Troubled Waters in the Safe Harbor

By David A. Becker

The Private Securities Litigation Reform Act was enacted in 1995 to curb “abusive” and “meritless” securities suits that constrained the efficient operation of the capital markets. One of the Reform Act’s most important provisions, the safe harbor protecting disclosure of forward-looking information, has played a critical role in reducing the number of suits filed on the basis of failed financial forecasts, and in allowing for the dismissal of such suits at the pleading stage.

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Criminal Sentencing in Federal Securities Prosecutions After United States v. Booker

By Alexandra A.E. Shapiro and William O. Reckler

For the past 18 years, federal courts operated under a determinate sentencing scheme in criminal cases. Sentences were based on binding Federal Sentencing Guidelines promulgated by the United States Sentencing Commission pursuant to the Sentencing Reform Act of 1984 (the “SRA”). Under that regime, federal courts had little, if any, real discretion in sentencing. However, the Supreme Court’s decision in United States v. Booker, 125 S. Ct. 738 (Jan. 12, 2005), ended some six months of uncertainty that had followed its Blakely v. Washington, 124 S. Ct. 2531 (June 24, 2004), decision and increased judicial discretion by striking down provisions of the SRA making the Sentencing Guidelines binding.

The Court did not go so far as to revert to an indeterminate sentencing scheme by completely doing away with the Sentencing Guidelines, and instead held that judges must take them into consideration when sentencing. Nonetheless, the Booker decision has far-reaching ramifications for all criminal defendants, including those charged with securities fraud. By giving district court judges back some of the discretion that they enjoyed in the pre-Guidelines era, the Court has created at least the possibility that sentencing judges will deviate from some of the exceedingly harsh results that have marked Guidelines sentences in recent securities fraud prosecutions. In doing so, it has created additional leverage for individual defendants in plea negotiations and may reduce the number of individuals who decide to cooperate with the government.

(Continued on Page 6)
Although plaintiffs often succeed in establishing class-wide reliance on defendants’ alleged false statements in securities fraud actions based on the “fraud on the market” theory, in some cases plaintiffs are prohibited from bringing class action securities fraud claims because they cannot establish that the security at issue traded in an “efficient market.” The U.S. District Court for the District of Massachusetts, however, recently made it easier for plaintiffs seeking class certification of a securities fraud action to establish class-wide reliance on defendants’ alleged false statements. Although this new decision is an outlier, if followed by other courts, it could impact the minority of securities fraud actions in which establishing class-wide reliance is truly at issue.

To maintain a class action in federal court, a plaintiff must demonstrate that the claims of a proposed class meet several requirements under the Federal Rules of Civil Procedure. One of these requirements is that common issues of law or fact “predominate” over any questions affecting only individual class members. If the circumstances surrounding each class member’s supposed reliance on the defendant’s alleged false statements differ sufficiently, then each class member must separately prove reliance, and the proposed class therefore fails the “predominance” requirement.

Because the circumstances relating to each plaintiff’s alleged reliance typically differ in some respects, securities fraud claims have historically not been readily susceptible to class action treatment. In 1988, however, the Supreme Court held that this barrier could be overcome with a rebuttable presumption of class-wide reliance through application of the “fraud-on-the-market” theory. Basic Inc. v. Levinson, 485 U.S. 224 (1988).

The fraud on the market theory is based on the “efficient market” hypothesis: In an open and developed securities market, the price of a company’s stock is determined by available, material information regarding the company and its business. In many securities fraud actions, where defendants’ stocks are heavily traded on a major exchange, market efficiency will generally not be an issue. However, where a lawsuit “involves small-cap stocks traded in less-organized markets, a demonstration of an efficient market is a prerequisite for [class] certification.” Unger v. Amedisys Inc., --- F.3d ---, No. 03-30965, 2005 WL 375684, at *4 (5th Cir. Feb. 17, 2005). In these situations, a plaintiff’s failure to show that the stocks trade in an efficient market will almost always be determinative – without class certification, practically no plaintiff will pursue his securities fraud claims.

Even at the class certification phase, the court must conduct a careful and thorough inquiry into the plaintiff’s assertions that the security traded in an efficient market. Thus, a court cannot simply presume that the plaintiff’s allegations are dispositive. Instead, as the court recognized in Unger, it “must address and weigh factors both for and against market efficiency.” Most courts use five factors to determine whether a security traded in an efficient market: (1) a large weekly trading volume; (2) the existence of a significant number of reports by securities analysts; (3) the existence of market makers and arbitrageurs in the security; (4) the eligibility of the company to file an S-3 registration statement and (5) a history of immediate movement of stock prices caused by unexpected corporate events or financial releases. Cammer v. Bloom, 711 F. Supp. 1264 (D.N.J. 1989). Some courts have applied additional factors, including (1) the company’s

(Continued on Page 18)
Victory for Ernst & Young in Clarent Trial

Latham successfully defended Ernst & Young LLP at trial in a securities fraud class action lawsuit in San Francisco involving Ernst & Young’s former audit client, Clarent Corporation, a company specializing in computer-based telephony systems. The complaint against Ernst & Young alleged that the auditor violated Section 10(b) of the Securities Exchange Act of 1934 by failing to detect a fraudulent round-tripping and cash recycling scheme committed by Clarent employees in 2000 and 2001. When the fraud was uncovered at Clarent, the company was forced to restate its financial statements for 2000 and the first two quarters of 2001, and it ultimately filed for bankruptcy in 2002.

The case against Ernst & Young was consolidated with a class action against Clarent and its officers and directors, and was set for trial just three months after Ernst & Young’s motion to dismiss was denied. The parties had less than 10 weeks to conduct all discovery in the case. Many of the officers and directors of Clarent, as well as Clarent’s outside counsel, settled the claims against them prior to trial. The defendants at trial were Ernst & Young and the former Chief Executive Officer of Clarent, Jerry Chang.

Following the expedited pre-trial schedule, the trial began on January 24, 2005 and lasted three weeks. The plaintiff class sought damages of $125 million against Ernst & Young. After a day and a half of deliberations, the jury returned a verdict in favor of Ernst & Young on all claims. This was one of only a very few class actions that have reached verdict under the Private Securities Litigation Reform Act of 1995. The Latham team was led by Global Litigation Department Chair Peter Wald, along with partners Peter Devereaux (Securities Litigation and Professional Liability Group Co-Chair), Michele Kyrouz and Janet Link, and associates Jacqueline Molnar, Matt Harrison, Brett Collins and Viviann Chui.

Victory for Ernst & Young before Eighth Circuit

In another significant victory for Ernst & Young, Latham successfully argued to the Eighth Circuit that a district court’s dismissal of a Section 10(b) claim, based on allegations which amounted to little more than the assertion that E&Y performed a “poor audit,” should be upheld. Refer to the summary of the decision in Ferris, Baker Watts, Inc. v. Ernst & Young, LLP, Case No. 04-1064 (8th Cir. Jan. 21, 2005), found in the “Circuit and State Round-Up” section of this Newsletter.

Summary Judgment for Koch on Section 16 Short-Swing Profits Claim

Latham also won summary judgment on behalf of Koch Investment Group (an affiliate of Koch Industries) in a shareholder derivative suit brought in the Southern District of New York. FTR Consulting Group, Inc. v. Advantage Fund II Ltd., et al., Case No. 02 Civ. 8608 (S.D.N.Y). The plaintiff alleged that Koch and several other shareholders in a venture company made “short-swing” profits in violation of Section 16 of the 1934 Act as a result of the vesting of certain warrants. These complex securities were structured so that, if the market price of the common stock that the defendants purchased at the same time was lower a year after the original purchase date, the defendants would be entitled to purchase additional shares at a fixed nominal price to make up the shortfall. A drop in the venture company’s market price resulted in a large amount of shares vesting to the defendants, which the plaintiff argued was a “purchase” that could be matched with sales of common stock occurring within 6 months.

The key issue was whether the warrants were “derivative securities” under the SEC rules; if so, their vesting would be exempt from Section 16. The plaintiff argued that the warrants were not derivatives at the time of acquisition because the amount of common stock issuable was not fixed until vesting. The defendants argued that the SEC rules required only that the exercise price be fixed, not the amount of shares issuable; and even if the warrants were analyzed as an “unorthodox transaction” under Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973), they would be exempt from Section 16 because they did not “present the potential for speculative abuse of inside information.” The district court agreed with the defendants, and granted summary judgment in their favor. The Latham team was led by Cathy Palmer and Alexandra Shapiro and also included Daiske Yoshida and Joseph Widman. ■
Circuit and State Round-Up

First Circuit

In Yang v. Odom, 382 F.3d 97 (3d Cir. 2004), the Third Circuit addressed the tolling of the statute of limitations during the pendancy of a class action securities fraud case. In Yang, a Georgia federal district court had dismissed a securities class action after it found each of three sub-classes defective under Rule 23 of the Federal Rules of Civil Procedure. After the dismissal, new plaintiffs brought identical class claims in federal court in New Jersey, arguing that the statute of limitations was tolled during the entire pendancy of the Georgia litigation under American Pipe & Construction Co. v. Utah, 414 U.S. 538 (1974). After the District of New Jersey dismissed the new class suit, the Third Circuit reversed, holding that when certification of a class is denied solely for defects in the class representative, rather than a defect in the class itself, the statute of limitations must be tolled. The ultimate rule resulting from the Yang decision puts the burden on district courts, and by extension lawyers advocating in those courts, to make clear that a class was not proper because of defects with the purported class, as opposed to defects with the proposed class representative. It also deepens a circuit split regarding American Pipe tolling, with the Third Circuit establishing the most plaintiff-friendly rule.

Second Circuit

In a case of first impression for the Second Circuit, the court in Dabit v. Merrill Lynch, 2005 WL 44434 (2d Cir. Jan. 11, 2005), addressed whether the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) preempts claims that do not allege that putative class members purchased or sold particular securities in reliance upon the defendant’s alleged misconduct. The Second Circuit consolidated two appeals by plaintiffs, Merrill Lynch brokers as lead plaintiffs on behalf of class action plaintiffs in Dabit v. Merrill Lynch & Co., No. 03-cv-3688 (CM) (S.D.N.Y. Jan. 10, 2005). The plaintiffs alleged that the defendant brokerages had engaged in a scheme to manipulate the price of certain stocks by buying and selling securities on behalf of customers, and that the defendant brokerages had failed to disclose material facts about the scheme to the plaintiffs. The defendants moved to dismiss the complaint, arguing that the plaintiffs’ claims were preempted by SLUSA. The court denied the motion to dismiss, holding that the plaintiffs’ claims were not preempted by SLUSA because the plaintiffs did not purchase or sell the securities in reliance upon the defendants’ alleged misconduct. The court further held that the plaintiffs’ claims were not barred by the statute of limitations because the plaintiffs had filed their complaint within the three-year period prescribed by SLUSA. The court concluded that the plaintiffs’ claims were timely filed and were not barred by the statute of limitations.

Third Circuit Tolls Statutes of Limitations for Class Actions Until Final Determination That the Class, Not Just the Representative, Is Deficient

By Ethan J. Brown and David A. Simonds

In Yang v. Odom, 382 F.3d 97 (3d Cir. 2004), the Third Circuit addressed the tolling of the statute of limitations during the pendancy of a class action securities fraud case. In Yang, a Georgia federal district court had dismissed a securities class action after it found each of three sub-classes defective under Rule 23 of the Federal Rules of Civil Procedure. After the dismissal, new plaintiffs brought identical class claims in federal court in New Jersey, arguing that the statute of limitations was tolled during the entire pendancy of the Georgia litigation under American Pipe & Construction Co. v. Utah, 414 U.S. 538 (1974). After the District of New Jersey dismissed the new class suit, the Third Circuit reversed, holding that when certification of a class is denied solely for defects in the class representative, rather than a defect in the class itself, the statute of limitations must be tolled. The ultimate rule resulting from the Yang decision puts the burden on district courts, and by extension lawyers advocating in those courts, to make clear that a class was not proper because of defects with the purported class, as opposed to defects with the proposed class representative. It also deepens a circuit split regarding American Pipe tolling, with the Third Circuit establishing the most plaintiff-friendly rule.
a proposed class that included investors, who suffered losses on their investments in a company’s stock which they “held,” rather than purchased or sold, upon Merrill Lynch’s analysts’ research reports which did not disclose alleged conflicts of interest. The plaintiffs’ state law class actions were dismissed by the district court as preempted by SLUSA, and the plaintiffs appealed.

SLUSA preempts “covered class actions” based upon state law that allege a misrepresentation in connection with the purchase or sale of nationally-traded securities. There was no dispute that the lawsuits were “covered class actions” or that they concerned nationally traded securities. Rather, the issue was whether Merrill Lynch’s alleged misrepresentations were “in connection with the purchase or sale” of covered securities. In its analysis, the court held that “in connection with the purchase or sale” has the same meaning in SLUSA as it has in the Securities Exchange Act and Rule 10b-5. Thus, to be preempted under SLUSA, “an action must allege a purchase or sale of covered securities made by the plaintiff or members of the alleged class.” Although the court found that the “in connection with” requirement does not preempt claims that do not allege purchases or sales made by the plaintiff or the alleged class members, to the extent that the “holding” claim of the proposed class represented by Merrill Lynch brokers contained implicit allegations of purchases made by the putative class members, the court held that the claim is preempted by SLUSA.

Second Circuit

In DeMarco v. Robertson Stephens Inc., No. 03 Civ. 590, 2005 WL 120233 (S.D.N.Y. Jan. 20, 2005), the Southern District of New York issued a decision further dividing that court on the issue of the showing which plaintiffs must make for certification of a class of investors alleging securities fraud claims against analysts. The plaintiffs sought class certification on §10(b) and Rule 10b-5 claims alleging that defendants, an investment bank and one of its research analysts, engaged in a “pump-and-dump” scheme whereby they fraudulently inflated the price of Corvis Corporation stock through favorable analyst reports while planning to sell their own holdings for a profit.

The court held that plaintiffs may argue a “fraud-on-the-market”

(Continued on Page 11)
Determinate Sentencing under the Guidelines

The Sentencing Guidelines specify in great detail how sentences are to be calculated. The Guidelines set a “base offense level” for the relevant crime. That base offense level is in essence preordained based on the jury’s verdict (or the defendant’s guilty plea). However, the base offense level must be increased if the sentencing judge finds by a preponderance of the evidence the existence of any number of facts that can lead to upward or downward adjustments specific to the defendant’s conduct. The Guidelines then require judges to further increase or decrease the offense level based on, among other things, the defendant’s role in the offense, the nature of the victim, and whether the defendant obstructed justice or accepted responsibility for his actions. A defendant’s sentencing range is then determined by a chart that considers both the offense level and the defendant’s prior criminal history.

The government frequently relies on a number of adjustments (“enhancements”) that can increase a defendant’s offense level in securities cases. These include, for example: endangering the solvency of a publicly traded company; serving as an officer or director of a publicly traded company at the time of the offense; or abuse of a position of public or private trust. The most significant enhancement in securities cases, however, stems from the enhancement for the amount of financial loss involved.

Several recent cases demonstrate the harsh effect of the enhancement for financial loss:

The most striking example is the sentence imposed by a district court in Houston on Jamie Olis, a former mid-level Dynegy executive, for his role in a gas trading and finance scheme. The jury’s verdict alone authorized only a sentence of zero to six months' imprisonment under the Sentencing Guidelines. However, at Olis’ sentencing, which occurred well before Booker was decided, the judge was required to impose a much higher sentence, largely driven by the loss amount. The judge found that Olis’ role in the offense cost Dynegy’s investors $100 million, enhancing his sentence to 24 years and causing the judge to lament his lack of sentencing discretion.1

The case of four ex-Merrill Lynch bankers and the Enron executive convicted in the so-called Enron Nigerian Barge Trial for falsifying Enron’s financial reports by reporting a non-existent sale of floating power plants and related obstruction of justice charges provides another stark example. The government contends that the amount of loss to investors in that case was $43 million. This could expose the defendants to 15 years in jail under the Guidelines.2

Finally, Adelphia executives John and Tim Rigas face up to 30 years in jail under the Guidelines after having been convicted for what the government alleges is a $2.3 billion accounting fraud.

Booker: Application of the Sixth Amendment to Determinate Sentencing Under the Guidelines

In the two-part Booker decision, the constitutional majority led by Justice Stevens held that because the Guidelines were binding, defendants had a right under the Sixth Amendment to have juries find, beyond a reasonable doubt, any facts that would lead to upward adjustments or enhancements which would increase the sentence. However, the Court did not invalidate the Guidelines in their entirety, nor did it require jury findings on such enhancements. Instead, a different “remedial” majority, led by Justice Breyer, simply excised the provisions that made the Guidelines mandatory and provided for de novo appellate review of sentences.3

Booker built on several earlier Supreme Court rulings. The most important of those earlier cases, Apprendi v. New Jersey, 530 U.S. 466 (2000), set aside a...
sentence that had been enhanced as a hate crime because that aspect of the defendant’s conduct had not been proven to a jury. According to the court, “[a]ny fact that increases the penalty for a crime beyond the statutory maximum must be submitted to a jury, and proved beyond a reasonable doubt.” More recently, in Blakely, the Court defined the “statutory maximum” to be that which could be imposed solely on the basis of facts reflected in the jury verdict or admitted by the defendant. Based on that definition, the Court concluded in Blakely that Washington’s state sentencing guidelines, which contained a system of enhancements similar to those in the Federal Sentencing Guidelines, violated defendants’ Sixth Amendment rights.

In Booker, the Court applied the logic in Apprendi and Blakely to the Federal Sentencing Guidelines, because, as binding rules, they have the force of law. As Justice Stevens explained, “everyone agrees that the constitutional issues presented by these cases would have been avoided entirely if Congress had omitted from the SRA the provisions that make the guidelines binding on district judges.” The Stevens majority held that defendants have a Sixth Amendment right to have juries determine, beyond a reasonable doubt, all facts that would require a sentence to be enhanced under the Guidelines. Thus, the 18-year-old sentencing regime, which required judges to enhance sentences beyond the maximum authorized by the jury alone (or the defendant’s admissions at a guilty plea), based on facts found by the judge by a mere preponderance, was held unconstitutional.

Although the majority opinion reads like a square defense of defendants’ right to a jury trial, the remedial decision paradoxically reacts to the infringement of that right by increasing judicial discretion. It simply severs the provisions of the SRA that make application of the Guidelines mandatory. To reach this awkward solution, the Court found that Congress’ intent in passing the SRA – to increase uniformity of sentencing – would be better served by making the Guidelines advisory than by striking them down entirely or requiring that enhancements be proven to a jury. The remedial opinion also invalidates the section of the SRA specifying a de novo standard of appeal for sentences that depart from the Guidelines and replaces it with a new, extrastatutory, “reasonableness” standard.

**The Impact of Booker on Securities Cases**

It will take some time to assess the full effect of the Booker decision, and the extent to which it will result in sentences that are lower or higher than what the Guidelines would have required. The Booker Court held that judges must still “consider” the Guidelines in imposing sentences. Nonetheless, the opinion has the potential to have a profound impact on securities fraud defendants.

As discussed above, white collar defendants faced a number of enhancements under the Guidelines that required judges to impose extraordinarily harsh sentences. After Booker, judges are free to deviate from the rigid Guidelines sentences. In addition to considering the Guidelines, judges must also take into account a variety of other factors set forth in the SRA, such as the history and characteristics of the defendant, the need to provide restitution, and the need to avoid disparity in sentencing among defendants found guilty of similar crimes. Sentences will be reviewed for “reasonableness.” Although it will take some time to flesh out exactly what that means, it is clear it will give district judges substantial discretion to impose “non-Guidelines” sentences.

Whether judges will opt to employ their new-found freedom and what weight they will give to the “advisory” Guidelines remains to be seen. The immediate effect of the decision is therefore to make it much harder for lawyers to advise their clients about their potential sentencing exposure. In one influential opinion, a district judge (Continued on Page 8)
opined that the Guidelines need not be
given any more weight than any of the
other factors in the SRA. United States v.
Ranum, No. 04-Cr-31 (D. Wisc. Jan. 19,
2005). On the other hand, at least one
court has already held that the
Guidelines should be given heavy
weight and sentences should only
deviate from them in "unusual cases for
clearly identified reasons." United States
v. Wilson, No. 2:03-CR-00882, --- F.
Supp. 2d ---, 2005 WL 78552 (D. Utah

The Second Circuit has not adopted such
an explicit or conservative position, but it
has suggested that district court judges
cannot simply dismiss the Guidelines.
United States v. Crosby, No. 03-1675, ---
F.3d ---, 2005 WL 240916, *5 (2d Cir.
Feb. 2, 2005), held that to fulfill their
statutory obligation to "consider" the
Guidelines, judges must actually
determine the applicable guidelines
range (and even analyze whether any
departures from the Guidelines would
have been permissible under the old,
binding regime). The opinion notes that
Booker only excised the portions of the
SRA making the Guidelines mandatory,
therefore increasing the importance of
the factors that the SRA instructs judges
to consider in sentencing, and in
particular the factors that point to the
Sentencing Guidelines themselves and
any pertinent policy statements issued
by the Sentencing Commission.
However, the Second Circuit did not
limit judges’ ability to deviate from those
Guidelines ranges once they are
calculated and considered, noting that it
was best to let district courts determine
the proper degree of deference to afford
the Guidelines in particular cases.

Significantly, the Second Circuit pointed
out that a sentencing judge might not
need to make a precise calculation of the
Guidelines in situations in which one or
more Guidelines ranges are applicable
and, having considered those
Guidelines, the judge decides to impose
a non-Guidelines sentence. The Crosby
court suggested that this approach
would be particularly helpful in that it
would allow judges to avoid the need to
resolve all factual issues necessary for a
Guidelines determination, and more
specifically that it would free judges of
the need to make difficult
determinations of monetary loss. For
example, in a complex accounting fraud
by executives of a public company, how
do courts determine the extent to which
shareholders’ losses are attributable to a
false or misleading financial statement?
The Second Circuit’s acknowledgment
that Booker might allow judges more
leeway in cases involving complex loss is
also consistent with Justice Breyer’s
position in Booker that one reason the
Court did not simply require juries to
make all findings of fact relevant to
sentencing was that the calculation of
economic loss in securities cases can be
exceedingly complex.4

Regardless of how frequently judges do
choose to invoke their authority to
deviate from the Guidelines’ range, their
power to do so affects plea negotiations.
Presently 95 percent of all sentences
imposed by federal courts are the result
of guilty pleas, many of them entered
pursuant to negotiated plea agreements.
Before Booker, the government had
substantial leverage in extracting
concessions (such as waiver of the right
to appeal sentences) when negotiating
pleas, because of the severity of the
Guidelines and the government’s ability
(despite its stated policy not to do this) to
“fact-bargain” over enhancements. Now,
however, courts are free to impose
sentences lower than the Guidelines
range based on a wide variety of
grounds that might not have qualified for

Whether judges will opt to employ their new-found
freedom and what weight they will give to the
“advisory” Guidelines remains to be seen. The
immediate effect of the decision is therefore to make
it much harder for lawyers to advise their clients
about their potential sentencing exposure.
a downward departure under the Guidelines (e.g., compulsive gambling disorder, defendant’s difficult upbringing or abuse suffered as a child, charitable works, difficult but not “extraordinary” family circumstances that would be exacerbated should the defendant be incarcerated, prompt payment of restitution, etc.). Thus, defendants have little incentive to enter agreements stipulating to particular Guidelines ranges. Any potential concessions by the government on Guidelines issues will carry less weight, given the judges’ increased discretion under Booker, and defendants will not want to waive the ability to argue for lower sentences based on the SRA factors.

In addition, when the Guidelines were binding, defendants had certainty about the advantages a plea could bring. The Guidelines virtually guaranteed a defendant who pleaded guilty a two or three-point reduction in offense level. Now it is less clear how much of a benefit judges will afford defendants for pleading guilty. Thus, more defendants will likely take their chances at trial.

Booker even more dramatically chills defendants’ incentives to cooperate with the government. Previously, cooperation agreements presented an alternative to the harsh reality of the Sentencing Guidelines, because the government could offer to file a motion for a downward departure that would release the judge from the Guidelines. It was the only sure way out of severe Guidelines sentences. Not surprisingly, in some districts 30 percent to 40 percent of defendants were cooperating with the government. That number is likely to go down dramatically after Booker. Now, defendants can refuse to cooperate and still have hope that a judge will acknowledge any mitigating factors that might exist and deviate from what seems like an unduly severe sentence.

Although Booker’s impact on securities litigation defendants depends both on how courts interpret the mandate that the Guidelines be “advisory” and the individual tendencies of judges to depart from them, it will ultimately depend on how Congress responds to Booker. As the Court’s remedial opinion says, “The ball now lies in Congress’ court.” For the moment, Congress has not rushed to enact new legislation, perhaps to allow some time to assess the judicial response to Booker. If Congress ultimately chooses to maintain some of the judiciary’s newfound discretion, it might simply impose a system of statutory minimums above which judges have full discretion. However, assuming that Congress prefers to limit judicial discretion as it did with the Guidelines, it may instead opt for a new regime which will require that all facts necessary for sentencing be proven to a jury, either at trial or at a sentencing hearing. Until such a system is installed, however, securities litigation defendants must give even more deference to the tendencies of the specific presiding judge when making strategic decisions regarding plea bargaining.

Endnotes
1 Tom Fowler, “Length of sentence at issue; Supreme Court decision changes rules, lawyer says - Ex-Dynegy official's appeal seeks shorter term,” Houston Chronicle (Feb. 1, 2005).
3 Justice Ginsburg provided the swing vote and was the only justice to join both majority opinions.
4 Interestingly, although the Enron Nigerian Barge court held a sentencing hearing before a jury in November, and the jury determined that the fraud amounted to $13.7 million, the court recently declared that hearing moot in light of Booker. This raises the possibility that the judge might find that the fraud amounted to either a greater or lesser amount, or not make any finding whatsoever. See Mary Flood, “Prosecutors go along with Skilling on trial date,” Houston Chronicle (Feb. 1, 2005).
Recent and Upcoming Seminars and Speaking Engagements

• Partner Laurie Smilan (NOVA) participated in a panel discussion entitled “Judicial Developments” at the 32nd Annual Securities Regulation Institute on January 21 in San Diego and on February 16 she participated in a Strafford Publications teleconference entitled “Is the PSLRA Safe Harbor Provision Really Safe?” Ms. Smilan also participated in the 2005 Risk and Insurance Management Society Annual Conference from April 18-20 in Philadelphia. In addition, she will be a featured speaker at the SEC Institute’s seminar on SEC Enforcement and Litigation on May 27 in Pentagon City and PLI’s 2005 Audit Committee Workshop on June 15 in New York.

• Partner Paul Dawes (SV) was a co-chair and featured speaker at Glasser Legal Works’ 14th Annual Litigation and Resolution of Class Actions Institute held in San Francisco from January 27-28. Mr. Dawes was also a featured speaker on a panel entitled “What Clients Want: How Litigation Counsel Choose Law Firms and Lawyers” at the 2005 Marketing Partner Forum on January 20 in San Diego.

• Partner Jay Pomerantz (SV) participated in a panel entitled “Electronic Discovery” at Glasser Legal Works’ 14th Annual Litigation and Resolution of Class Actions Institute on January 27 in San Francisco.

• Partner Pam Palmer (LA) and associate Robert Malionek (NY) participated in a meeting of the ABA Task Force on the Attorney-Client Privilege on February 10 in Salt Lake City. On February 11, Ms. Palmer provided testimony regarding the tension between public companies and their auditors with respect to privileged information at a public hearing held by the Task Force.

• Associate Robert Malionek (NY) served as moderator of a panel discussion for The American Lawyer and D&O Advisor entitled “The Changing Relationships Among the Board, the In-House Counsel and the Executive Management Team” at the Harvard Club in New York on February 16.

• Partner Jamie Wine (LA) was a featured speaker at the PricewaterhouseCoopers Leadership Forum on Intellectual Property and Complex Litigation on February 17 in Palm Springs. In addition, Ms. Wine participated on a panel presentation with a securities class action attorney entitled “Discovery and Communication Issues” at CLE’s International seminar on Class Actions on February 24 in Los Angeles.


• Partner William Baker (DC) participated in a Healthcare Compliance Certification Program entitled “Sarbanes-Oxley and Healthcare Compliance: Attorney Reporting and Responding to Whistleblowers” from Feb 28-March 3 at Seton Hall University. Mr. Baker was also a featured speaker at the ABA Section of Business Law Spring Meeting held in Nashville from March 31-April 3.

• Partner John J. Huber (DC) appeared as a panelist on the Securities and Exchange Commission’s Roundtable on Implementation of Internal Control Reporting Provisions of Sarbanes-Oxley Section 404, on April 13 in Washington, D.C.

• Partners David Brodsky (NY) and William Baker (DC) participated in the 2005 SIA Compliance & Legal Division Annual Seminar from April 3–6 in Palm Desert. Mr. Brodsky also participated as a co-chair at the 3rd National Corporate Counsel’s Guide to Conducting and Managing Internal & External Investigations, a program hosted by the American Conference Institute, from April 18-19 in New York.

• Partner Peter Benzian (SD) will speak at the next “Select Topics For Trial Lawyers: Class Actions in California” seminar on August 26 in San Diego. The seminar is sponsored by Lorman Education Services.
determination on class certification? (2) Does the American Pipe tolling apply only to intervening plaintiffs or also to plaintiffs filing an entirely new suit in a different forum? (3) Does tolling apply only to plaintiffs asserting individual claims or can new plaintiffs bring new class claims? (4) How does a subsequent court determine whether the rejection of a class under Rule 23 was based on deficiencies of the class or the class representative?

**Does Tolling Terminate Upon Initial Rejection of The Class or Not Until a Final Determination on Class Certification?**

Absent tolling, the limitations period would have expired long before the plaintiffs brought their action. The statute of limitations for securities fraud (which at the time was one year) begins to run either upon discovery of the untrue statement or after such discovery should have been made by the exercise of reasonable diligence. Tolling began on the date that the Georgia action was filed, and the defendants contended that the tolling ended after the Georgia court’s initial rejection of class certification. Because the plaintiffs did not bring their action within one year of discovery, if the tolling period extended only until the Georgia court’s initial denial of class certification, the defendants argued that the plaintiffs’ claims before the New Jersey District Court were barred. The Third Circuit disagreed and instead found that the tolling period did not end until the Georgia court denied with prejudice a second attempt to obtain class certification, six months later, thus making the plaintiffs’ claims timely.

**Does the American Pipe Tolling Apply Only to Intervening Plaintiffs or Also to Plaintiffs Filing an Entirely New Suit In a Different Forum?**

The Third Circuit interpreted American Pipe to mean that tolling applies to plaintiffs filing a new case in a different forum as well as to intervenors. The Third Circuit noted that the Supreme Court in American Pipe had reasoned that because a defendant is on notice once a class complaint is filed of “the need to preserve evidence and witnesses respecting the claims of all the members of the class . . . tolling the statute of limitations thus creates no potential for unfair surprise, regardless of the method class members choose to enforce their rights upon denial of class certification.” The defendants argued that such an expansion of American Pipe could lead to forum shopping. Indeed, the plaintiffs admitted that they filed their new case in New Jersey instead of intervening in Georgia for the purpose of avoiding unfavorable Eleventh Circuit precedent on the statute of limitations issue.

Nonetheless, the Third Circuit concluded that there was no principled basis to limit American Pipe to intervenors.

**Does Tolling Apply Only to Plaintiffs Asserting Individual Claims or Can New Plaintiffs Bring New Class Claims?**

In deciding whether tolling should be limited to individual claims or extended to new class claims, the Third Circuit found that its prior decision in McKowan was in part controlling. In that case, an intervenor sought to take over the role of lead plaintiff after the Third Circuit had found that the original lead plaintiff was not adequate under Rule 23. The McKowan court held that tolling should apply because the intervenor “was not attempting to resuscitate a class that a court held to be inappropriate as a class action and that the class certification motion had not been rejected because of [lead plaintiff’s] deficiencies as a class representative.” The Third Circuit held in McKowan that “American Pipe tolling applies to would-be class members who file a class action following the denial of class certification due to Rule 23 deficiencies of the class representative,” but that American Pipe would not apply to “sequential class actions where the earlier denial of certification was based on a Rule 23 defect in the class itself.”

Having analyzed its earlier decision in McKowan, the Third Circuit in Yang noted that most circuits that have addressed this
issue had not dealt with whether the defect was with the class representative or the class itself. For instance, the First, Second and Fifth Circuits are in agreement with the Third Circuit that if a prior court had found defects in the class itself, tolling would not apply but were silent as to what happens if the defect is with the class representative.\(^2\)

As the court explained, only the Ninth and Eleventh Circuit 5 have addressed the specific circumstance at issue in Yang. The Eleventh Circuit denies tolling to all subsequent class plaintiffs regardless whether the original class was denied for a defect with the class or just the representative.\(^3\) The Third Circuit specifically rejected this approach because it was overbroad, relied on overruled authority and was contrary to policy encouraging class actions in order to avoid numerous individual suits.

Instead, the Third Circuit followed the Ninth Circuit in Catholic Social Servs., Inc. v. I.N.S., 232 F.3d 1139 (9th Cir. 2000) (en banc). In Catholic Social Services, the Ninth Circuit abandoned prior precedent and permitted class certification for a subsequent class where the original class was abrogated because of a new statute. The Third Circuit acknowledged that there were some factual and procedural differences between Yang and Catholic Social Services and that its reading of Catholic Social Services was broad, but it placed great reliance on the fact that several district courts in California had applied tolling to subsequent class claims where the original class had been denied based solely on the sufficiency of the prior class representative, as opposed to defects in the class itself. The Third Circuit thus concluded that the reasoning of Catholic Social Services was applicable to extend tolling where class certification is denied because of the class representative’s defects.

**How Does a Subsequent Court Determine Whether the Rejection of a Class Under Rule 23 Was Based on Deficiencies of the Class or the Class Representative?**

The Third Circuit then addressed the three subclasses at issue, finding that for two of the subclasses the statute of limitations should be tolled for new class claims. Its decision was based in large part on the reasons given by the Georgia District Court for rejecting each of the three subclasses. As to the Telco merger class, the Georgia court found that the proposed class representative was not typical of the class members because of when he sold his stock. Thus, the defect plainly was with the representative, and tolling was permitted. As to the NACT merger class, the Georgia court found that the class failed the numerosity requirement of Rule 23. Accordingly, tolling was precluded for class claims because the defect was with the class itself. The Third Circuit analyzed the Open Market class in depth. The opinion of the Georgia court noted that the proposed lead plaintiff was not suitable because he would have particular problems trying to show reliance, based on when he purchased his stock. In fact, it found that the lead plaintiff’s claims might be directly at odds with the class he sought to represent. However, the Georgia court specifically stated that it denied class certification because the lead plaintiff failed to “meet his burden with regard to the typicality, commonality, adequacy, and superiority requirements.” Despite the use of language commonly used to describe defects with a class, the majority looked behind the court’s statement to conclude that the deficiencies were only with the representative and, therefore, tolling should apply.\(^4\)

**Conclusion**

In general, Yang establishes that tolling will apply to subsequent plaintiffs where a class has not been certified because of deficiencies with the class representative. The case is significant because the circuits are now split on American Pipe tolling. Under the Third Circuit’s decision, rejected plaintiffs who can argue that their class was denied for problems with the class representative may get another bite at the apple in the Third Circuit under Yang. Because of this broad rule, the Third Circuit may become a haven for plaintiffs seeking to revive class claims lost at the class certification stage. To avoid this result, where applicable, it is critical to obtain a clear ruling from the court denying class certification that its decision was based on class, as opposed to representative, defects.

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**Endnotes**

1. Once class certification is denied, the Eleventh Circuit does not permit intervening plaintiffs to bring new class claims, but instead limits them to individual claims. See Griffin v. Singletary, 17 F.3d 356 (11th Cir. 1994).

2. Basch v. Ground Round, Inc., 199 F.3d 6 (1st Cir. 1998); Korwek v. Hunt, 827 F.2d 874 (2nd Cir. 1987); Salazar-Calderon v. Presidio Valley Farmers Ass’n, 765 F.2d 1334 (9th Cir. 1985).


4. Judge Alito, concurring in part and dissenting in part, agreed with the overall holding that the class claims should be tolled if there are deficiencies with the class representative. However, he wrote that the Open Market class claims should not have been tolled because the Georgia District Court’s opinion stated that certification had been denied based on defects with the class and not with the lead plaintiff. Judge Alito thought it unwise to go beneath the language used by the district court and attempt to distill what the court might have meant, as opposed to what it said.
theory of reliance on analyst statements to allege predominance of common issues for the class under Fed. R. Civ. P. 23(b)(3), and next considered the issue of what evidentiary burden the plaintiffs must meet at the class certification stage. Although recognizing that in Basic v. Levinson, 485 U.S. 224 (1988), the Supreme Court held that plaintiffs may succeed on §10(b) claims under a fraud-on-the-market theory of reliance based on allegations that false and misleading statements by the issuer of the securities artificially inflated their price, the court determined that analysts are situationally distinguishable from issuers and thus the showing required for class certification was not controlled by Basic.

The court noted that, while the Second Circuit has yet to decide what evidentiary showing, if any, the plaintiff must make at the class certification stage for the Basic presumption to apply to analyst statements, see Hevesi v. Citigroup, Inc., 366 F.3d 70, 79 (2d Cir. 2004), other decisions from the Southern District of New York have reached varying results on analyst cases. See DeMarco v. Lehman Bros., 222 F.R.D. 243, 247 (S.D.N.Y. 2004) (requiring a higher showing by plaintiffs in claims against analysts, by allowing fraud-on-the-market reliance only with a prima facie showing that the analyst's statements materially impacted the market price); In re WorldCom Sec. Litig., 219 F.R.D. 267, 300 (S.D.N.Y. 2003) (holding fraud-on-the-market reliance sufficient to certify class with no holding of an evidentiary burden). The court in Robertson Stephens held that a prima facie showing of material impact on market price caused by the analysts' statements – which was the higher showing required of plaintiffs in the DeMarco case – was not required. The court concluded that such a higher showing would run contrary to the principle that merits determinations are not required at the certification stage. Based on the mix of "market activity evidence, logical arguments," and studies on the influence of analyst statements, Judge Lynch held that plaintiffs made "some showing" of a common legal and factual argument of reliance for the class, and this was sufficient to justify class certification.

Second Circuit

In In re WorldCom, Inc. Securities Litigation, 2004 U.S. Dist. LEXIS 25155 (S.D.N.Y., Dec. 22, 2004), the Southern District of New York provided the most extensive judicial interpretation yet of the “due diligence” and “reliance” defenses provided to underwriters accused of violating their responsibilities with respect to statements in a prospectus or registration statement under the Securities Act of 1933. Responding to claims of liability under Sections 11 and 12 of the 1933 Act for inaccuracies in WorldCom’s registration statements in 2000 and 2001, WorldCom’s underwriters moved for summary judgment on their affirmative due diligence defense. Specifically, the underwriters argued that their reliance on audited financial statements and accountants’ comfort letters relieved them of any need to perform due diligence, and even if and where required to perform due diligence, they did so adequately as a matter of law by relying on management communications and their assessments of WorldCom’s risks based on their overall knowledge of the company.

As established by past precedent, to take advantage of the “reliance defense,” an underwriter must demonstrate that the

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allegedly misleading statement was made “on the authority of an expert” and the underwriter must have had “no reasonable ground to believe and did not believe … that the statements therein were untrue or that there was an omission to state a material fact.” The court in WorldCom explained that an accountant qualifies as an “expert” under the 1933 Act, but only that audited financial statements are “expertised” portions of a registration statement, not comfort letters given by auditors based on their review of a company’s financial information subsequent to the last audited financial statements. The underwriters thus could not establish a “reliance” defense based upon the comfort letters. Even with respect to the audited financial statements, however, the court determined that an underwriter may not rely upon such “expertised” statements when there was a “reasonable ground to question the reliability” of the audited financial statements. The court determined that a discrepancy between WorldCom’s line costs, as reported in its financial statements, and the line costs of WorldCom’s competitors, in addition to WorldCom’s decision to not take impairment charges to its networks despite declines in the telecommunications industry, were both “red flags” that a jury might determine to have created an additional duty on the part of the underwriters to inquire.

The “due diligence defense,” which relates to non-expertised portions of a registration statement such as unaudited financial statements, requires a defendant to prove that it had, “after reasonable investigation, reasonable ground to believe and did believe … that the statements therein were true and that there was no omission to state a material fact.” Though the Court noted the lack of a “rigid rule” for determining reasonableness, it concluded that a comfort letter alone is insufficient. The Court noted the following actions that may be important to establishing the reasonableness of an underwriters’ investigation: (1) verifying management’s representations; (2) investigating beyond “merely…listening to management’s explanations of the company’s affairs” and being the “devil’s advocate”; and (3) completing a “careful review of the issuer’s financial statements and important contracts.” The court warned that if the issuer utilized “aggressive or unusual accounting strategies,” reasonableness might require the underwriter to consult with an accounting expert. The court examined, and found wanting, the underwriters’ “cursory” inquiries, limited discussions with WorldCom and its auditors and general failure to “inquire” into issues of public prominence, and concluded that questions of fact existed as to the reasonableness of the underwriters’ investigation. The court felt that the “enormity” of the underlying $16 billion bond offerings and the “general deterioration” of WorldCom’s financial statements warranted a “particularly probing inquiry by a prudent underwriter” acting as if this were its own property. The court denied the underwriters’ summary judgment motion, and the decision will certainly have far-reaching implications both for litigating the due diligence defense and, more practically, for the method by which underwriters will perform future due diligence on all aspects of a prospectus or registration statement.

Second Circuit

In Lentell v. Merrill Lynch & Co., No. 03-7948, --- F.3d ----, 2005 WL 10744 (2d Cir. Jan. 20, 2005), the lead plaintiffs for a putative class of investors in two internet companies sued Merrill Lynch and one of its research analysts under Section 10(b) of the Exchange Act and Rule 10b-5. The investors alleged that Merrill Lynch and the analyst recommended falsely optimistic recommendations to purchase the companies’ stock because this would help Merrill cultivate its investment banking clients. The investors appealed the dismissal of their claims. The Court addressed two relevant issues: loss causation and statute of limitations.

First, the court affirmed the district court’s dismissal because the investors failed to plead loss causation adequately. The investors alleged that they relied upon Merrill Lynch’s reports of the integrity of the market in which they purchased stock and that the stock later became worthless, but they failed to “allege facts that support an inference that Merrill’s misstatements and omissions concealed the circumstances that
bear upon the loss suffered.” Specifically, the investors included “no allegation that the market reacted negatively to a corrective disclosure regarding the falsity of Merrill’s . . . recommendations and no allegation that Merrill misstated or omitted risks that did lead to the loss.” This was insufficient to plead loss causation under Second Circuit precedent.

Second, the court considered whether a series of well-publicized articles describing the conflicts of interest within Merrill Lynch were sufficient to put the investors on inquiry notice and begin the limitations period. It concluded that they did not, reversing the district court’s decision on this point. The court held that “[c]onflicts of interest present opportunities for fraud, but they do not, standing alone, evidence fraud,” and thus because the articles did not not state that Merrill Lynch was issuing false analysts’ reports or recommendations, the investors were not put on inquiry notice regarding alleged misrepresentations.

**Eighth Circuit**

In *Ferris, Baker Watts, Inc. v. Ernst & Young, LLP*, Case No. 04-1064 (8th Cir. Jan. 21, 2005), the Eighth Circuit affirmed the district court’s dismissal of a Section 10(b) claim against Ernst & Young (“E&Y”), holding that allegations of a “poor audit” are insufficient, standing alone, to raise a strong inference of scienter.

Ferris, Baker Watts, Inc. (“FBW”) sued E&Y based on E&Y’s audit of MJK Clearing, Inc. (“MJK”), a broker-dealer. MJK had paid $160 million in cash to another broker-dealer, Native Nations Securities, Inc., as collateral for borrowed securities, primarily for three thinly traded securities. MJK in turn lent shares of one such entity to FBW in exchange for approximately $20 million in cash collateral. When the price of one of those securities collapsed, Native Nations failed to return to MJK the $160 million in cash collateral it owed MJK, causing MJK to collapse. As a consequence, FBW was unable to reclaim $20 million in cash collateral that it had paid MJK.

Because the district court dismissed FBW’s Section 10(b) and Rule 10b-5 claims against E&Y for failing to allege scienter sufficiently, this was the sole issue on appeal. The Eighth Circuit reaffirmed its previous holdings that a court should disregard all “blanket” assertions that do not meet the particularity requirements of the Private Securities Litigation Reform Act (“PSLRA”), because “inferences of scienter had to be both ‘reasonable’ and ‘strong’ to survive a motion to dismiss.”

In arguing that it pled scienter adequately, FBW pointed to its allegations that E&Y had stated falsely that it had conducted the audit in accordance with GAAS even though (1) E&Y knew from its review that there was a complete absence of internal controls at MJK; (2) E&Y failed to investigate whether the $160 million receivable from Native Nations was impaired; and (3) E&Y failed to investigate events between the time of its audit and the time of its issuance of its “clean” audit opinion. In addition, FBW argued that E&Y disregarded GAAP by ignoring risks regarding the receivable from Native Nations, as well as material inadequacies in MJK’s internal controls.

The Eighth Circuit held that “allegations of GAAP violations are insufficient, standing alone, to raise an inference in scienter.” It pointed out that FBW’s own allegations contradicted its assertion that E&Y’s audit was so superficial that it essentially amounted to no audit at all, noting that the complaint stated that E&Y did undertake a series of actions with respect to the receivable as part of its audit.

At most, FBW had alleged only a “poor audit,” and not “the intent to deceive, manipulate, or defraud required for securities fraud.” This was insufficient to survive a motion to dismiss under the PSLRA. The Latham & Watkins team, which assisted E&Y in the appeal, was led by partners Miles Ruthberg and Ethan Brown.
However, in the wake of recent corporate scandals, the protections of the safe harbor are at risk of significant erosion. The Seventh Circuit’s recent decision in Asher v. Baxter International, 377 F.3d 727 (7th Cir. 2004), the district court’s decision on remand in Asher, and the Ninth Circuit’s total failure to apply the safe harbor’s provisions in Nursing Home Pension Fund, Local 144 v. Oracle Corp., 380 F.3d 1226 (9th Cir. 2004), demonstrate disregard for the express language and legislative intent behind the safe harbor.

**Legislative Purpose Underlying The Safe Harbor**

In adopting the Reform Act, Congress found that companies’ assessments of their own future potential were extremely valuable to investors, but that companies’ fear of strike suits subjecting them to liability if their projections turned out to be incorrect was chilling their willingness to disclose such information. Accordingly, Congress enacted the safe harbor provision to encourage disclosure of forward-looking information by providing certainty that forward-looking statements would not be actionable if accompanied by a “meaningful” risk disclosure. Thus, the safe harbor immunizes a forward-looking statement so long as it is “accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.” Further, the safe harbor has a second “prong,” or “alternative inlet,” that immunizes forward-looking statements from liability even if not accompanied by meaningful cautionary language unless the plaintiffs plead particularized facts showing that the defendants made the statements with actual knowledge that they could not be achieved. 15 U.S.C. § 78u-5(c)(1).

**A Brewing Storm: Asher v. Baxter International, Inc.**

A fundamental precept of the immunity provided by the safe harbor is that a company’s risk disclosures need not, in hindsight, have disclosed the “right” risks – i.e., those that ultimately caused the predictions not to come to pass. Congress recognized that a Company ought not to be subject to liability for incorrectly predicting future results, or for failing to predict what risks may cause a projection not to be achieved. Accordingly, Congress required only that the risk factors be “meaningful,” i.e., sufficient to alert investors that a projection is not a guarantee. As the Eleventh Circuit explained in its seminal Harris v. Ivax decision, “When an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward.” 182 F.3d 799, 803 (11th Cir. 1999).

Judge Easterbrook’s recent decision in Asher, if followed, casts grave doubt – at least in the Seventh Circuit – on whether companies can confidently continue to rely on the safe harbor when making financial projections and predictions of future performance. In Asher, shareholders of Baxter International brought suit against the company after its stock dropped on the announcement of disappointing financial results. The plaintiffs alleged that Baxter’s forecasts were misleading because, at the time they were made, Baxter already knew of the problems which ultimately caused it not to achieve its forecasts.
capitalization; (2) the bid-ask spread of the stock; and (3) the percentage of stock not held by insiders (the “float”).


Generally, none of the above-referenced factors is dispositive. However, as the Fifth Circuit recently held in Unger, even at the class certification phase, a trial court “must engage in thorough analysis, weigh the relevant factors, require both parties to justify their allegations, and base its ruling on admissible evidence.” Thus, according to Unger, the district court must use the factors as an analytical tool – not merely as a checklist – and thoroughly evaluate the significance of factors that disfavor a finding of market efficiency.

Unger serves as as example of the typical efficient market analysis employed by federal courts. In Unger, the defendant’s stock traded on the NASDAQ over-the-counter bulletin board. The Fifth Circuit ruled that the district court failed to evaluate thoroughly whether this stock traded in an efficient market. Instead, the district court relied on bare allegations, one-sided affidavits and unexplained Internet printouts. Moreover, the court failed to evaluate the significance of factors that weighed against market efficiency. Consequently, the Fifth Circuit vacated the class certification order and remanded to the district court for further proceedings.¹

In re PolyMedica Corp. Sec. Litig., 224 F.R.D. 27 (D. Mass. 2004), represents a marked departure from the efficient market analysis embraced by Unger and many other courts. PolyMedica held that an “efficient market” is one in which market prices generally reflect most publicly available information. This standard arguably makes it easier for plaintiffs to avail themselves of the presumption of reliance under the “fraud on the market” theory. The PolyMedica definition of market efficiency is at odds with virtually all other courts that have examined this issue. These other courts have adopted, either explicitly or implicitly, the academic economists’ semi-strong form of market efficiency, as described in Unger.² Under the semi-strong hypothesis, a capital market is efficient if prices incorporate rapidly or promptly all publicly available information.

In PolyMedica, the defendants were alleged to have artificially inflated the price of PolyMedica common stock by materially misrepresenting the company’s sales, revenues and accounts receivable, and by issuing false press releases. The defendants opposed the lead plaintiff’s motion for class certification, arguing, inter alia, that the proposed class could not rely upon the fraud on the market presumption. The defendants argued that economic analysis provided both direct and indirect evidence that, for a significant portion of the proposed class period, the market for PolyMedica’s stock was not efficient. Specifically, the defendants provided evidence of persistent arbitrage opportunities during the proposed class period, something that should not exist in an efficient market. The defendants argued that if the price of a security reflects all material public information, it is not possible to generate arbitrage profits.

The PolyMedica court summarily dismissed the economic evidence of an inefficient market for PolyMedica stock. The court acknowledged that the defendants’ approach closely followed the academic economists’ definition and existing case law. Nevertheless, the court looked to Basic and concluded that the Supreme Court had implicitly rejected using the economic or academic definition of an efficient market. Instead, the PolyMedica court cobbled together various statements from Basic in footnotes and “created” a new definition of market efficiency. The court ruled that an “efficient” market does not have to reflect all publicly available material information rapidly. Rather, it ruled that
an “efficient” market is “simply one in which market professionals generally consider most announced material statements about companies, thereby affecting stock market prices.”

Although concluding that the company’s stock traded in a market that generally considered most publicly available material statements during the applicable period, and thus certifying the class, the PolyMedica court nonetheless evaluated four of the accepted “efficient market” factors. The plaintiff provided evidence of (1) a cause-and-effect relationship between most unexpected corporate events or financial results and an immediate response in the company’s stock prices; (2) an average trading volume of 10 percent of shares outstanding; (3) the existence of 17 reports by four different securities analysts; and (4) significant market capitalization. The PolyMedica court implied that these factors would not have been sufficient to support a finding of market efficiency even under the semi-strong approach. Nevertheless, under its “new” definition, the court concluded that PolyMedica stock traded in an efficient market during the contested time period.

In virtually all other cases, including those with relevant facts similar to those in PolyMedica, courts utilize the academic economists’ semi-strong approach to market efficiency. For example, in Krogman v. Sterritt, 202 F.R.D. 467 (N.D. Tex. 2001), the court concluded that the company’s common stock, which was listed on the NASDAQ over-the-counter bulletin board, did not trade in an efficient market. The court found that a 0.3 percent trading volume and the lack of any reliable relationship between stock price and unexpected company news weighed strongly against finding market efficiency. Moreover, a 5.6 percent bid-ask spread, 46 percent market float and only one market analyst who followed the stock during the relevant time period also suggested market inefficiency. However, the court found that the company’s eligibility to file an S-3 registration statement and its market capitalization in the top 60 percent of NASDAQ, AMEX and NYSE stocks weighed in favor of finding market efficiency. Nevertheless, the court concluded that the company’s stock traded in an inefficient market because most of the factors identified in Cammer and in academic economic literature weighed against the presumption that all publicly available information was incorporated into the price of the stock.

No other courts have yet adopted the PolyMedica market efficiency definition. In one subsequent ruling, the court declined to decide which approach was correct. See In re Initial Pub. Offering Sec. Litig., No. 21 MC 92, 2004 WL 2297401 (S.D.N.Y. Oct. 13, 2004).

Instead, it determined that regardless of whether the academic semi-strong approach or broader PolyMedica definition of market efficiency was applied to the facts of the that case, the outcome would be the same.

In conclusion, not all securities trade in an efficient market. While the PolyMedica decision could make it easier for some plaintiffs to avail themselves of the fraud on the market presumption, a plaintiff must still provide admissible evidence that most of the factors described above favor market efficiency. Otherwise, a plaintiff cannot establish class-wide reliance and her class action securities fraud claims will fail.

Endnotes

1 Other circuits agree that findings of class-wide reliance at the class certification stage must be based on admissible evidence using rigorous, though preliminary, standards of proof. See, e.g., Gariety v. Grant Thornton LLP, 368 F.3d 356 (4th Cir. 2004); Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154 (3d Cir. 2001); Szabo v. Bridgeport Mach., Inc., 249 F.3d 672 (7th Cir. 2001); Binder v. Gillespie, 184 F.3d 1059 (9th Cir. 1999).

2 Many other circuit courts have also adopted this reasoning. See, e.g., Gariety v. Grant Thornton, LLP, 368 F.3d 356 (4th Cir. 2004); Binder v. Gillespie, 184 F.3d 1059 (9th Cir. 1999); Freeman v. Laventhal & Horwath, 915 F.2d 193 (6th Cir. 1990).
Troubled Waters in the Safe Harbor
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raised a strong inference that the statements “were known to be false when made,” the court made no mention of “actual knowledge” as the applicable standard under the safe harbor, instead applying a standard of “deliberate or conscious recklessness.”

Moreover, the Oracle court, like Baxter, was apparently concerned that the ultimate causes of Oracle’s earnings miss might have pre-existed the company’s announcement of its shortfall. The Oracle court concluded that, because Oracle’s senior management said they monitored a computer system that allegedly contained sales figures reflecting the company’s problems, it could be inferred that senior management “must have known” – classic fraud-by-hindsight language – that the forecasts could not be met. As in Asher, this result seems antithetical to the requirement that actual knowledge be shown.

Conclusion—Charting the Shoals of the Safe Harbor

The Seventh Circuit’s Asher decision raises the question of what measures a company can take to protect itself if it desires to continue to provide financial projections to investors. Plainly, thorough and carefully-considered non-boilerplate risk disclosures are required. Moreover, it may be advisable specifically to identify the risks disclosed as themselves being predictions, adding language that risks are “among the primary risks we foresee at the present time.” Most importantly Asher counsels that companies must update their risk disclosures to reflect changing conditions. Although potentially daunting, it is nonetheless good practice to evaluate and update the company’s risk warnings every time a press release or public filing is issued.

Oracle and the district court’s Asher decision on remand are dangerous because it is almost always possible, with the benefit of hindsight, to identify information that could have led management to determine, at an earlier point in time, that its forecasts would not be achieved. Congress intended the safe harbor’s two prongs to prevent just that sort of second-guessing. Hopefully, subsequent courts will be more faithful to the statute’s intent.