The SEC, Bucking Case Law Trend, Urges Reviving Time-Barred Claims Based On Sarbanes-Oxley
Blair G. Connelly and Robert J. Malionek

One of the many changes the Sarbanes-Oxley Act of 2002 (SOX) effected was an extension of the statute of limitations for securities fraud claims. Before SOX, the Supreme Court’s decision in Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991), imposed a limitations period of the earlier of (a) one year from the date of discovery of the facts giving rise (Continued on Page 6)

Invoking the “Truth-On-The-Market” Defense in Motions to Dismiss Securities Fraud Claims
Patrick E. Gibbs

A recent decision in United States District Court for the Southern District of New York held that securities fraud claims against H&R Block, Inc. (Block) were barred as a matter of law by the “truth-on-the-market” defense—a defense which the Court itself characterized as “rarely an appropriate basis” for dismissing such claims. Plaintiffs in White v. H&R Block, Inc., No. 02 Civ. 8965 (MBM), 2004 WL 1698628 (S.D.N.Y. July 28, 2004), alleged that Block fraudulently misled investors by failing to disclose the existence of 20 class action lawsuits against Block relating to its Refund Anticipation Loan (RAL) program. Citing “extensive press coverage” of the lawsuits, as well as publicly-available research reports discussing the RAL litigation, Judge Michael B. Mukasey found that “the truth was all over the market,” and therefore the “truth-on-the-market” defense barred the plaintiffs’ claims. This case is a good reminder that the “truth-on-the-market” defense is alive and well but only applies in certain circumstances.

The “truth-on-the-market” defense is a corollary to the “fraud-on-the-market” theory first recognized by the United States Supreme Court in Basic, Inc. v. Levinson, 485 U.S. 224 (1988). The “fraud-on-the-market” theory posits that “the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” Using the “fraud-on-the-market” theory, a securities fraud plaintiff can dispense with the need to demonstrate individual reliance upon (Continued on Page 8)
The Errors in the Ninth Circuit’s Loss Causation Decision

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The Supreme Court has agreed to review a highly controversial decision by the Ninth Circuit Court of Appeals in *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933 (9th Cir. 2003), that has important implications for defendants in fraud-on-the-market securities class actions. In *Dura*, the Ninth Circuit held that plaintiff investors satisfy the securities laws’ “loss causation” requirement merely by alleging that they paid too much for a company’s stock due to alleged misrepresentations, and need not show that their stock actually lost value when the truth was revealed.

It has been 16 years since the Supreme Court endorsed the efficient market theory underpinning the “transaction causation” or reliance element of a fraud-on-the-market claim under Section 10(b) of the Securities Exchange Act of 1934, *Basic v. Levinson*, 485 U.S. 224 (1988). In *Dura*, the Supreme Court is poised to resolve a circuit split over how the efficient market theory operates on plaintiffs’ obligation to prove the separate “loss causation” element of a Section 10(b) claim.

The Ninth Circuit’s *Dura* decision is unpopular with more than just the *Dura* defendants; the Department of Justice, the Securities and Exchange Commission and the Securities Industry Association all urged the Supreme Court to review and reverse the decision. The root of the controversy lies in the Ninth Circuit’s failure to give full effect to the efficient market theory—the economic concept that the price of a security in an efficient market reflects all publicly known information—as it pertains to plaintiffs’ obligation to prove loss causation. Plaintiffs have long been permitted to use the efficient market theory to establish a presumption of reliance, which satisfies the element of transaction causation and enables Section 10(b) claims to be brought as class actions. *Dura* is anomalous because the court permitted plaintiffs to rely on the efficient market theory to establish class-wide reliance on an alleged misrepresentation, and then allowed plaintiffs to escape the efficient market theory when it came to prove that their stock lost value when the truth was revealed. In so holding, the Ninth Circuit placed itself squarely in conflict with several other federal courts of appeals and with loss causation and damages limitations codified in the Private Securities Litigation Reform Act of 1995 (the Reform Act).

At stake in the Supreme Court’s review of *Dura* is whether companies—not only in the Ninth Circuit but nationwide—may be forced to defend class action lawsuits prosecuted by investors who cannot plead or prove that their stock lost value due to the defendant’s alleged misrepresentations.

Background

This securities class action was brought on behalf of investors who purchased stock in Dura Pharmaceuticals Inc. between April 15, 1997 and February 24, 1998. At the start of the class period, Dura issued a press release describing its financial results for the first quarter of 1997. The company reported both “strong progress” in selling its respiratory antibiotic product, Ceclor CD, and completion of a “patient dosing” milestone necessary to submit a new drug application to the FDA for its asthma product, Albuterol Spiros. The plaintiffs closed the alleged class period on February 24, 1998, when Dura announced that it expected to fall short of its forecasted revenues and earnings per share for 1998, in part due to slower than expected sales of Ceclor CD. Dura’s February announcement did not mention Albuterol Spiros.

The day following Dura’s unfavorable press release, the price of the stock fell 47 percent. Approximately nine months later —after the close of the class period—Dura announced that the
CIBC Dismissed from Major Securities Class Action

The United States District Court for the District of Columbia recently dismissed, with prejudice, claims asserted against Latham client CIBC World Markets Corp. under Section 10(b) of the Securities Exchange Act of 1934 and Sections 12(a)(1) and 12(a)(2) of the Securities Act of 1933. See In re InterBank Funding Corp. Sec. Litig., 329 F. Supp. 2d 84 (D.D.C. 2004). The Court also rejected the plaintiffs’ motion for reconsideration. Plaintiffs sought to plead that CIBC’s due diligence regarding certain securities of InterBank Funding Corporation (IBF), a now-bankrupt entity, should have revealed allegedly fraudulent conduct by IBF. Plaintiffs asserted that a putative class of IBF investors suffered approximately $200 million in damages.

The Court rejected the plaintiffs’ allegations as insufficiently pled under the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 et seq. (including the failure to plead facts establishing CIBC’s “scienter,” or knowledge of the alleged fraud), for lack of standing with respect to certain claims, and for failure to comply with the applicable statute of limitations with respect to other claims. Significantly, the District of Columbia Circuit has not published an opinion applying the Reform Act (the only circuit not to do so). As a result, the district court was not bound by an appellate decision controlling the application of the Reform Act’s pleading requirements. Nevertheless, the Court held that plaintiffs did not meet even the most lenient pleading standards.

The plaintiffs have filed a notice of appeal to the District of Columbia Circuit. This case may, therefore, represent the first opportunity for that circuit to address the applicable pleading standards under the Reform Act. Indeed, the district court’s decision is one of only a handful of post-Reform Act decisions in that jurisdiction, and therefore constitutes significant precedent in its own right. CIBC was represented in this matter by New York partner David M. Brodsky, Washington, D.C. partner DeMaurice F. Smith and New York associate Jeff G. Hammel.

In Dura, the Supreme Court is poised to resolve a circuit split over how the efficient market theory operates on plaintiffs’ obligation to prove the separate “loss causation.”
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“misrepresentation touches upon the reasons for the investment’s decline in value.” The Ninth Circuit recognized the ambiguity inherent in this standard, however, and elaborated: “in a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.” On that basis, the court concluded, “it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred.” The Ninth Circuit thus held that the plaintiffs’ allegations of price inflation satisfied the loss causation requirement and reversed the district court’s decision.

Loss Causation Without Causing the Loss?

The Ninth Circuit’s decision is fundamentally at odds with the Reform Act and with the efficient market theory underpinning all fraud-on-the-market securities class actions. The Reform Act codified the long-standing judicial interpretation of Rule 10b-5 requiring plaintiffs to prove that their loss was caused by the defendants’ misrepresentations. Under the Reform Act and preexisting case law, this causation requirement consists of two components: transaction causation (the plaintiff relied on the defendant’s misrepresentations when making investment decisions); and loss causation (the misrepresentation caused the plaintiff’s loss).

Considering the first of these components, the Supreme Court recognized in Basic v. Levinson, 485 U.S. 224 (1988), that investors could not satisfy the “commonality” requirement necessary to maintain a class action if each investor were required to prove transaction causation (or reliance). Dissatisfied with that outcome, the Supreme Court decided that plaintiffs could invoke a fraud-on-the-market presumption of reliance—i.e., a presumption that all investors rely on the integrity of a stock’s market price as a proxy for all available material information about the company. The economic foundation supporting that presumption is the efficient market theory, which holds that all material information about a company is rapidly reflected in the company’s stock price. Together, these concepts allow a shareholder class to demonstrate transaction causation by claiming that a material misrepresentation artificially inflated the stock price (the efficient market theory) and that shareholders purchasing at the market price thereby relied on the misrepresentation (the fraud-on-the-market presumption).

The efficient market theory likewise has implications for the loss causation requirement. Known as the “truth-on-the-market” presumption of causation, the theory is that an artificially inflated stock price remains inflated until the misrepresentations are corrected. Investors who buy stock at the fraudulently inflated price but sell the stock before the inflation is eliminated by way of a corrective disclosure (sometimes called “in and out” class members) do not incur a compensable loss. In other words, recoverable economic loss is not caused by the alleged price inflating misrepresentations until the “truth” is disclosed and absorbed by the efficient market causing the stock price to drop (deflate). Any adverse price movement occurring prior to a corrective disclosure is necessarily caused by facts or market conditions other than the alleged misrepresentation since the falsity is not yet known and, therefore, not reflected in the price of the stock.

Since plaintiffs have the benefit of the efficient market theory to obtain a presumption of transaction causation (or reliance)—as they do in virtually every securities class action—they should not be permitted to sidestep the attendant consequences of that theory when it comes to their obligation to prove loss causation. But, this is precisely what (Continued on Page 13)
D.C. Circuit Establishes “Extreme Recklessness” Standard for Aiding and Abetting Liability in SEC Actions

Jamie L. Wine and Jill M. Ray

In Howard v. Securities Exchange Commission, 376 F.3d 1136 (D.C. Cir. 2004), the District of Columbia Circuit held, in a divided opinion, that the SEC must meet the heightened scienter standard of “extreme recklessness” in order to meet its burden in establishing a charge of aiding and abetting securities fraud. In vacating and remanding sanctions imposed against broker Nicholas P. Howard, the majority held that the SEC could not establish Howard’s scienter absent evidence that he acted with “extreme recklessness” —a clarification from prior decisions which suggested that mere “recklessness” would be sufficient. In a concurring opinion, Circuit Judge Henderson agreed with the result, but argued against the imposition of a heightened standard of “extreme recklessness.” This decision is important for a number of reasons, including that the District of Columbia Circuit has jurisdiction to hear appeals from any final order of the SEC (along with the circuit in which an appellant resides or maintains a principal place of business). See 15 U.S.C. § 78y(a)(1).

Procedural and Factual Background

Pursuant to Sections 15(b) and 21B of the Securities Exchange Act of 1934, the SEC is authorized to impose suspension and civil monetary penalties to address violations of the financial reporting provisions of the federal securities laws. Pursuant to these rules, Howard was sanctioned for an aiding and abetting violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-9 in connection with two private placement offerings. See In the Matter of Nicholas P. Howard, Admin. Proc. File No. 308873.

Howard was a senior vice president of a registered broker dealer. He participated in soliciting investors for each of two private placement offerings by NEH, a company formed to acquire, develop and operate hotel and resort properties in Eastern Europe. The first offering was made on a “best efforts, part-or-none” basis. In these types of offerings, Rule 10b-9 requires the prompt return of investor funds if the required minimum proceeds are not raised through bona fide sales to the investing public by the stated deadline. The SEC charged that Howard and others engaged in fraudulent strategies designed to make it appear that the share offering minimum had been reached when, in fact, the offering fell short. After an evidentiary hearing, an Administrative Law Judge found that the conduct not only violated Rule 10b-9, but also the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act. Because these violations were not disclosed to subsequent investors, the ALJ determined that the second NEH offering also violated the securities laws.

In his defense, Howard argued that he was not aware that the first NEH offering was being sold on a “part-or-none” basis, and that he did not know the legal... (Continued on Page 7)
The SEC argues that defendants who could not have been sued at all the day before SOX was enacted can now be subjected to millions of dollars in potential liability for the same conduct.
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requirements for such an offering. Though the ALJ found that Howard’s violations were “not extremely egregious” and were without “a high conscious intent,” the ALJ concluded that Howard, as an experienced securities professional, possessed the necessary scienter for aiding and abetting because he was “reckless” in not knowing the restrictions applicable to the transactions. Howard was suspended for three months from associating with any broker or dealer, fined $50,000, and ordered to cease and desist from future violations of the securities laws. Howard appealed.

The Majority’s Application of an Extreme Recklessness Standard

It is well established that the SEC may bring charges against a secondary actor for aiding and abetting a primary violation of the securities laws only upon proof of scienter. See e.g., Investors Research Corporation v. Securities and Exchange Commission, 628 F.2d 168, 177-78 (D.C. Cir. 1980). Requiring proof of an “awareness of wrongdoing”—or scienter—is designed to protect innocent, incidental participants in securities laws violations from harsh civil, criminal or administrative penalties. A showing of actual knowledge or recklessness has been deemed sufficient to satisfy this requirement. See Graham v. Securities and Exchange Commission, 222 F.3d 994, 1004 (D.C. Cir. 2000).

The majority opinion in Howard addressed the specific degree of recklessness required to establish scienter for aiders and abettors. The court criticized the ALJ for purporting to apply a recklessness standard to Howard’s conduct while, in fact, applying a lower “should have known” negligence standard. Howard, 376 F.3d at 1138. Essentially, the ALJ concluded Howard was liable because he should have known the legal restrictions that applied to “part-or-none” offerings. The court found this determination was inconsistent with the Circuit’s decision in Investors Research, requiring proof of a “general awareness of wrongdoing.” Further, while recklessness can support a finding of scienter for aiders and abettors, the court emphasized that the degree of recklessness is important. To establish scienter for aiding and abetting liability, the evidence must demonstrate that the defendant acted with “extreme recklessness.” Mere recklessness alone is insufficient: “We are willing to assume that the [ALJ] thought—incorrectly—that reckless conduct amounted to a form of awareness of wrongdoing. But we are unwilling to assume that it properly evaluated Howard’s conduct under the extreme recklessness standard.”

The Concurring Opinion

In the concurring opinion, Judge Henderson agreed that the record did not establish that Howard acted with the requisite scienter, but disagreed with the application of an “extreme recklessness” standard. Pointing to Securities and Exchange Commission v. Steadman, 967 F.2d 636 (D.C. Cir. 1992), Judge Henderson argued that the majority blurred the distinction between the scienter required for a primary violation and the degree of scienter required (Continued on Page 19)
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a defendant’s alleged misrepresentations or omissions, because such misrepresentations or omissions are deemed to be incorporated into the market price of the stock.

Because the “fraud-on-the-market” theory presumes that all publicly available information is reflected in the price of the stock, a defendant can rebut the theory by showing that the truth was also publicly known, and therefore also reflected in the price of the relevant stock. The Second Circuit in Ganino v. Citizens Utilities Co., 228 F.3d 154 (2d Cir. 2000), explained this theory as follows:

Under [the truth-on-the-market theory], a misrepresentation is immaterial if the information is already known to the market because the misrepresentation cannot then defraud the market. A defendant may rebut the presumption that its misrepresentations have affected the market price of its stock by showing that the truth of the matter was already known. However, the corrective information must be conveyed to the public with a degree of intensity and credibility sufficient to counter-balance effectively any misleading information created by the alleged misstatements.

Thus, the “truth-on-the-market” defense is “intensely fact-specific and is rarely an appropriate basis for dismissing a § 10(b) complaint.” The White Court found, however, that “rarely appropriate’ is not the same as ‘never appropriate,’" and the facts before it were sufficient to justify precisely such a dismissal.

The “Truth-on-the-Market” Defense

Block disclosed the existence of the RAL lawsuits in a press release issued May 2, 2000, stating that Block had reserved $5 million for a pending class action settlement; the same release stated that Block had not lost any of the RAL lawsuits. Block referred to the RAL lawsuits a second time in its Form 10-K405 filed on July 28, 2000. The Form 10-K405 incorporated Block’s Annual Report which stated that Block had “provided for the pending settlement of class action lawsuits involving refund anticipation loans;” that there had not been “any final judgments rendered” against Block in the RAL litigation; and that Block admitted no wrongdoing in connection with the settlement. Finally, in a press release issued September 26, 2000, Block announced a nationwide class action settlement of the then-pending RAL lawsuits.

In addition to Block’s disclosure, the RAL lawsuits were also the subject of intense media coverage in and around the summer of 2000. In particular, around July 25, 2000, the RAL lawsuits were discussed in what the Court characterized as a “torrent” of newspaper articles reporting that a court had rejected a proposed $25 million class action settlement.

However, despite the settlement announced by Block in September 2000, Block continued to face new RAL lawsuits. Between July 30, 2001 and July 29, 2002, Block filed a series of SEC reports that did not refer specifically to the RAL litigation, although they reported that Block was involved in unspecified litigation matters; that management believed the litigation would not have a material adverse affect on the company’s consolidated results of operations or financial position; and that the amounts claimed in the pending legal proceedings were “substantial in some instances,” but “the ultimate liability” was “difficult to predict.”

On November 1, 2002, Avalon Research Group, Inc. released a report discussing two class action lawsuits filed against Block in Texas seeking damages of up to $2 billion. Trading of Block’s stock was temporarily halted, and Block issued a press release in response to what it characterized as “market rumors” concerning the litigation. When trading
resumed, Block's stock dropped 8 percent by the close of trading on November 1, 2002, and dropped another 14 percent on November 7, 2002, the day after a court in Texas indicated that it would order Block to repay approximately $75 million to customers in connection with the RAL litigation.

The White plaintiffs sued, alleging that Block violated Section 10(b) of the Exchange Act and Rule 10b-5 by failing to disclose sufficient information regarding the RAL litigation. Block moved to dismiss on the ground, inter alia, that, because of the substantial amount of public information

allege Block concealed involved public filings in public proceedings in publicly accessible courts all across the country.... In short, the ‘concealed’ information was inherently public information.” Second, the Court noted the substantial press coverage of the litigation during the summer of 2000, when a court rejected a proposed $25 million settlement. Finally, the Court reasoned that Block had, in fact, discussed the RAL litigation in several public SEC filings during the summer of 2000. Taken together, the Court

found that these facts demonstrated that the allegedly concealed

surrounding the RAL lawsuits, the plaintiffs’ claims were barred by the “truth-on-the-market” defense. The Court agreed and dismissed the plaintiffs’ claims with prejudice.

In so doing, the Court emphasized several key facts. First, the Court noted that the RAL lawsuits were, by their very nature, public information. As the Court explained: “This is not a case involving private information held internally by the company, hidden away from the public and available only to the officers or directors. To the contrary, the information that plaintiffs

information was known to the market, thus precluding the plaintiffs from relying on the “fraud-on-the-market” theory in support of their claims.

Given the fact-specific nature of the “truth-on-the-market” defense, the White decision is necessarily limited to its facts. It is, however, a reminder that under the right circumstances, the premise underling the “fraud-on-the-market” theory can act as a shield or as a sword, and that the presumption that market prices reflect “all” public information does indeed apply to “all” such information. ■

The White Court found, however, that “‘rarely appropriate’ is not the same as ‘never appropriate,’” and the facts before it were sufficient to justify a dismissal based on the truth-on-the-market defense.
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history sufficient to rebut the traditional presumption against retroactivity that attaches when there is no express statutory command. Accordingly, the district court granted the motion to dismiss, and the plaintiff appealed.

In its amicus brief, the SEC primarily argues that Landgraf “does not require Congress to expressly include terms like ‘retroactive’ or ‘revival’ to indicate retroactive intent.” The SEC argues that Section 804’s command to apply the new limitations periods to “all proceedings...commenced on or after the date of enactment” is sufficient, and accordingly there is no need to resort to judicial presumptions against retroactivity. Alternatively, the SEC argues that even if such a presumption applied, it is rebutted by the legislative history showing that Section 804 was motivated by a desire to help “existing victims of recent egregious frauds involving large, well-known corporations...like Enron...” whose claims would otherwise have been barred. The SEC also argues that

Section 804(c) merely specified that Congress did not intend to create any new types of fraud claims beyond those which already existed before SOX was enacted, and did not indicate that Congress had precluded the “revival of barred claims.”

To evaluate the merits of the SEC’s position, it is first necessary to examine the Supreme Court’s decisions in Landgraf and its progeny, which govern the retroactivity analysis.

Application of the Landgraf Analysis to Section 804

The Background and Purpose of the Landgraf Analysis

In Landgraf, the Supreme Court laid out a three-part test that courts must apply in determining whether a statute may be given “retrospective” or “retroactive” effect:

When a case implicates a federal statute enacted after the events in suit, the court’s first task is to determine whether Congress has expressly prescribed the statute’s proper reach. If Congress has done so, of course, there is no need to resort to judicial default rules. When, however, the statute contains no such express command, the court must determine whether the new statute would have retroactive effect, i.e., whether it would impair rights a party possessed when he acted, increase a party’s liability for past conduct, or impose new duties with respect to transactions already completed. If the statute would operate retroactively, our traditional presumption teaches that it does not govern absent clear congressional intent favoring such a result.

The facts of Landgraf are instructive. The plaintiff had tried a claim against her former employer for intentional discrimination under Title VII of the 1964 Civil Rights Act and obtained a finding of discrimination by the district judge, but found her case dismissed.
because the statute as it existed at the time of her trial did not provide for any relief. By the time of her appeal, however, Congress had passed the Civil Rights Act of 1991 (the 1991 Act), which authorized compensatory and punitive damage awards for the conduct at issue. The Court of Appeals nonetheless affirmed the dismissal, as did the Supreme Court. While acknowledging that Congress intended the 1991 Act as a major correction of what Congress believed were inadequacies in the prior law—i.e., Congress was “expanding the scope of relevant civil rights statutes in order to provide adequate protection to victims of discrimination,” the Court determined that the existence of this remedial purpose was insufficient in and of itself to warrant applying the relevant provisions of the 1991 Act retroactively.

Instead, the Court held, Congress would need to express a much clearer intention than it did in the 1991 Act to cause a statute with “retrospective” effect to be applied “retroactively.” The language used by Congress in the 1991 Act, at Section 402(a), was: “Except as otherwise specifically provided, this Act and the amendments made by this Act shall take effect upon enactment.” Considering the circumstances of Landgraf—namely, that the application of the 1991 Act to that case would have created new damages liability for the defendants when no such liability existed at the time the case arose and was tried—this language was an insufficient expression of Congress’ intent to have the statute apply retroactively. As the Court noted, this language “would have been an especially inapt way to reach pending cases.”

The Court demanded that Congress clearly express a retroactive intent when enacting a statute that changes rights and liabilities because it recognized that statutes with retrospective effects may “sweep away settled expectations suddenly and without individualized consideration,” and thus have “the potential for disruption or unfairness.” Because of these serious consequences, for centuries courts have applied a presumption against retroactive application of statutes, and have refused to infer such application from ambiguous statutory language. Applying the 1991 Act to cases arising before its effective date “would have important consequences, including the possibility that trials completed before its enactment would need to be retried and the possibility that employers would be liable for punitive damages for conduct antedating the Act’s enactment.” As the Court explained, “[r]equiring clear intent assures that Congress itself has affirmatively considered the potential unfairness of retroactive application and determined that it is an acceptable price to pay for the countervailing benefits.” In other words, because retroactive application is inherently unfair as a general matter, courts will not infer that such was Congress’ intent.

Has Congress “Expressly Prescribed the Statute’s Proper Reach”?

The SEC’s primary argument is that Landgraf’s “clear expression” requirement is satisfied by the provision in Section 804 that the new, extended statute of limitations “shall apply to all proceedings addressed by this section that are commenced on or after the date of enactment of this Act.” Considering the circumstances of Landgraf—namely, that the application of the 1991 Act to that case would have created new damages liability for the defendants when no such liability existed at the time the case arose and was tried—this language was an insufficient expression of Congress’ intent to have the statute apply retroactively. As the Court noted, this language “would have been an especially inapt way to reach pending cases.”

The SEC points to three cases in which courts found that a statute of limitations applies retroactively based on similar language. However, all three of those cases were decided before Landgraf, and are therefore of questionable utility in this analysis.

The SEC also argues that the provision in Section 804(c)—that “nothing in this section shall create a new, private right of action”—is “irrelevant” to the analysis because this language is “contained in its own separate subdivision,” and thus not necessarily intended to (Continued on Page 12)
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address the retroactivity issue. As discussed below, the vast majority of courts that have actually applied the Landgraf analysis to Section 804 have rejected these arguments.

Beginning with In re Enterprise Mortgage Acceptance Co. LLC Sec. Litig., 295 F. Supp. 2d 307, 317 (S.D.N.Y. 2003), the Southern District of New York became the first court in the Second Circuit to preclude Section 804’s retroactive operation to claims that were already time-barred at the time it was enacted. In Enterprise, plaintiffs filed their original complaints in June 2002, asserting violations of Section 10(b) of the 1934 Act based upon purchases of securities from Enterprise dating back to 2000; the plaintiffs also asserted, but immediately dismissed because time-barred under Lampf, claims based upon securities purchases dating back to 1998 and 1999. In May 2003, after SOX was enacted, plaintiffs filed amended complaints reasserting their earlier time-barred claims, claiming that Section 804 revived those claims. The plaintiffs made the same argument now employed by the SEC—that the language of Section 804(b) is, in fact, a clear expression by Congress that the statute revives previously time-barred claims. The court rejected that argument, stating that Congress did not use express language on the issue of whether the statute “applies retroactively or that it operates to revive time-barred claims… If Congress wanted Section 804 to clearly revive time-barred claims, it could have used the unambiguous language it had used in previous statutes that revived formerly time-barred claims.”

In L-3 Communications Corp. v. Clevenger, 2004 WL 1941248, at *4-5 (E.D. Pa. Aug. 31, 2004), the Eastern District of Pennsylvania addressed the issue, emphasizing that “cases where the Supreme Court has found a true intent to apply a statute retroactively ‘have involved statutory language that was so clear that it could sustain only one interpretation.’” The court then considered the same “plain language” argument made by the SEC—that Section 804 lengthens the statute of limitations for all cases commenced after July 30, 2002, whether or not the underlying claim was already time-barred. The court found that “[t]his is not an unreasonable literal interpretation of Section 804(b), but it is simply one such interpretation… Therefore, the statute cannot overcome the presumption against applying it to previously time-barred claims.” For that reason, Congress has been remarkably clear—and far clearer than Section 804(b)—when it intends for a statute of limitations to apply retroactively.

Like the district court in AIG Asian Infrastructure Fund, other courts have noted that the existence of Section 804(c) tends to negate any inference that Congress intended Section 804 to apply retroactively. The fact that Congress went out of its way to include language in Section 804 precluding any use of the statute to assert new claims is inconsistent with an interpretation of Section 804 that would breathe new life into previously dead claims. See, e.g., L-3 Communications, 2004 WL 1941248, at *5. Indeed, the Supreme Court in Hughes Aircraft Co. v. United States ex rel. Schumer, 520 U.S. 939, 943-44 (1997) indicated that allowing a plaintiff to bring a claim that was previously foreclosed “essentially creates a new cause of action,” and that such an interpretation of the qui tam statute would be similar to “extending a statute of limitations after the pre-existing period of limitations has expired,” which “impermissibly revives a moribund cause of action.” Given the Supreme Court’s reasoning, it is difficult to reconcile Congress’ express statement that it did not intend to create a “new, private right of action” with an interpretation that would have exactly the effect described in Hughes. (Continued on Page 15)
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the Ninth Circuit has allowed. Its decision that loss causation requires nothing more than proof of price inflation incorrectly collapses the separate elements of transaction causation and loss causation by ignoring the truth-on-the-market presumption. This means, for example, that “in and out” investors in the Ninth Circuit may seek to claim compensable injury under Dura, even though their losses were not actually caused by the alleged misrepresentation.

The Ninth Circuit Alone Among the Courts of Appeals

The Ninth Circuit’s interpretation of loss causation is at odds with decisions from the Second, Third, Seventh and Eleventh Circuits that uniformly require plaintiffs to demonstrate that the price drop giving rise to their losses was caused by the alleged misrepresentation (i.e., that the drop followed a corrective disclosure revealing the previously undisclosed or misrepresented information). Thus, the Second and Eleventh Circuits have stated what, prior to Dura, appeared obvious: the loss causation requirement requires proof of a “causal connection” between the loss and the corrective disclosure. Each rejected the notion adopted in Dura that inflation alone is sufficient. Likewise, the Third Circuit held in Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000), that “an investor must also establish that the alleged misrepresentations proximately caused the decline in the security’s value to satisfy the element of loss causation.” The Seventh Circuit reached the same conclusion in Bastian v. Petren Resource Corp., 892 F.2d 680, 684 (7th Cir. 1990), where Judge Posner, a widely regarded expert on the intersection of law and economics, rejected as inadequate a claim for which the investors “alleged the cause of their entering into the transaction in which they lost money but not the cause of the transaction’s turning out to be a losing one.” Judge Posner concluded that plaintiffs must plead facts showing that “but for the circumstances that the fraud concealed, the investment that they were induced by the fraud to make would not have lost its value.” Absent this requirement, Judge Posner said, plaintiffs whose investments lose value as a result of any other market factors would receive an underserved windfall. Id.

Together, these cases from four of the nation’s courts of appeals set forth the majority, and better reasoned, view that the loss causation requirement is meaningful and is not subsumed in the determination of transaction causation or reliance. The Ninth Circuit’s decision in Dura stands alone in reaching the opposite conclusion.

The Statutory Conflict

The Dura decision also conflicts with the Reform Act, which requires plaintiffs to prove causation to recover under Section 10(b) and Rule 10b-5. 15 U.S.C. § 78u-4(b)(4). Moreover, Congress incorporated the principles of loss causation into the Reform Act’s damages calculation provision. 15 U.S.C. § 78u-4(e). The Reform Act caps damages at the difference between the price paid and the mean trading price during the 90-day period “beginning on the date which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.” Congress explained in the House Conference Report the purpose behind this so-called “bounce back” provision:

Typically, in an action involving a fraudulent misstatement or omission, the investor’s damages are presumed to be the difference between the price the investor paid for the security and the price of the security on the day the corrective information gets disseminated to the market…The Conference Committee intends to rectify the
The Errors in the Ninth Circuit’s Loss Causation Decision

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...uncertainty in calculating damages by providing a ‘look back’ period, thereby limiting damages to those losses caused by the fraud and not by other market conditions. Together, the statutory language and the legislative history leave no doubt that Congress intended for plaintiffs to prove a causal link between the stock price decline and the alleged misrepresentations.

The Ninth Circuit’s decision that this causal link is not required obviously cannot be reconciled with that.

What is at Stake in Dura?

In the typical securities class action, the end of the class period coincides with the corrective disclosure that triggers the decline in stock price for which the plaintiffs hope to recover. In Dura, there was no corrective disclosure during the class period. Assuming arguendo that the plaintiffs suffered any loss of stock value based on alleged misrepresentations during the class period, those losses were not due to the misrepresentations about Albuterol Spiros.

If the Supreme Court affirms Dura, that decision will open the door to fraud-on-the-market securities class actions when a company’s stock price has not declined in response to a corrective disclosure.
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One court has reached the opposite conclusion. In In re Sawtek, Inc. Sec. Litig., 2003 U.S. Dist. LEXIS 25757, at *21-22 (M.D. Fla. Dec. 23, 2003), the Middle District of Florida issued its second decision on the issue of retroactive application of Section 804. In the first, Roberts v. Dean Witter Reynolds, 2003 WL 1936116, at *3 (M.D. Fla. Mar. 31, 2003), the court reviewed the legislative history of the Act to conclude that Section 804 should be applied retroactively. In Sawtek, the court disagreed with the reasoning in Roberts, but not the ultimate decision. Like the argument advanced by the SEC, the court in Sawtek held that the plain language of Section 804 manifested Congress’ unambiguous intent to apply the longer statute of limitations to all proceedings commenced after the Act’s effective date, and thus the court found no need to resort to the legislative history. The court allowed the parties time to seek interlocutory appeal because, at the time, the Eleventh Circuit was already expected to be considering this issue. The order was appealed, and while the Roberts appeal was closed without consideration by the Eleventh Circuit, oral argument in Sawtek was heard on November 21, 2003. The appeal is still pending.

Later decisions from other courts, presumably able to consider the reasoning and holding in Sawtek, have all rejected its conclusion. See Johnson v. Aljian, 2004 U.S. Dist. LEXIS 14986, at *12-13 (C.D. Cal. July 30, 2004) (finding Sawtek’s reasoning “unpersuasive”). In fact, based on our findings, all other reported decisions have concluded that the provision in Section 804(b) that the new, extended statute of limitations under SOX “shall apply to all proceedings addressed by this section that are commenced on or after the date of enactment of this Act” does not (Continued on Page 16)
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"expressly prescribe the statute’s proper reach." See, e.g., In re Enron Corp. Sec. Derivative & ERISA Litig., 2004 WL 405886, at *7 (S.D. Tex. Feb. 25, 2004) (finding "an absence of any expression of specific intent that Sarbanes-Oxley should apply retroactively, either in the Act or the legislative history"); Glaser v. Enzo Biochem, 303 F. Supp. 2d 724, 734 (E.D. Va. 2003) (holding that “Congress's provision that the [SOX] statute of limitations would apply to all proceedings on or after July 30, 2002 applies only to actions that may have accrued but that were not time-barred under the previous one-year limitations period”); In re Heritage Bond Litig., 289 F. Supp. 2d 1132, 1148 (C.D. Cal. 2003) (holding that retroactive application of Section 804 would impermissibly increase a party’s liability by reviving claims that were time-barred on July 30, 2002); see also cases discussed herein.

The disagreement about the import of Section 804(b) can be resolved by recalling the purpose of Landgraf's "clear expression" analysis: For a court to be sure that Congress has actually weighed the unfairness of applying a statute retroactively, it must receive a statutory message from Congress that is nothing short of crystal clear. Instead, the only question that Section 804(b) appears to answer definitively is whether the statute applies to cases filed before July 30, 2002 – the date SOX was enacted. Based on the language of Section 804(b), it does not. But on the question of whether the statute will be applied to revive claims based on past conduct that were already time-barred, most courts have concluded that Section 804(b) is less than crystal clear (or silent). It is the "proper reach" of this aspect of the statute, the true retroactivity question, which Congress must address with clarity before it will be given such operation. The language of Section 804 does not necessarily demonstrate that Congress truly considered the consequences of upsetting settled expectations by retroactively altering rights and liabilities; its purpose could just as easily have been to make clear that Section 804 does not apply to claims that were already pending. Under these circumstances, Landgraf demands application of the judicial presumption against retroactive application. The question then becomes whether the statute would have a truly "retrospective" effect.

Would Section 804 have a Retrospective Effect?

There is little debate about whether the new, extended statute of limitations in Section 804 would have true "retrospective effect" as defined by Landgraf—that is, "it would impair rights a party possessed when he acted, increase a party’s liability for past conduct, or impose new duties with respect to transactions already completed." The Supreme Court’s opinion in Hughes seems to foreclose any doubt that Section 804 would alter rights and liabilities of parties, and the SEC did not dispute that point in its brief. Parties that have argued the point in other cases have had no success. In In re WorldCom, Inc. Sec. Litig., 2004 WL 1435356, at *7 (S.D.N.Y. June 28, 2004), for example, the court stated that "[a]pplying the statute of limitations that was lengthened in July 2002 to claims that expired in June 2002 would affect the substantive rights of the defendants by depriving them of a defense on which they were entitled to rely.” Thus, the only remaining question is whether the traditional presumption against retroactive application has been rebutted.

Was There a "Clear Congressional Intent" Favoring Retroactivity?

The SEC points to particular statements in the legislative history of SOX, arguing that they evidence the "clear Congressional intent" required by Landgraf to override the presumption against applying statutes retroactively.
In Roberts, the Middle District of Florida used the same rationale to conclude that Section 804 should be applied retroactively. The court found that the language in Section 804 was unclear on the question of “retroactive application,” so it turned to the legislative history of SOX. The court focused on statements by Senator Leahy, in the midst of discussing the huge financial losses suffered by investors “because of Enron,” noting that “[t]hese are people who would like, in these kinds of cases, at least to have a statute of limitations such that we can go after them,” and other similar comments. The court found that because these remarks refer to events prior to enactment of SOX—i.e., the Enron collapse—and because of the legislative record’s “section-by-section analysis,” which provided that “[t]he section, by its plain terms, applies to any and all cases filed after the effective date of the Act, regardless of when the underlying conduct occurred,” Congress must have intended Section 804 to have retroactive effect.

Roberts, however, stands alone in its interpretation of SOX’s legislative history. Multiple courts have already issued opinions expressly disagreeing with the analysis in Roberts. In Enterprise, for example, the Southern District of New York found that Senator Leahy’s remarks suggest nothing about “the resurrection of time-barred claims,” and must be read in connection with his statement that extending the statute of limitations “would’ve helped so many people”—as opposed to “does help so many people”—defrauded in the past “by Enron and others.” The court in Enterprise found further that the “section-by-section analysis” demonstrated only that the new “statute of limitations can reach conduct that happened not only after the enactment of the Act, but also before its enactment.”

**Conclusion**

In the end, the near-unanimous view of the courts that Section 804 does not apply retroactively may be the strongest evidence that Congress was less than “clear” about its intent in that regard. If Congress had in fact provided the sort of clear statement that Landgraf requires, it is hard to explain how so many judges failed to see it. Indeed, it is precisely that lack of clarity which has led those courts to conclude that, under Landgraf, Section 804 cannot be used to bring dead claims back to life. Whether the SEC’s recent foray into this issue will persuade the Second Circuit to adopt the minority view remains to be seen. However, in weighing the SEC’s arguments the Second Circuit may wish to consider that Section 804 applies only to private claims and not to enforcement actions. Moreover, the retroactivity analysis under Landgraf involves general principles of statutory interpretation, rather than specialized matters of federal securities law. For both of these reasons, there is no reason for the court to pay any special deference to the SEC’s views on this point.

**Endnotes**

1. That the SEC would even have a view on the subject is noteworthy, in that Section 804 by its terms applies only to private claims. In its brief, the SEC states that it “has an interest in assuring that investors are not precluded from asserting their claims by an erroneous interpretation” of Section 804, and that it also has “a more general interest in ensuring that courts do not adopt overly restrictive interpretations of Sarbanes-Oxley’s provisions and thereby undermine Congress’ objectives in enacting this legislation.” (SEC Brief at 2-3, available at http://sec.gov/litigation/briefs/aig.pdf.)

2. Landgraf was decided in 1994; thus, the requirement that Congress provide a clear statement of retroactive intent had been the law for several years when Congress enacted Section 804 in 2002.

Recent Seminars and Speaking Engagements

Attorneys from Latham & Watkins’ securities litigation and professional liability group regularly speak at events and conferences around the country.

- Partner Peter Benzian (SD) participated in a seminar entitled “California Class Actions” on August 27 sponsored by Lorman Education Services.

- Partner Laurie Smilan (NOVA) participated on panels entitled “Defending the Class Action” and “Developments in Internal Investigations” for Practising Law Institute’s Securities Litigation & Enforcement Institute 2004 in New York and San Francisco. In addition, Laurie will participate in the Securities Regulation Institute Panel on Judicial Developments on January 21, 2005 in San Diego.

- Partners Peter Devereaux, Pamela Palmer and David Schindler (LA) participated in Latham’s General Counsel Forum “Cooperation Conundrum: The Complexities of Responding to Government Investigations” on October 7 in Los Angeles.

- Partner Jay Pomerantz (SV) will participate on a panel discussion entitled “In the Bull’s Eye: Increased Liability for Corporate Directors since Enron” on October 21 at the National Association of Corporate Directors Northern California Chapter meeting in San Francisco.

- Partner David M. Brodsky (NY) will participate on a panel entitled “Advice from More Experts: More Successful Strategies for Winning Commercial Cases in Federal Courts” on Friday, October 22, 2004, sponsored by the New York State Bar Association. Mr. Brodsky will speak on “Deposition Techniques.”

- Partner Paul Dawes (SV) will participate on a panel entitled “Exploring Expectations of Audit Committee Effectiveness” at the Fall 2004 San Francisco KPMG Audit Committee Roundtable on November 16. Paul will also participate in Latham’s General Counsel Forum “Inside the Board Room: The Evolving Standards Applicable to Directors’ Duties and D&O Coverage Developments” on December 7 in Silicon Valley and December 9 in San Francisco.
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for a secondary violation. She noted that the Steadman court referred only to a primary violation in stating that “extreme recklessness may also satisfy this intent requirement.” Judge Henderson argued that the cases cited in Steadman require only “recklessness” in support of aiding and abetting, and bolstered her argument by pointing to Graham: “We have held that knowledge or recklessness is sufficient to satisfy that requirement.” Although the Graham court also observed that the defendant “acted with at least extreme recklessness in aiding [the] stock scheme,” Judge Henderson contended that this language described only the extent of Graham’s recklessness, but did not impose a new heightened scienter standard for aiding and abetting.

Conclusion

Howard raises the bar for the SEC to seek sanctions for aiding and abetting of securities violations. Only conduct that is “extremely reckless” will suffice.

Endnotes

1. In Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994), the Supreme Court held that no private right of action for aiding and abetting liability exists under Section 10(b) of the Exchange Act. Despite this ruling, aiders and abettors still may face sanctions for their conduct under Sections 15(b) and 21B of the Exchange Act.
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