reported. With respect to the second issuer, respondents failed to perform sufficient procedures, failed to take steps to prevent reliance on their audit opinion after concluding that the previously issued financial statements were misleading, added documents to their work papers after the documentation completion date without complying with PCAOB Auditing Standard No. 3, and failed to take steps required by Section 10A(b) after becoming aware that an illegal act had occurred. With respect to the third issuer, respondents failed to test the adequacy of a reserve for an asset which constituted 85 percent and 40 percent of the issuer's 2005 and 2006 total reported assets, respectively, and added documents to their work papers without complying with AS3.

3. *In the Matter of Moore & Associates, Chartered, and Michael J. Moore, CPA*, PCAOB Release No. 105-2009-0006 (Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions)

In an August 27, 2009 order, the PCAOB revoked the registration of Moore & Associates, Chartered and barred Michael J. Moore, CPA from being an associated person of a registered accounting firm for violations of Section 10(b) of the Exchange Act and Rule 10b-5, PCAOB rules and auditing standards in auditing the financial statements of three issuer clients,

PCAOB rules and quality control standards, and noncooperation with a Board investigation. After M&A registered with the Board in October 2004, Moore began auditing the financial statements of public companies for the first time in more than ten years. Over the next three years, M&A accepted nearly 300 public audit engagements, with Moore serving as the auditor with final responsibility on each. Respondents added new clients at a near-exponential rate while the audit staff was comprised of inexperienced staff members—at times including casual acquaintances and conveniently located relatives—overseen by one professional. M&A staffed the audits with assistants who had no accounting or auditing education, experience or training. The individuals planned and executed the audits with little or no supervision. Respondents violated Section 10(b) of the Exchange Act and Rule 10b-5 by issuing audit reports that represented that the audits had been conducted in accordance with PCAOB standards, when they knew, or were reckless in not knowing, that such representations were false. In addition, respondents failed to cooperate with the Board's investigation of this matter by (i) creating and producing false work papers that did not accurately reflect the work performed on the relevant audits; (ii) falsely testifying that the work papers produced by respondents were true and accurate audit work papers completed during the audit, although he knew they were not; and (iii) failing to produce documents required by the Accounting Board Demand.

4. *In the Matter of The Blackwing Group, LLC and Sara L. Jenkins, CPA*, PCAOB Release No. 105-2009-0007 (Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions)

In a December 22, 2009 order, the PCAOB revoked the registration of a company and barred Sara L. Jenkins, CPA from being an associated person of a registered accounting firm for violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in auditing the financial statements of two issuer clients, PCAOB rules and auditing standards, noncooperation with a Board inspection, and noncooperation with a Board investigation. Respondents failed to perform or performed very few audit procedures in connection with the issuance of these audit reports, in violation of PCAOB rules and auditing standards. For example, respondents failed to exercise due professional care and professional skepticism. In addition, they failed to obtain sufficient competent evidence to afford a reasonable basis for an opinion regarding the financial statements. In each case, respondents also repeatedly violated Section 10(b) and Rule 10b-5 by issuing audit reports that represented that the audits had been conducted in accordance with PCAOB standards, when they knew, or were reckless in not knowing, that such representations were false. In several instances, respondents in fact failed to perform any audit procedures. In addition, respondents attempted to hide their deficient audit work by altering work papers in anticipation of the Board's inspection of the Firm and by making other misrepresentations to the Board's inspection staff during the Board's 2008 inspection of the Firm. Respondents also provided false documents and made false statements to Enforcement staff during the Board investigation relating to the above.