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**PLEADING SECURITIES FRAUD CLAIMS – ONLY PART  
OF THE STORY**

**Marc I. Steinberg\***

I wish to thank the Loyola University Chicago School of Law for inviting me to present at its Annual Institute for Investor Protection. In particular, I extend my appreciation to Professor Michael Kaufman for his friendship and support throughout the decades of our academic careers as well as to Professors Charles Murdock and Steven Ramirez for their courtesy.

*The Current Landscape*

This year's topic focuses on effective and ethical pre-filing strategies for investigating and pleading securities fraud class action claims. This is an important subject in the field of securities litigation. The failure to survive a motion to dismiss based on deficient pleading of claims alleged in a federal securities class action results in the end of the litigation (when such motion is granted with prejudice).<sup>1</sup>

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<sup>1</sup> See Section 21D(b) of the Securities Exchange Act (setting forth pleading requirements in private actions brought for alleged violation of that Act); Rule 9(b) of the Federal Rules of Civil Procedure (requiring that fraud be pleaded with particularity); Rule 12(b)(6) of the Federal Rules of Civil Procedure (seeking a court order to dismiss the complaint “for failure to state a claim upon which relief may be granted”).

The option to institute the class action in state court ordinarily is unavailable: The Securities Litigation Uniform Standards Act (SLUSA)<sup>2</sup> generally preempts state law with respect to securities class actions<sup>3</sup> involving nationally traded securities<sup>4</sup> (with the exception of specified misconduct in the context of tender offers, going private transactions, mergers, and the exercise of appraisal

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<sup>2</sup> Pub. L. No. 105-353, 112 Stat. 3227 (1998). See H.R. Rep. No. 105-803, 105<sup>th</sup> Cong., 2d Sess. (1998).

<sup>3</sup> Class actions are defined more broadly under SLUSA than under Rule 23 of the Federal Rules of Civil Procedure. Pursuant to SLUSA, a “covered class action” means:

- (i) any single lawsuit in which –
  - (I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or
  - (II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or
- (ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which –
  - (I) damages are sought on behalf of more than 50 persons; and
  - (II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

Section 101 of SLUSA, *amending*, § 16(f)(2)(A) of the Securities Act and § 28(f)(5)(B) of the Exchange Act.

<sup>4</sup> The term “nationally traded security” or “covered security” is defined as a security that meets the standards set forth in Section 18(b) of the Securities Act. These securities include those that are listed for trading on the New York Stock Exchange and the Nasdaq Stock Market (NMS). Securities issued by registered investment companies also are defined as nationally traded securities.

rights).<sup>5</sup> As a consequence, except for alleged improprieties in the merger and acquisition setting, securities class actions filed in state court arise today only with respect to securities that are not nationally traded.<sup>6</sup> Accordingly, with respect to nationally traded companies, plaintiffs ordinarily are relegated to instituting solely derivative and individual actions in state court alleging state law and concurrent federal law causes of action.<sup>7</sup>

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<sup>5</sup> See Section 101 of SLUSA, *amending*, Section 16(d)(1) of the Securities Act and Section 28(f)(3)(A) of the Exchange Act. In addition, SLUSA excludes from federal preemption suits instituted by a state, a political subdivision thereof, or a state pension plan provided that such state, political subdivision thereof, or state pension plan is named as a plaintiff in such action and has authorized its participation in such action. See Section 101 of SLUSA, *amending*, Section 16(d)(2) of the Securities Act and Section 28(f)(3)(B) of the Exchange Act. As another exception, “a covered class action that seeks to enforce a contractual agreement between an issuer and an indenture trustee may be maintained in a State or Federal court by a party to the agreement or a successor to such party.” Section 101 of SLUSA, *amending*, Section 16(d)(3) of the Securities Act and Section 28(f)(3)(C) of the Exchange Act.

<sup>6</sup> See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006) (holding that SLUSA preempts state law holder class action claims of the type alleged in the complaint at bar). See generally J. Hamilton & T. Trautmann, *Securities Litigation Uniform Standards Act of 1998: Law and Explanation* (CCH 1998); Casey, *Shutting the Doors to State Court: The Securities Litigation Uniform Standards Act of 1998*, 27 Sec. Reg. L.J. 141 (1999); Levine & Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California Blue Sky Laws*, 54 Bus. Law. 1 (1998); Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 Cornell L. Rev. 1 (1998).

<sup>7</sup> See Section 101 of SLUSA, *amending*, Section 16(f)(2)(B) of the Securities Act and Section 28(f)(5)(C) of the Exchange Act (stating that “the term ‘covered class action’ does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation”). For the definition of “covered class action,” see note 3 *supra*. The Securities Act allows for concurrent jurisdiction while the Securities Exchange Act provides exclusive federal court jurisdiction. See Section 22(a) of the Securities Act; Section 27(a) of the Exchange Act.

As another obstacle, the heightened “strong inference” pleading requirement set forth in the Private Securities Litigation Reform Act of 1995 (PSLRA)<sup>8</sup> obligates a plaintiff in a securities fraud action to plead “with particularity both the facts constituting the alleged violation, and the facts evidencing scienter, i.e., the defendant’s intention ‘to deceive, manipulate, or defraud.’”<sup>9</sup> When undertaking this task, a court must assess not only the inferences drawn by the plaintiff but also competing inferences that rationally arise from the facts alleged in the complaint.<sup>10</sup>

As the Supreme Court reasoned:

An inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant’s conduct. To qualify as

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<sup>8</sup> Pub. L. No. 104-67, 109 Stat. 737 (1995).

<sup>9</sup> *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007). A plaintiff instituting a securities fraud action under Section 10(b) of the Securities Exchange Act, pursuant to the PSLRA, must adhere to the following:

- (1) A requirement that a plaintiff in the complaint in any private securities fraud action alleging material misstatements and/or omissions “specify each statement alleged to have been misleading; the reason or reasons why the statement is misleading; and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”
- (2) A requirement that in any private action under the 1934 Act in which the plaintiff “may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each such act or omission alleged to violate the [1934 Act], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”

Section 21D(b)(1)-(2) of the Securities Exchange Act.

<sup>10</sup> *Tellabs*, 551 U.S. at 322-23.

“strong” within the intendment of [the PSLRA], we hold, an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.<sup>11</sup>

These heightened pleading requirements, as well as the enhanced “plausibility” pleading standard embraced by the Supreme Court with respect to non-fraud claims,<sup>12</sup> signify that fewer securities class actions will survive the motion to dismiss stage. With the PSLRA’s mandate that (absent exceptional circumstances) all discovery must be stayed pending the subject court’s decision

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<sup>11</sup> *Id.* at 314. Notably, the collective scienter and group published doctrines have been rejected by the majority of lower courts, making the plaintiff’s task to plead fraud under the PSLRA with the requisite particularity against corporate insiders more difficult. The group published doctrine provides that statements contained in group-published documents, such as periodic SEC reports filed by an issuer, are attributable to officers and directors who have daily involvement in normal company operations. For cases rejecting the group published doctrine, see, e.g., *Winer Family Trust v. Queen*, 503 F. 3d 319, 337 (2d Cir. 2007) (citing cases rejecting group published doctrine); *Southland Securities Corp. v. InSpire Insurance Solutions, Inc.*, 365 F. 3d 353, 364-65 (5<sup>th</sup> Cir. 2004). Likewise, the collective scienter theory has been largely rejected. See, e.g., *Pugh v. Tribune Co.*, 521 F. 3d 686, 697 (7<sup>th</sup> Cir. 2008) (opining that “the corporate scienter inquiry must focus on the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation’s officers and employees”). But see *Glazer Capital Management LP v. Magistri*, 549 F. 3d 736, 744 (9<sup>th</sup> Cir. 2008) (stating that “in certain circumstances, some form of collective scienter might be appropriate”).

<sup>12</sup> The liberal “no set of facts” pleading standard embraced by the Supreme Court in *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957), for non-fraud claims (under Rule 8(a)(2) of the Federal Rules of Civil Procedure) has been abandoned by the Court in favor of plausibility pleading that requires claimants to plead “enough facts to state a claim for relief that is plausible on its face.” *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 575 (2007) (Stevens, J., dissenting). See the majority opinion in *Bell Atlantic*, 550 U.S. at 548-70; *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009). See generally Steinberg & Gomez-Cornejo, *Blurring the Lines Between Pleading Doctrines: The Enhanced Rule 8(a)(2) Plausibility Standard Converges With the Heightened Fraud Pleading Standards Under Rule 9(b) and the PSLRA*, 30 Rev. Litig. 1 (2010).

on a motion to dismiss,<sup>13</sup> plaintiffs frequently are challenged to marshal the requisite facts and strong inference of fraudulent intent to proceed with the litigation.

### *Statistical Evidence*

Statistics illustrate this challenge as securities class actions are dismissed with regularity by the federal district courts. For example, in 2012, 47% of motions to dismiss were granted.<sup>14</sup> In addition, 17% of these motions were granted (and denied) in part, 5% were granted without prejudice, and 15% were voluntarily dismissed by claimants. Taking into account that 14% of motions to dismiss were denied in their entirety (plus the 17% of cases in which motions were denied in part), that signifies that approximately 31% of federal securities class actions proceeded in 2012 beyond the motion to dismiss stage.<sup>15</sup>

### *Misleading Import of the Statistics*

These numbers are misleading – perhaps for a surprising reason: They are *artificially low* due to the fact that plaintiffs today institute federal securities class

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<sup>13</sup> Section 21D(b)(3)(B) of the Securities Exchange Act.

<sup>14</sup> NERA Economic Consulting, Recent Trends in Securities Class Action Litigation: 2012 Full-Year Review at 16 (Jan. 29, 2013).

<sup>15</sup> *Id.* at 16-17. Admittedly, these percentages add up to 98% rather than 100%. Note that these percentages are taken from the NERA Review. See note 14 *supra*. Irrespective of this seeming high percentage of cases that result in dismissal, “over the last 17 years since the PSLRA became law, the annual rate of dismissals has never exceeded the rate of settlements. In 2012, defendants settled 92 cases while achieving a dismissal of 72 cases.” Gibson, Dunn, 2013 Mid-Year Securities Litigation Update at 4 (July 16, 2013).

actions against fewer defendants than prior to the PSLRA's enactment. As contrasted with yesteryear, federal securities class action complaints alleging fraud-based violations (namely, Section 10(b) claims) currently often name only: (1) key executive officers (such as the chief executive officer, chief financial officer, and chief operating officer); (2) the chair of the board of directors; (3) outside directors who serve on key committees (such as the audit or compensation committee) whose alleged misconduct while serving as a committee member caused the improprieties; (4) the auditors (who certified the company's financial statements); and (5) the underwriters (of a subject registered offering).<sup>16</sup> Collateral actors – including attorneys, accountants (who have not certified financial statements), commercial and investment bankers (and their representatives), and consultants – are named as defendants in these class actions on relatively rare occasions.<sup>17</sup>

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<sup>16</sup> With respect to naming outside directors and certain executive officers who do not serve as directors, note that judicial rejection of the group published and collective scienter doctrines render it significantly more difficult for plaintiffs to name these fiduciaries in their class action complaint, particularly in view that all discovery ordinarily is stayed pending the court's ruling on the motion to discuss. See *supra* notes 11, 13 and accompanying text; *infra* notes 18-22 and accompanying text. Further note that Section 10(b) litigation normally is pursued against directors, officers, underwriters, and auditors in a registered offering where the Section 11 remedy is unavailable due to the tracing requirement. See, e.g., *Krim v. pcOrder.com, Inc.*, 402 F. 3d 489 (5<sup>th</sup> Cir. 2005); note 43 *infra*.

<sup>17</sup> Ordinarily, these collateral actors are named as defendants only if they themselves make a statement that is communicated to investors. See *infra* notes 23-48 and accompanying text.



Consequently, although roughly 31% of securities fraud class actions in 2012 passed the motion to dismiss stage, fewer collateral defendants today are subject to Section 10(b) liability exposure. The answer explaining why this eventuality transpired is multifaceted. Its sources are attributable to the PSLRA and the Supreme Court's restrictive interpretations of the federal securities laws.

*Impact of the PSLRA's Stay of Discovery and the Threat of Sanctions*

As discussed earlier, the PSLRA ordinarily stays all discovery until and unless the claimants fend off the defendants' motion to dismiss.<sup>18</sup> Without access to documentary materials, use of interrogatories, and the taking of deposition testimony, the plaintiffs' task to plead fraud with the requisite particularity against collateral actors is difficult. Also pertinent is that the prospect of sanctions being levied under Rule 11 of the Federal Rules of Civil Procedure<sup>19</sup> for the bringing of unwarranted claims has been accentuated by the PSLRA's mandate that the court, upon conclusion of the action, must review the parties' and attorneys' compliance with Rule 11(b) and impose sanctions for such noncompliance.<sup>20</sup> The presumed sanction for filing a complaint that violates Rule 11(b) "is an award to the

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<sup>18</sup> Section 21D(b)(3)(B) of the Securities Exchange Act. See *supra* note 13 and accompanying text.

<sup>19</sup> See Rule 11(c) of the Federal Rules of Civil Procedure.

<sup>20</sup> See Section 21D(c) of the Securities Exchange Act.

prevailing party of all attorney's fees and costs incurred in the entire action.”<sup>21</sup> In view of this reality and Supreme Court decisions discussed below that confine the Section 10(b) liability exposure of collateral actors,<sup>22</sup> there frequently exists a strong disincentive to name collateral actors in securities fraud class actions.

### *Impact of Supreme Court Decisions*

Perhaps surprisingly, the hallmark Supreme Court ruling that significantly limited the liability of collateral actors in securities fraud actions predated the PSLRA. In the *Central Bank of Denver* decision,<sup>23</sup> handed down in 1994, the Supreme Court overturned decades of lower court precedent to hold that aider and abettor liability may not be imposed in private Section 10(b) actions.<sup>24</sup> Applying a strict statutory construction, the Court's focus was on the scope of conduct

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<sup>21</sup> Private Securities Litigation Reform Act Joint Explanatory Statement of the Committee of Conference (1995), *summarizing*, Section 21D(c) of the Securities Exchange Act.

<sup>22</sup> See *infra* notes 23-48 and accompanying text.

<sup>23</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

<sup>24</sup> *Id.* at 192 (Stevens, J., dissenting) (emphasis in original) (“In *hundreds* of judicial and administrative proceedings in every circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5.”). In the PSLRA, Congress made clear that the Securities and Exchange Commission (SEC) may pursue aiders and abettors based on violations of the Securities Exchange Act. See Section 20(e) of the Securities Exchange Act. For a recent SEC enforcement action where the SEC emerged victorious in an action alleging aiding and abetting liability under Section 10(b), see *SEC v. Apuzzo*, 689 F. 3d 204 (2d Cir. 2012). For an article analyzing *Central Bank of Denver* and its ramifications, see Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 *Notre Dame L. Rev.* 489 (1995).

prohibited by the language of Section 10(b).<sup>25</sup> Because collateral actors (such as attorneys, accountants, bankers, and brokers) frequently were named as aiders and abettors in securities fraud actions prior to *Central Bank of Denver*,<sup>26</sup> their continued vulnerability in this context would depend on the parameters of Section 10(b) primary liability as construed by the federal courts.

The *Central Bank of Denver* Court provided a glimmer of hope to investors and the plaintiffs' bar with the following admonition:

The absence of [Section] 10(b) aiding and abetting liability does not mean that secondary actors in the securities market are always free from liability under the Securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller relies may be liable as a primary violator under [Rule] 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.<sup>27</sup>

Invoking this language, plaintiffs asserted, with some success, that collateral actors who labored behind the scenes to orchestrate fraudulent schemes perpetrated by

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<sup>25</sup> 511 U.S. at 173-75.

<sup>26</sup> See, e.g., *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F. 2d 490, 495 (7<sup>th</sup> Cir. 1986); *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.*, 602 F. 2d 478, 484-85 (2d Cir. 1979); *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F. 2d 38, 44-48 (2d Cir. 1988); *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 888-89 (S.D.N.Y. 1978).

<sup>27</sup> 511 U.S. at 191.

primary participants were themselves subject to primary liability under Section 10(b).<sup>28</sup> This success was relatively short-lived.

In two separate decisions, handed down in 2008 and 2011, the Supreme Court eviscerated much of the thrust of its admonition issued in *Central Bank of Denver*. In the first case, *Stoneridge Investment Partners*,<sup>29</sup> alleged financial misconduct was engaged in by Charter Communications and two of its customers/suppliers, Motorola and Scientific-Atlanta. Plaintiffs sued Motorola and Scientific-Atlanta as primary violators of Section 10(b). Concluding that the investing public did not have knowledge of the allegedly deceptive transactions between Charter and the defendants, the Court ruled that the plaintiffs were unable to prove the requisite element of reliance.<sup>30</sup> As the Court reasoned: “[N]o member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts during the relevant times [and that] as a result, [plaintiffs] cannot show a claim upon any of the respondents’ actions except in an indirect claim that

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<sup>28</sup> See, e.g., *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1050 (9<sup>th</sup> Cir. 2006) (stating that a defendant employs a deceptive device within the meaning of Section 10(b) if his/her role “has the principal purpose and effect of creating a false appearance of fact in the furtherance of a scheme to defraud”); *In re Lernout & Hauspie Securities Litigation*, 236 F. Supp. 2d 161, 174-77 (D. Mass. 2003) (finding that where a financial institution engaged in allegedly deceptive transactions as part of a scheme to defraud, private liability exposure exists under Rule 10b-5(a) and (c)).

<sup>29</sup> *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

<sup>30</sup> *Id.* at 159-61.

we find too remote for liability.”<sup>31</sup> Today, after *Stoneridge*, those collateral actors who direct or orchestrate a fraudulent scheme may be primarily liable under Section 10(b) only if investors were aware of the subject collateral actor’s conduct.<sup>32</sup> A consequence of *Stoneridge* is that collateral actors, who unbeknownst to investors orchestrate behind the scenes the perpetration of a fraudulent scheme, will avoid Section 10(b) primary liability.<sup>33</sup>

Although *Stoneridge* was disappointing to investors, there remained a seemingly attractive rationale in the plaintiffs’ arsenal: namely, those collateral actors who knowingly drafted materially false disclosures in securities documents (such as offering materials)<sup>34</sup> or who otherwise provided advice or direction in regard thereto were primary participants within Section 10(b)’s scope.<sup>35</sup> Although

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<sup>31</sup> *Id.* at 159.

<sup>32</sup> See M. Steinberg, *Understanding Securities Law* 318 (5<sup>th</sup> edition 2009) (“Clearly, after *Stoneridge*, such primary liability under Section 10(b) is viable only if investors knew (‘actual or presumed’) of the subject defendant’s allegedly deceptive acts.”).

<sup>33</sup> See, e.g., *Pugh v. Tribune Company*, 521 F. 3d 686 (7<sup>th</sup> Cir. 2008). See generally Black, *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: Reliance on Deceptive Conduct and the Future of Securities Fraud Actions*, 36 Sec. Reg. L.J. 330 (2008).

<sup>34</sup> See, e.g., *Molecular Technology v. Valentine*, 925 F. 2d 910, 917-18 (6<sup>th</sup> Cir. 1991); *Klein v. Boyd*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. 1998), *vacated for rehearing en banc*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,165 (3d Cir. 1998). For court decisions prior to *Janus Capital* holding that drafters of disclosure documents were not subject to Section 10(b) primary liability, see, e.g., *Schatz v. Rosenberg*, 943 F. 2d 485 (4<sup>th</sup> Cir. 1991); *Abell v. Potomac Insurance Co.*, 858 F. 2d 1104 (5<sup>th</sup> Cir. 1988), *reversed on other grounds*, 492 U.S. 914 (1989).

this rationale was rejected by several lower federal courts,<sup>36</sup> it was accepted by numerous other courts.<sup>37</sup> In those latter jurisdictions, invocation of this rationale permitted plaintiffs to state primary Section 10(b) claims against, among others, attorneys, accountants, and investment banks.<sup>38</sup>

Subsequently, in a decision handed down in 2011, the Supreme Court in *Janus Capital*<sup>39</sup> applied a narrow construction in defining the meaning of the word “make” for purposes of primary liability under Rule 10b-5(b) (which makes unlawful the making, directly or indirectly, of a material misrepresentation or half-truth with the requisite scienter).<sup>40</sup> The Court held: “[T]he maker of a statement is the person or entity with ultimate authority over the statement, including its content

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<sup>35</sup> See, e.g., *SEC v. Wolfson*, 539 F. 3d 1249, 1260-61 (10<sup>th</sup> Cir. 2008). Most courts declined to recognize primary Section 10(b) liability premised on the allegedly intentional rendering of deficient advice to issuers. See, e.g., *Ziemba v. Cascade International, Inc.*, 256 F. 3d 1194 (11<sup>th</sup> Cir. 2001); *Wright v. Ernst & Young, L.L.P.*, 152 F. 3d 169 (2d Cir. 1998); *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324 (N.D. Ga. 1988).

<sup>36</sup> See cases cited *supra* notes 34-35.

<sup>37</sup> See cases cited *supra* notes 34-35. For a review of pertinent case law prior to the Supreme Court’s decision in *Janus Capital*, see M. Steinberg, *Securities Regulation: Liabilities and Remedies* § 10.03[2] (2012).

<sup>38</sup> See, e.g., *Molecular Technology v. Valentine*, 925 F. 2d 910, 917-18 (6<sup>th</sup> Cir. 1991); sources cited *supra* notes 34-35, 37.

<sup>39</sup> *Janus Capital Fund, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

<sup>40</sup> Rule 10b-5(b) makes it unlawful for any person, using a means of interstate commerce, “[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . . .” Hence, subsection (b) of Rule 10b-5(b) encompasses misrepresentations and half-truths. Its scope does not reach pure omissions. Omissions come within the scope of Rule 10b-5(a) and (c).

and whether and how to communicate it.”<sup>41</sup> According to the Court, attribution of a statement to a collateral actor constitutes “strong evidence” that the statement was “made” by the actor to whom the statement is attributed.<sup>42</sup> Although this attribution rationale may provide support for subjecting underwriters in registered Securities Act offerings to Section 10(b) primary liability exposure,<sup>43</sup> other collateral actors (such as attorneys, accountants, and consultants) when they advise rather than themselves “speak” to investors are unlikely to come within Section 10(b)’s primary liability net.<sup>44</sup>

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<sup>41</sup> 131 S. Ct. at 2302.

<sup>42</sup> *Id.*

<sup>43</sup> Accordingly, underwriters and placement agents who exercise control over the content of a company’s offering materials may be deemed to have “made” the allegedly materially false statements made therein. See *Scott v. ZST Digital Networks, Inc.*, 896 F. Supp. 2d 877, 889-91 (C.D. Cal. 2012); *In re National Century Financial Enterprises, Inc.*, 846 F. Supp. 2d 828, 861-62 (S.D. Ohio 2012). But see *SEC v. Tambone*, 597 F. 3d 436 (1<sup>st</sup> Cir. 2010) (en banc).

Note that, even in Securities Act registered offerings, Section 10(b) is sought to be invoked in securities class actions (in addition to Section 11 of the Securities Act) due to two main reasons: the longer statute of limitations for Section 10(b) claims; and the onerous tracing requirements that must be met under Section 11 for purchasers who acquired their shares in the secondary trading markets. See Steinberg & Kirby, *The Assault on Section 11 of the Securities Act: A Study in Judicial Activism*, 63 Rutgers L. Rev. 1 (2010).

<sup>44</sup> See, e.g., *SEC v. Garber*, 2013 WL 1732571 (S.D.N.Y. 2013); *In re DVI Inc. Securities Litigation*, 2013 U.S. Dis. LEXIS 8834 (E.D. Pa. 2013); *Louisiana Municipal Police Employees Retirement System v. KPMG, LLP*, [2012-2 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,993 (N.D. Ohio 2012).

As a generalization, after *Janus Capital*, the inquiry ordinarily focuses on whether a subject defendant-officer “made” the allegedly materially misstatement(s) under Rule 10b-5(b) or engaged in deceptive conduct coming within Rule 10b-5(a) and (c). See, e.g., *SEC v. Sells*, [2012-2 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,975 (N.D. Cal. 2012); *Sawant v.*

As a result, such collateral actors ordinarily are subject to Section 10(b) primary liability exposure only when they make an affirmative statement to investors, such as the issuance of an attorney opinion letter,<sup>45</sup> an auditor opinion in a prospectus or SEC annual report (Form 10-K),<sup>46</sup> or a fairness opinion issued by an investment banker.<sup>47</sup> In other contexts, unless a collateral actor (whose role is known to investors) orchestrates a scheme to defraud that goes beyond the representations communicated to investors,<sup>48</sup> primary Section 10(b) liability exposure will not prevail.

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Ramsey, [2012-2 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,967 (D. Conn. 2012); Hawaii Ironworkers Annuity Trust Fund v. Cole, 2011 WL 3862206 (N.D. Ohio 2011); In re Merck & Co. Inc. Securities, Derivative & ERISA Litigation, 2011WL 3444199 (D.N.J. 2011).

<sup>45</sup> See, e.g., Thompson v. Paul, 547 F. 3d 1055, 1063 (9<sup>th</sup> Cir. 2008); Rubin v. Schottenstein, Zox & Dunn, 143 F. 3d 263, 266-68 (6<sup>th</sup> Cir. 1998); Trust Company of Louisiana v. N.N.P. Inc., 104 F. 3d 1478, 1490 (5<sup>th</sup> Cir 1997); Kline v. First Western Government Securities, Inc., 24 F. 3d 480, 491 (3d Cir. 1994); Ackerman v. Schwartz, 947 F. 2d 841, 848 (7<sup>th</sup> Cir. 1991). See generally M. Steinberg, *Attorney Liability After Sarbanes-Oxley* §§ 2.05, 11.03 (2012).

<sup>46</sup> See, e.g., Cooper v. Pickett, 137 F. 3d 616, 621 (9<sup>th</sup> Cir. 1997); McIntire v. China MediaExpress Holdings, Inc., 2013 WL 752954 (S.D.N.Y. 2013).

<sup>47</sup> See, e.g., Hershkowitz v. Nutri/System, Inc., 857 F. 2d 179, 184, 189-90 (3d Cir. 1988).

<sup>48</sup> Accordingly, primary liability under Rule 10b-5(a) and (c) may be imposed “when the scheme also encompasses conduct beyond those misrepresentations” that comprise the Rule 10b-5(b) claim. SEC v. Mercury Interactive LLC, 2011 U.S. Dist. LEXIS 134580, at \*6 (N.D. Cal. 2011), *quoting*, WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc., 655 F. 3d 1039, 1057 (9<sup>th</sup> Cir. 2011). See generally Gilman, *Scope of Primary Liability Under Section 10(b) of the Exchange Act and Rule 10b-5 Following Janus Capital Group*, 40 Sec. Reg. L.J. 269 (2012).



### *The Rest of the Story*

In view of these legislative and judicial developments, it becomes clear why plaintiffs are bringing Section 10(b) class action claims against fewer defendants. While the enhanced pleading requirements mandated by the PSLRA annually result in dismissal of scores of securities class actions,<sup>49</sup> this is only part of the story. Additional developments discussed in this article also play a major role in limiting available avenues of recompense for aggrieved investors. When evaluated in conjunction with one another – the staying of discovery until and unless the motion to dismiss is fended off, the unavailability of the Section 10(b) private remedy against aiders and abettors, and the narrow construction of the requisite conduct that subjects a collateral actor to Section 10(b) primary liability exposure – the conclusion emerges that these developments adversely impact the quest of investors to hold those collateral actors perceived responsible for their financial losses to answer for the alleged misconduct. To some extent, state court individual actions, state derivative suits, and state class actions (involving securities of enterprises that are not nationally traded) may be available against collateral

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<sup>49</sup> According to NERA Economic Consulting, 60 securities class actions were dismissed in 2012. See NERA Review, *supra* note 14, at 23. Gibson Dunn reported that 79 securities class actions were dismissed in 2012. See Gibson Dunn Securities Litigation Update, *supra* note 15.

actors.<sup>50</sup> Yet, the availability of instituting an individual action in state court often is a reality only for those investors (e.g., frequently institutional investors) who have suffered large financial losses.<sup>51</sup>

Upon assessing the foregoing developments and their impact, it becomes clear that investors who seek recovery in a securities fraud class action are ordinarily relegated to suing certain select insiders and the auditor who certified the company's financial statements.<sup>52</sup> Collateral actors who are blameworthy and who would serve as "deep pockets" to help compensate investors for their losses normally are outside the purview of Section 10(b) private liability exposure.

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<sup>50</sup> See discussion *supra* notes 6-7 and accompanying text. A recent example of such a case is the Mortgage Ltd./Radical Bunny state court litigation in which two prominent law firms settled the suit brought by investors by paying \$88 million. See Weiss, *Greenberg Traurig, Quarles to Pay \$88M to Settle Suit by Mortgage Investors*, ABA Journal (online) (June 22, 2012).

<sup>51</sup> Clearly, the relatively small amount of losses that an ordinary investor may suffer when victimized by alleged fraud is not of sufficient monetary amount to incentivize that investor to incur the costs of bringing a lawsuit on his/her own. That is a key rationale underlying the societal benefit of the class action mechanism.

<sup>52</sup> See discussion *supra* notes 2-51 and accompanying text.