The Harvard Law School Forum on Corporate Governance and Financial Regulation
SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

The Supreme Court's Recent Focus on 10b-5 Cases

Posted by Noam Noked, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Friday September 21, 2012

Editor's Note: The following post comes to us from Paul A. Ferrillo, litigation counsel at Weil, Gotshal & Manges LLP. This post is based on a survey of securities fraud litigation by Mr. Ferrillo, Robert F. Carangelo, David Schwartz and Matt Altemeier; the full guide, including complete footnotes, is available here.

Years from now, when historians write the history of the Roberts Court, perhaps they will be able to explain why, in the second half of the first dozen years of the 21st Century, the Supreme Court suddenly became so interested in taking up cases under the federal securities laws. Indeed, a review of recent private 10b-5 jurisprudence reveals that the last two years have generated more United States Supreme Court precedent than the previous eighteen.[1] These cases could have profound implications for how public and private companies around the globe meet their reporting obligations, defend against class actions, and/or maintain their credibility in the eyes of regulators, judges, and investors. We discuss this plethora of recent Supreme Court cases below, concluding with a discussion of *Amgen, Inc. v. Connecticut Retirement Plans & Trust Funds*, which will be heard by the Supreme Court in November 2012.

In *Merck & Co. v. Reynolds*, plaintiff investors brought a 10b-5 action against Merck & Co., alleging that it had "knowingly misrepresented the risks of heart attacks accompanying the use of Merck's pain-killing drug, Vioxx (leading to economic losses when the risks later became apparent)."[2] The applicable statute of limitations, 28 U.S.C. § 1658(b), states that a cause of action may be brought no later than the earlier of two years after discovery of the facts constituting the violation or five years after the violation itself. Merck argued that the plaintiffs knew or should have known of facts constituting the violation more than two years prior to filing

[1] *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (although *Wal-Mart* does not specifically mention Section 10(b) or Rule 10b-5, it is relevant to the class certification stage of securities litigation); *Janus Capital Grp., Inc. v. First Deriv. Traders*, 131 S. Ct. 2296 (2011); *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011); *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011); *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010); and *Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (2010); *with Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005); and *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

[2] 130 S. Ct. 1784, 1790 (2010).

their complaint. The district court agreed and dismissed the complaint, and the Third Circuit reversed.

Merck argued before the Supreme Court that the statute of limitations began to run when the plaintiffs were on "inquiry notice," which it defined as the point when a plaintiff possesses information "sufficiently suggestive of wrongdoing that he should conduct a further inquiry." Merck contended that a number of public disclosures concerning the risks associated with Vioxx put the plaintiffs on inquiry notice more than two years before they filed suit, making their claim untimely.

In a unanimous opinion, the Supreme Court rejected Merck's proposed inquiry notice standard, holding that the limitations period for a 10b-5 claim "begins to run once the plaintiff did discover *or a reasonably diligent plaintiff would have 'discover[ed]* the facts constituting the violation'—whichever comes first." Among the facts a reasonably diligent plaintiff must discover to trigger the statute of limitations, the Court continued, are facts showing scienter—"an important and necessary element" of the claim.

Applying these standards, the Court reasoned that an FDA warning letter and products-liability complaints filed against Merck did not contain enough specific information concerning the defendants' states of mind to trigger the limitations period. Because no facts in evidence suggested scienter on the part of Merck more than two years prior to the filing of the complaint, the Court affirmed the Third Circuit's judgment and held the complaint timely.

In *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010), the plaintiffs sought to represent a class of foreign stock purchasers against National Australia Bank Limited ("National"), HomeSide Lending, Inc. ("HomeSide"), and HomeSide executives for violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5. In February 1998, National, an Australian bank with ordinary shares listed on a foreign securities exchange, purchased HomeSide, a Florida-based mortgage services company.[3] Plaintiffs alleged that HomeSide manipulated financial models in its public disclosures by underestimating refinancing rates, which inflated the value of their mortgage business. The district court granted the defendants' motion to dismiss for lack of subject matter jurisdiction because the alleged fraudulent scheme occurred abroad. The Second Circuit affirmed.

To determine whether Section 10(b) should apply extraterritorially, the Supreme Court began with the presumption against extraterritorial effect requiring Congress to give clear indication of extraterritorial application. After acknowledging that the Second Circuit had given extraterritorial effect to Section 10(b) for nearly fifty years through "judge-made rules," Justice Antonin Scalia

[3] *Morrison*, 130 S. Ct. at 2875.

proclaimed them judicial fantasy. Using textual analysis, Justice Scalia determined that there was no affirmative indication of extraterritorial application in Section 10(b).

The Court then proceeded to create its own "'transactional test,'" which applies Section 10(b) to "the purchase or sale of a security listed on an American stock exchange" *or* the "purchase or sale of any other security in the United States." Unfortunately, this test has raised more questions than answers. While interpretation of the first prong—"a security listed on an American stock exchange"—is clear, lower courts continue to struggle with application of the second prong.

In *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), the Supreme Court, in the tradition of *Basic* and *Tellabs*, refused to adopt a bright-line rule as to materiality and scienter. The plaintiffs alleged that Matrixx and three executive officers failed to disclose reports that one of its core products, Zicam, a nasal spray which accounted for 70 percent of Matrixx's sales, was linked to anosmia (loss of smell) in users.[4] The district court granted Matrixx's motion to dismiss, holding that the plaintiffs had not alleged any reports showing a "statistically significant correlation between the use of Zicam and anosmia . . . ." The Ninth Circuit reversed, finding that an allegation of "statistical significance" was not required to establish materiality.

In a unanimous decision, the Supreme Court affirmed the Ninth Circuit. Relying on *Basic*, Justice Sonia Sotomayor rejected a bright-line rule to determine materiality, noting that any approach that "'designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over-inclusive or under-inclusive.'" Based upon its seminal decision in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), Justice Sotomayor noted that the materiality element is satisfied when there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." Applying these principles, the Court found several facts alleged in the complaint (including product-related complaints and the institution of four products liability lawsuits) that raised "'a reasonable expectation that discovery will reveal evidence' satisfying the materiality requirement." The Court explained that the plaintiffs did not need to allege knowledge of a statistically significant relationship between Zicam and anosmia to successfully plead scienter because the complaint contained numerous other allegations from which recklessness could be inferred.

While *Matrixx* does little to change the traditional materiality standard, questions remain whether *Matrixx*'s discussion of materiality and scienter will significantly alter how pharmaceutical and biotechnology companies report adverse event information to investors and the public at large,

---

[4] *Matrixx*, 131 S. Ct. at 1314.

and whether this decision will spill over into business sectors beyond the drug and health industry.

In *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011), the Erica P. John Fund ("EPJ Fund") alleged that Halliburton Co. made various misrepresentations designed to inflate its stock price in violation of Section 10(b) and Rule 10b-5. The alleged false statements concerned the scope of potential liability in asbestos litigation, expected revenue from construction contracts, and the benefits of a merger.[5] The district court denied class certification, stating that the EPJ Fund failed to prove loss causation. The Fifth Circuit affirmed, following the precedent set in *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 401 F.3d 316 (5th Cir. 2005) (requiring proof of loss causation at the class certification stage).

The Supreme Court reversed the Fifth Circuit's decision, holding that the plaintiffs did not have to prove loss causation at the class certification stage to invoke the class-wide presumption of reliance promulgated in *Basic*. In a unanimous decision for the Court, Chief Justice Roberts held that the elements of reliance and loss causation are wholly independent elements of a Section 10(b) claim. Relying on *Basic*, Chief Justice Roberts noted that the fraud-on-the-market theory underpinning the presumption of reliance focuses on material misrepresentations that permeate an efficient market and thereby affect all purchasers and sellers. "Loss causation, by contrast, requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss." Thus, the Court reasoned, to invoke the *Basic* presumption a plaintiff need only demonstrate that "the alleged misrepresentations were publicly known . . . that the stock traded in an efficient market," and that the transaction took place "'between the time the misrepresentations were made and the time the truth was revealed.'"

In *Janus Capital Grp., Inc. v. First Deriv. Traders*, 131 S. Ct. 2296 (2011), plaintiff First Derivative Traders, representing a class of purchasers of Janus Capital Group, Inc. ("JCG") stock, asserted claims against JCG and Janus Capital Management LLC ("JCM"), an investment adviser and wholly-owned subsidiary of JCG, for violations of Section 10(b) and Rule 10b-5.[6] JCG ran a family of mutual funds organized as a Massachusetts business trust, the Janus Investment Fund ("JIF"). Although JIF was started by JCG, JIF is a separate legal entity and retained JCM as its investment adviser. Through its business, JIF issued prospectuses stating that Janus funds were not suitable for market timing. First Derivative alleged that JCM and JCG mislead the investing public concerning implementation of measures to curb market timing in response to a September 2003 complaint filed by New York's Attorney General.

[5] *Halliburton*, 131 S. Ct. at 2183.
[6] *Janus*, 131 S. Ct. at 2299.

Despite allegations that JCM was "significantly involved in preparing the prospectuses [of JIF]," and that all of the officers of JIF were also officers of JCM, the Supreme Court ultimately determined that JCM could not be liable because "[a]lthough JCM, like a speechwriter, may have assisted [JIF] with crafting what [JIF] said in the prospectuses, JCM itself did not 'make' those statements for purposes of Rule 10b-5." The Court ultimately held that "[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not 'make' a statement in its own right." Because JIF and JCM are separate legal entities and there was nothing on the face of the prospectuses to indicate attribution to JCM, the Court reversed the Fourth Circuit. The judicial distinction between one who "assists" in preparation of public statements and one who "controls" the ultimate outcome of a public statement could have profound implications for secondary and related actors in 10b-5 actions.

Although *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011), does not mention Rule 10b-5, it has the potential to impact future 10b-5 cases. In *Wal-Mart*, three named plaintiffs representing 1.5 million class members, each a current or former female employee of the company, asserted sexual discrimination in violation of Title VII of the 1964 Civil Rights Act.[7] Specifically, the plaintiffs alleged that local managers' discretion over pay and promotions was exercised disproportionately in favor of men, leading to an unlawful disparate impact on female employees. The district court and Ninth Circuit each approved certification of the class.

Reversing the Ninth Circuit, Justice Scalia, in a 5-4 decision, determined that the central issue in the case was Rule 23(a)(2)'s commonality requirement. Justice Scalia determined that the plaintiffs could not satisfy Rule 23(a)(2) because they failed to allege any uniform employment practice and the allegations centered on local managers enacting local decisions. The Court emphasized that commonality does not merely require '"the raising of common "questions"—even in droves—but, rather the capacity of a classwide proceeding to generate common *answers* apt to drive the resolution of the litigation'" and to "resolve an issue that is central to the validity of each one of the claims in one stroke." The Court ruled that the evidence presented could not generate such common answers because the plaintiffs could not demonstrate a common method of exercising discretion that permeated the company. Following *Wal-Mart*, circuit and district courts have struggled with several questions—namely, does this language generally set a stricter commonality standard under Rule 23(a) and, if so, is that standard applicable to 10b-5 securities class actions?

[7] *Wal-Mart*, 131 S. Ct. at 2547.

Though primarily concerned with Rule 23 class certification requirements, Justice Scalia's opinion in *Wal-Mart* also touched upon whether class certification expert witnesses should be subjected to *Daubert* scrutiny—a frequently-litigated issue.[8] In *Wal-Mart*, the district court determined that courts need not apply "the full *Daubert* 'gatekeeper' standard" to expert testimony at class certification, holding instead that "a lower *Daubert* standard should be employed . . . ."[9] The Ninth Circuit, sitting en banc, affirmed this determination.[10] The Supreme Court, however, characterized the district court's decision as finding that "*Daubert* did not apply to expert testimony at the certification stage . . . ."[11] After stating that "[w]e doubt that is so," the Supreme Court went on to explain that "even if properly considered, [the expert] testimony does nothing to advance [the plaintiffs'] case" because it failed to address the dispositive question at issue. Thus, while the Court's expressed "doubt" is dicta, it nonetheless signals a preference for full *Daubert* scrutiny at the class certification stage.[12]

Looking ahead, in the fall of 2012, in addition to *Comcast*, the Supreme Court will hear arguments in *Amgen* addressing a circuit split regarding whether plaintiffs must prove materiality to invoke the fraud-on-the-market theory's class-wide presumption of reliance at the class certification stage.[13]

In *Amgen*, the plaintiffs brought a putative class action under Rule 10b-5, alleging that Amgen and several of its directors and officers misstated and failed to disclose safety information about two of Amgen's pharmaceutical products. In determining whether the plaintiffs must prove materiality to gain the benefit of the fraud-on-the-market presumption, the Ninth Circuit identified a circuit split on the issue originating from divergent interpretations of a footnote in *Basic*.[14] Ultimately, the Ninth Circuit agreed with the Seventh Circuit[15] that *Basic* only envisioned materiality as an essential element of the fraud-on-the-market presumption *on the merits*, and therefore ruled that plaintiffs "must plausibly allege—but need not *prove* at this juncture—that the

[8] *See generally Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993).
[9] *Dukes v. Wal-Mart, Inc.*, 222 F.R.D. 189, 191 (N.D. Cal. 2004) (citations omitted).
[10] *Dukes v. Wal-Mart Stores, Inc.*, 603 F.3d 571, 602-03 (9th Cir. 2010) (en banc).
[11] *Wal-Mart*, 131 S. Ct. at 2553-54.
[12] Indeed, the admissibility of expert evidence at the class certification phase will be addressed by the Supreme Court this fall. The Court recently granted *certiorari* in *Comcast Corp. v. Behrend* to answer the question of "[w]hether a district court may certify a class action without resolving whether the plaintiff class has introduced admissible evidence, *including expert testimony*, to show that the case is susceptible to awarding damages on a classwide basis." 2012 WL 113090 (U.S. June 25, 2012) (emphasis added). Resolution of this question implicates not only the admissibility of expert testimony specifically, but also the extent to which courts consider merits issues at class certification generally—topics highly relevant to any securities fraud class action.
[13] *See Conn. Ret. Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170 (9th Cir. 2011), *cert. granted*, 132 S. Ct. 2742 (2012).
[14] *See Basic Inc. v. Levinson*, 485 U.S. 224, 248 n.27 (1988).
[15] *See Schleicher v. Wendt*, 618 F.3d 679 (7th Cir. 2010).

claimed misrepresentations were material."[16] For the same reason, the Ninth Circuit also did not allow the defendants to rebut the plaintiffs' materiality showing.

The Ninth Circuit's approach, however, differs from the Second and Fifth Circuits, which require plaintiffs to prove materiality at the class certification stage to utilize the *Basic* presumption, and which also allow defendants an opportunity to rebut that showing.[17] The Third Circuit takes a middle-of-the-road approach, which does not require evidence of materiality to invoke the fraud-on-the-market presumption, but at least permits defendants an opportunity to rebut the presumption once established.[18] Given the special significance of class certification in 10b-5 cases, the outcome of this case could have meaningful ramifications for future securities class actions.

[16] *Amgen*, 660 F.3d at 1172.

[17] *See In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474 (2d Cir. 2008); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 401 F.3d 316 (5th Cir. 2005), *abrogated on other grounds by Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011).

[18] *See In re DVI, Inc. Sec. Litig.*, 639 F.3d 623 (3d Cir. 2011).