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Securities Cases That Will Matter Most In 2019

By **Todd Cosenza and Jonathan Waisnor** (January 29, 2019, 3:24 PM EST)

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The year 2018 saw the U.S. Supreme Court issue a number of important securities rulings. In Lucia v. SEC, the Supreme Court held that the U.S. Securities and Exchange Commission's in-house administrative law judges, or ALJs, are subject to the appointments clause of the Constitution and are not regular government employees. In Digital Realty Trust Inc. v. Paul Somers, the court unanimously found that a whistleblower who was fired after reporting alleged financial misconduct internally was not entitled to the protection of the Dodd-Frank Act's anti-retaliation provisions because he did not report his allegations to the SEC first.

The Second Circuit, in United States v. Martoma, continued to wrestle with the implications of its 2014 decision in United States v. Newman — and the Supreme Court's decision in Salman v. United States, which appeared to overrule parts of Newman.

In the private securities class action arena, the Supreme Court held in Cyan Inc. v. Beaver County Employees Retirement Fund that the Securities Litigation Uniform Standards Act does not deprive state courts of jurisdiction over securities class action lawsuits, and held in China Agritech Inc. v. Resh that individuals who opt out of a class and then later attempt to bring a subsequent class action (such as when class certification is denied) are not entitled to the benefit of American Pipe tolling.

2019 also promises to be a significant year for securities litigation, with the Supreme Court hearing several cases of first impression relating to both SEC enforcement and private securities litigation. Below are a few of the cases that will play a role in defining the reach of the federal securities laws in 2019 and beyond.

Emulex Corp. v. Varjabedian

The Supreme Court recently granted a petition for certiorari in Emulex Corp. v. Varjabedian.[1] The critical question presented by Emulex is whether the standard applicable to claims for misleading statements in a proxy statement under Section 14(e) of the Exchange Act is negligence, rather than the scienter standard applied to securities claims under Rule 10b-5.

Prior to the Ninth Circuit's decision in Emulex, the Second, Third, Fifth, Sixth and Eleventh circuits had all held that Section 14(e) claims required scienter, or the making of a false or misleading statement either knowingly or recklessly. The Ninth Circuit's decision is an important opportunity for the Supreme Court to clarify the standard applicable to claims under Section 14(e), which are increasingly being brought in federal court after the Delaware Chancery Court's decision in Trulia, or, quite possibly, to eliminate the private right of action under this statute entirely.

Emulex was a shareholder class action arising from a tender offer of a telecommunications company. Shortly after Emulex filed a recommendation that shareholders accept the proxy statement with the SEC, a shareholder filed a class action lawsuit claiming that the company's recommendation statement failed to include a summary of the financial advisor's comparable transaction premium announcement, an alleged material omission.

In reversing the district court decision, the Ninth Circuit held that the language of Section 14(e), which prohibits the making of "any untrue statement of a material fact" or "any fraudulent, deceptive, or manipulative acts or practices," in connection with a tender offer required only a standard of negligence, not the scienter typically applied to claims under Section 10b-5 of the Exchange Act. Section 14(e) has traditionally been thought of as the "anti-fraud" provision in Section 14, analogous to Section 10b-5. This was despite the fact that Second, Third, Fifth, Sixth and Eleventh circuits have all held that Section 14(e) requires allegations of scienter, not negligence.

The importance of the Ninth Circuit's decision in Emulex cannot be overstated. Frequently, after an announcement of a significant public company transaction, a shareholder lawsuit is filed alleging various failures to disclose material information contained in the (often voluminous) SEC filings accompanying such transactions. Often, defendants are forced to settle these cases and make significant payments of attorneys fees to class counsel as a form of "deal tax" after only a short period of discovery, with no additional funds going to shareholders.

The Delaware Chancery Court's 2016 decision in Trulia effectively eliminated these kinds of settlements in Delaware, but, in turn, creative plaintiffs have filed such cases in federal and state courts across the country. Should the Ninth Circuit's decision stand, expect to see an uptick in these cases filed in Ninth Circuit federal courts, as plaintiffs lawyers migrate toward a jurisdiction that is less skeptical of these claims.

A petition for certiorari was granted on Jan. 4, 2019. In addition to challenging the standard applied by the Ninth Circuit, the petitioners have argued that Section 14(e) of the Exchange Act does not contain a private right of action. If the Supreme Court endorses this argument, it will considerably curtail the volume of merger litigation claims across the country.

Lorenzo v. SEC

In November 2018, the Supreme Court granted certiorari[2] to resolve a circuit split over whether fraudulent scheme liability under Section 17(a)(1) of the Securities Act and SEC Rules 10b-5(a) and (c) extends to persons who would not be considered "makers" of the misstatements for purposes of Rule 10b-5(b) and the Supreme Court's test in Janus Capital Group Inc. v. First Derivative Traders.[3]

If the Lorenzo decision is overturned, it could be more difficult for the SEC to pursue securities fraud actions on a fraudulent scheme theory where the person responsible for disseminating the misstatement did not have primary authority over its contents.

The appellant, Francis Lorenzo, was the director of investment banking for a brokerage firm that advised a firm client, Waste2Energy. Waste2Energy was struggling financially and began to sell convertible debentures in which Lorenzo's firm was an advisor. Lorenzo sent emails "on behalf of" the company's CEO to two potential investors in the debentures that omitted mentioning Waste2Energy's serious financial difficulties. The investors later lost money on the investment.

The SEC commenced enforcement proceedings against Lorenzo, the CEO of Waste2Energy and the brokerage firm. An ALJ found that the emails Lorenzo sent contained material misstatements, that Lorenzo knew the statements were false or misleading, and that his conduct violated Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act — specifically, all three subdivisions of the implementing regulations of Section 10(b), Rules 10b-5(a), (b) and (c).

The judge ordered Lorenzo to pay a civil penalty of $15,000, and imposed on him a lifetime ban from working in the securities industry. The ALJ rendered these findings and sanctions even after finding that Lorenzo sent the emails at the request of the CEO and had not actually read the emails before sending them to investors. The SEC affirmed the sanctions against Lorenzo, and he petitioned for review of the SEC's decision before the D.C. Circuit.

The D.C. Circuit held that the record supported the SEC's conclusion Lorenzo acted with scienter with respect towards the statements contained in the emails. However, it found that under the Janus test, Lorenzo was not the "maker" of the material falsehoods contained in the emails, because he did not have final authority over the email's misstatements, and thus there was no violation of Rule 10b-5(b).

In light of this, the D.C. Circuit remanded to the SEC for reconsideration of the sanctions imposed upon Lorenzo. However, the D.C. Circuit did not reverse the SEC's conclusion that Lorenzo faced liability under Rules 10b-5(a) and (c) and Section 17(a)(1), finding that it was irrelevant whether he was the "maker" of those statements for purposes of liability under Rule 10b-5(b).[4]

Lorenzo petitioned the Supreme Court to review the D.C. Circuit's decision. Lorenzo contended that the D.C. Circuit's decision undermines the distinction the Supreme Court drew in Janus and other cases between "misstatements" and "fraudulent schemes," and improperly imposes liability on him even though he had only a secondary role in disseminating the statements to investors.

The SEC, however, argued that Lorenzo's actions were sufficient to render him a "maker" of the statements because he delivered the speech, and that the Supreme Court has never extended the requirements of Janus to cases brought under Rules 10b-5(a) and (c) and Section 17(a)(1).

The Supreme Court granted the petition in June 2018. The case is being closely watched by securities lawyers, both for its substantive impact on securities law as well as whether a majority of the Supreme Court will adopt a position consistent with the views of its newest member Justice Brett Kavanaugh, who dissented from the D.C. Circuit's decision.[5]

First Solar v. Mineworkers Pension Scheme

Another petition stemming from a Ninth Circuit decision would, if granted, give the Supreme Court a chance to address the appropriate standard to be applied to the question of loss causation in the context of claims under Section 10(b) of the Exchange Act and Rule 10b-5.[6]

The defendant in this case was First Solar, one of the world's largest producers of photovoltaic solar panel modules. The plaintiffs alleged that First Solar failed to disclose, and in fact actively concealed, a manufacturing defect in its products, and misrepresented the cost and scope of the defects on its financial statements. The plaintiffs alleged violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5.

The Ninth Circuit, on the defendant's motion for summary judgment, resolved an apparent inconsistency within the circuit regarding the proper standard of loss causation, with some cases suggesting that the stock price drop must follow a "revelation of fraud," while others applying the proximate causation standard followed by the Second Circuit and other circuits. The Ninth Circuit, responding to a certified question from the district court, held that loss causation "requires no more than the familiar test for proximate cause."

According to the Ninth Circuit, "[d]isclosure of the fraud is not a sine qua non of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss." It also held that "[a] plaintiff may also prove loss causation by showing that the stock price fell upon the revelation of an earnings miss, even if the market was unaware at the time that fraud had concealed the miss."

The defendants petitioned the Supreme Court for certiorari in August 2018, and the court invited the Solicitor General of the United States to file a brief expressing its views. If the petition is granted, the Supreme Court would have the opportunity to clarify that the standard for showing loss causation requires the plaintiff to prove a price drop that is directly connected to announcement of a fraud, rather than a drop potentially months or years before or after the actual disclosure of the fraud giving rise to the lawsuit.

Arkansas Teacher Retirement System v. Goldman Sachs Group Inc.

In 2019, the Second Circuit will consider whether the U.S. District Court for the Southern District of New York's certification of a plaintiff class under the price maintenance theory based on general statements of corporate principles in public filings was appropriate in the face of significant evidence that disclosures of the company's alleged misconduct had no effect on its stock price.[7]

At issue here is whether securities law class action defendants will have an opportunity to rebut Basic Inc. v. Levinson's[8] fraud-on-the-market presumption at the class certification stage, as required by the U.S. Supreme Court in Halliburton Co. v. Erica P. John Fund Inc.[9]

A class of plaintiffs brought suit in 2010 against Goldman Sachs, claiming that Goldman had made false and misleading statements to purchasers of four collateralized debt obligations which allegedly incurred losses of $1 billion. As is typical in securities class actions, the plaintiffs alleged that Goldman defrauded its shareholders by making various general statements regarding corporate principles and internal controls in public filings.

These statements were analogous to the types of "statements about reputation, integrity, and compliance with ethical norms" that the Second Circuit has routinely held are ... too general to cause a reasonable investor to rely upon them."[10] The plaintiffs alleged Goldman's general statements were false and misleading because they were inconsistent with later disclosed conflicts of interest relating to the CDOs.

The district court initially certified a class of plaintiffs based on these allegations, finding that the defendants had failed to "conclusively" prove an absence of price impact. The Second Circuit, on appeal from class certification, reversed and remanded, with instructions to the district court to consider the class certification decision under the correct standard — whether the defendants had shown by a preponderance of the evidence that the alleged misrepresentations did not have a price impact on the stock.[11]

On remand, Goldman offered evidence that on 36 dates on which the media had reported negatively on Goldman's alleged conflicts of interests and business practices, there was no corresponding decline in its stock price. This significant evidence severer the link between the challenged statements and the company's stock price. Nonetheless, the district court recertified the plaintiff class, finding that the evidence presented regarding the media reports was insufficient to rebut the fraud on the market presumption, because the reports did not constitute "hard evidence" of misconduct in connection with the CDOs in question, and some of the media reports were accompanied by Goldman's denials.[12]

Instead, the district court found that the statements had price impact based on the plaintiffs' "alleg[ation]" that the alleged misstatements "served to maintain an already inflated stock price," and the "state[ment]" by plaintiffs' expert that "the price declines following" reports of government lawsuits and investigations "were caused by the news of Goldman's conflicts."[13]

The defendants filed a second interlocutory appeal, asking the Second Circuit to determine whether the evidence put forward by Goldman sufficiently rebutted the Basic presumption when measured against the plaintiff's reliance on generic statements of corporate principles and risk controls.

If upheld, the district court's decision would effectively allow plaintiffs to obtain near-automatic class certification by invoking the price maintenance theory. Nearly all companies make general statements, like those challenged here, that arguably would be "corrected" by any allegation of wrongdoing. And every securities class action involves a stock drop on a "corrective disclosure" date.

Thus, if a court could simply assume, that a general statement about business practices could cause inflation at the start of a class period and then maintain inflation for a multi-year period, then class certification would effectively be automatic in cases involving these sorts of "routine representations."[14] This would effectively make illusory the rebuttable presumption required by Basic Inc. v. Levinson and Halliburton Co. v. Erica P. John Fund Inc., and create a virtually insurmountable hurdle for defendants at the class certification stage.

Conclusion

Especially given the recent market turmoil, it is more important now than ever that participants in the securities market have the benefit of clear and predictable rules governing their potential liability to investors and in SEC proceedings. With petitions for cert granted in Lorenzo and Emulex, 2019 is already shaping up to be an important year for securities litigation at the Supreme Court.

Securities law practitioners will also continue to closely monitor cases pending at the circuit level, especially in the Second Circuit, where many securities cases are brought, and the Ninth Circuit, which has issued several recent plaintiff-friendly decisions, and traditionally has a high proportion of cases that are reviewed by the Supreme Court. This year will also shed light on how the addition of Justice Kavanaugh to the Supreme Court might shape the court's approach to securities law issues.

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[1] Emulex Corp. v. Varjabedian, 18-459 (9th Cir. 2018).

[2] Lorenzo v. Securities and Exchange Commission, 17-1077 (D.C. Cir. 2017).

[3] Janus Capital Group Inc. v. First Derivative Traders, 564 U.S. 135 (2011).

[4] The D.C. Circuit decision is also notable for a spirited dissent penned by then Judge Brett Kavanaugh. Judge Kavanaugh wrote that he would have reversed the SEC's entire decision on the basis that Lorenzo, who did not have any knowledge of the truth or falsity of the statements made in the emails and sent them only at the behest of the CEO, could not be subject to liability under the federal securities laws or traditional principles of criminal liability, specifically the lack of any mens rea. Judge Kavanaugh pointed to Supreme Court decisions drawing an "important distinction" between primary and secondary liability and what he maintained was the SEC's attempts to "expand the scope of primary liability under the securities laws," as well as what he perceived as the overreach and unfairness of the SEC's administrative law system.

[5] Note that if Justice Kavanaugh recuses himself due to his involvement in the decision below, then a 4-4 decision would mean that the decision below stands until such time as the Supreme Court can take up the issue in another case.

[6] Mineworkers' Pension Scheme et al. v. First Solar Inc., 15-17282 (9th Cir. 2018).

[7] Willkie Farr represents a group of former SEC officials and law professors who filed a brief in support of Goldman's petition for permission to appeal.

[8] Basic Inc. v. Levinson, 485 U.S. 224 (1988).

[9] Halliburton Co. v. Erica P. John Fund Inc., 134 S. Ct. 2398 (2014).

[10] City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG, 752 F.3d 173, 183 (2d Cir. 2014).

[11] Arkansas Teachers Retirement System v. Goldman Sachs Group Inc., No. 16-250 (2d Cir. Jan. 12, 2018).

[12] In re Goldman Sachs Grp. Inc. Sec. Litig., No. 10-cv-3461 (PAC), 2018 WL 3854757, at *4 (S.D.N.Y. Aug. 14, 2018).

[13] Id. at *2.

[14] ECA Local 134 IBEW Joint Pension Tr. of Chicago v. JP Morgan Chase Co., 553 F.3d 187, 206 (2d Cir. 2009).