

SECOND CIRCUIT ISSUES SIGNIFICANT SECURITIES DECISION

Last week, the Second Circuit, in *ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, issued an important decision on the pleading standards for securities class actions. The decision affirmed the district court's dismissal of a class action complaint against JP Morgan Chase Co. ("JP Morgan") arising out of the Enron scandal, and reinforced established precedent holding that GAAP violations, without more, are an insufficient basis for securities fraud claims. The Second Circuit once again emphasized the heightened pleading standards for scienter (or wrongful intent) that investors must satisfy in bringing a securities fraud claim. In dismissing the securities claims, the Second Circuit also noted that courts should conduct a vigorous analysis of materiality at the pleading stage.

Factual Background and the District Court's Decision

The class action alleged that shareholders of JP Morgan were defrauded by the firm's transactions with Enron. In particular, the plaintiffs claimed that JP Morgan assisted Enron in a concerted effort to mischaracterize debt by creating two special purpose entities, Mahonia Ltd. and Mahonia Natural Gas Ltd. (collectively, Mahonia), through which JP Morgan provided Enron with \$2 billion in loans. The plaintiffs further alleged that JP Morgan improperly disclosed and accounted for the loans to Enron as viable trades rather than as impaired loans. In addition, the plaintiffs claimed that JP Morgan violated GAAP (specifically, SFAS No. 57) by failing to report the Enron/Mahonia "loans" as "related-party" transactions. After JP Morgan's role in these alleged transactions was disclosed following Enron's bankruptcy, JP Morgan's stock price dropped.

Based principally on those allegations, the plaintiffs asserted securities law violations under Sections 10(b) and 14(a) of the Securities Exchange Act of 1934 as well as Section 11 of the Securities Act of 1933. The district court dismissed almost all the claims based on plaintiffs' failure to adequately allege scienter. The court found that, while plaintiffs properly pleaded that JP Morgan violated GAAP by not reporting the Enron/Mahonia deals as "related-party" transactions, "merely alleging a GAAP violation is insufficient to establish scienter." As to the remaining allegations – that JP Morgan had improperly accounted for the Mahonia transactions "as trades rather than loans" – the district court held that the supposedly improper accounting was not material and, therefore, not actionable under the securities laws.

Second Circuit's Decision

The Second Circuit affirmed the district court's dismissal of the complaint, finding that the complaint failed to adequately plead scienter or the existence of a material misstatement.

As to scienter, the Second Circuit first rejected as insufficient the alleged violation of SFAS No. 57 relating to JP Morgan's failure to treat Mahonia as a related party. Reaffirming established precedent, the court stated: "[A]llegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim Only where such allegations are coupled with evidence of corresponding fraudulent intent might they be sufficient." The Second Circuit went on to hold that the complaint did not otherwise sufficiently allege either "strong circumstantial evidence of conscious misbehavior or recklessness" or that defendants had the "motive and opportunity" to commit fraud. Plaintiffs argued that JP Morgan's desire to receive supposedly "inflated fees" from the Enron/Mahonia transactions sufficiently evidenced motive. But the Second Circuit disagreed and found that any such fees actually would have benefited JP Morgan's shareholders by enhancing the Company's profitability. In fact, the court commented that "[i]t seems implausible to have both an intent to earn excessive fees for the corporation and also an intent to defraud Plaintiffs by losing vast sums of money." Plaintiffs' other motive allegations – that JP Morgan was motivated to inflate its stock in anticipation of an acquisition and that two individual officer defendants were seeking increased compensation and bonuses – were rejected as too generic to support a securities fraud claim. Again reaffirming established precedent, the Second Circuit noted that "[i]f scienter could be pleaded solely on the basis that defendants were motivated because an inflated stock price or improved corporate performance would increase their compensation, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions."

As to materiality, the Second Circuit's analysis focused on SEC Staff Accounting Bulletin No. 99, which sets forth both quantitative and qualitative factors for determining whether an alleged misstatement or omission is material. The court found that under these factors, any alleged misrepresentation of the Enron/Mahonia transactions as trades (rather than loans) was immaterial. The Second Circuit found that, while a \$2 billion misclassification of these transactions "may sound staggering," it was immaterial because it represented "a minute fraction" of the \$715 billion of assets on JP Morgan's balance sheet. The Second Circuit further found that the alleged mischaracterization of the loans as trades was not qualitatively material for a number of reasons. First, although the plaintiffs alleged that JP Morgan should have accounted for the Mahonia transactions differently, "there is no allegation that the transaction itself was illegal." Second, the court noted that JP Morgan's transactions with Enron "were not a significant aspect of [JP Morgan's] operations, considering the fact that [JP Morgan] earned less than .1% of its revenues from Enron-related transactions each year." Third, even though the market reacted when JP Morgan's involvement in the Enron scandal was disclosed, the Second Circuit stated "that market volatility alone is too blunt an instrument to be depended on in considering whether a fact is material."

Ramifications of the Second Circuit's Decision

The Second Circuit's determinations in *ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.* will likely have important ramifications. Following the Supreme Court's 2007 decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the decision underscores the heavy burden investors face in surviving a motion to dismiss in the securities law context. The Second Circuit also reaffirmed that generalized allegations of GAAP violations are not sufficient to state a claim under the securities laws. And the Second Circuit made clear that securities claims (including those brought under Section 10(b) and Section 11) can be dismissed on materiality grounds as a matter of law at the motion to dismiss stage.

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If you have any questions concerning the foregoing or would like additional information, please contact Antonio Yanez, Jr. (212-728-8725, ayanez@willkie.com), Todd G. Cosenza (212-728-8677, tcosenza@willkie.com), or the attorney with whom you regularly work.

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