Securities Plaintiffs Win Two Out of Three at Supreme Court

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The U.S. Supreme Court issued three decisions in securities fraud cases this term. Plaintiffs' lawyers scored victories in the first two cases. They could not get the hat trick, however, as the justices' third opinion in this area limited the scope of private causes of action.

In their first two decisions, the justices made it tougher to dismiss securities fraud cases at the pleadings stage. *Matrixx Initiatives Inc. v. Siracusano* , decided in March, emphasized that there was no bright-line rule for "materiality" of false statements or omissions under Rule 10b-5, and that a plaintiff's burden of pleading scienter was not especially onerous. Plaintiffs' lawyers notched another victory on June 6 in *Erica B. John v. Halliburton* , which held unanimously that plaintiffs did not need to establish "loss causation" at the class-certification stage if their complaint relied on a fraud-on-the-market theory.

The most potentially far-reaching decision, however, was announced on June 13. In *Janus Capital Group Inc. v. First Derivative Traders* , the court rejected an attempt to expand the scope of potential defendants in securities fraud actions. Specifically, the court held that only the issuer "makes" a disputed statement, pursuant to Rule 10b-5, even though counsel or other consultants may have also participated in composing the statement.

'Matrixx Initiatives Inc. v. Siracusano'

In *Matrixx* , the court held unanimously that there was no bright-line definition of "materiality" for purposes of Rule 10b-5. At the same time, the justices clarified that plaintiffs sufficiently plead scienter if the inference of bad faith "is at least as compelling, if not more compelling" than an inference of good faith. Both holdings emphasized the importance of a fact-specific approach — as opposed to bright-line rules — that might make it more difficult to obtain summary judgment in securities fraud suits.

Matrixx manufactured a cold remedy called Zicam. The company began to receive sporadic reports that Zicam caused a condition called anosmia (loss of sense of smell). According to plaintiffs, Matrixx intentionally kept those reports secret because of its fear that the reports would drive the company's stock down. According to Matrixx, it decided not to disclose the reports because they were not yet "statistically significant." Both parties agreed, though, that Matrixx made positive statements about Zicam's economic and medical prospects after receiving the adverse-incident reports. When those negative reports were reported publicly, the price of the company's stock plummeted, and shareholders sued the company alleging fraud.

The lower courts reached different results. The district court dismissed the complaint for failure to plead materiality and scienter adequately. The 10th U.S. Circuit Court of Appeals, however, reversed and reinstated the case.

The Supreme Court affirmed the 10th Circuit in a unanimous opinion. Perhaps the die was cast when Matrixx urged the high court to adopt a bright-line standard of materiality — yet proved unable to articulate the boundaries of any bright line (relying instead on the question-begging standard of "statistically significant"). In any event, the court banked sharply in the opposite direction and instead endorsed a "fact-specific inquiry … that requires consideration of the source, content, and context" of what was known to a company; statistical significance, while relevant, is not the only factor that a reasonable investor would consider relevant to a decision to transact the company's stock.

'Erica P. John Fund Inc. v. Halliburton'

The facts and holding of *Halliburton* pale next to the procedural drama attendant to the case. The Supreme Court agreed to hear the fund's appeal only days after its lawyer, Caryl Boies, died of lung cancer at the age of 48. Her father, noted advocate David Boies, adopted the case in her honor. On June 6, the court awarded Caryl Boies — through her father — a posthumous, unanimous victory.

Virtually any securities fraud holding might seem blasé compared to that backstory. This one seems especially unworthy. In essence, the court clarified that plaintiffs in a private securities fraud action did need to prove "loss causation" in order to prevail on the merits of their Rule 10b-5 claim, but they did not have to prove "loss causation" in order to obtain class certification.

The fund (as class representative) alleged that Halliburton deliberately made false statements about its projected earnings in an effort to inflate its stock price. In particular, the fund alleged that Halliburton downplayed the scope of its potential liability in asbestos litigation while overplaying both its anticipated revenue from construction contracts and the benefits of a merger with another company. Halliburton's later corrective statements on these matters caused its stock price to drop. The trial judge and the 5th Circuit both rejected class certification because the plaintiffs failed to prove "loss causation" — in other words, that the corrected truth of Halliburton's prior falsehoods actually caused the stock price to fall as opposed to other factors.

Reversal seemed likely from the outset. The 5th Circuit was the only court to require proof of "loss causation" at the class-certification stage — weighed against at least three opposing circuits — and Halliburton conceded that "loss causation" was not a required element of the class-certification decision. Where was there to go from here? Halliburton left itself the unsavory argument that, basically, the 5th Circuit employed a poor choice of words but applied the law correctly in substance. It should come as no surprise that Halliburton's lawyers were unable to pull a rabbit out of their hats.

'Janus Capital Group Inc. v. First Derivatives Traders'

As mentioned earlier, the court issued its opinion in *Janus Capital* on June 13. At issue was whether a third party who assists an issuer to craft a disclosure itself "makes" a statement within the meaning of Rule 10b-5. Ratifying too broad a definition of the term "make" would have undermined prior decisions of the court that foreclosed aiding-and-abetting liability under private lawsuits invoking Rule 10b-5 (*Central Bank of Denver, N.A.*) and recognized that Congress had precluded any judicial expansion of the private right of action to enforce Rule 10b-5 (*Stoneridge Investment Partners LLC*).

In this case, Janus Capital Group Inc. (JCG) sold shares in its mutual funds through prospectuses. A wholly owned subsidiary, Janus Capital Management LLC (JCM), was responsible for the funds' administrative and compliance services. During the relevant time period, the prospectuses stated that the funds were not intended for "market timing" transactions, which were purportedly harmful to the funds' long-term investors. Contrary to these representations, JCG secretly and knowingly allowed such transactions with 12 different market-timers yielding billions of dollars in trades. The revelation of these secret deals, according to the complaint, caused the funds' stock price to drop materially.

The 4th Circuit reversed the district court's dismissal of the complaint. In particular, the court held that JCM "made" the statements in JCG's prospectuses by participating in the drafting. The 4th Circuit went on to note that the public would reasonably attribute the prospectus statements to JCM given its close relationship with JCG.

Questioning at oral argument suggested that several justices would be reluctant to define "make" broadly. Doing so would simply take away with one hand an immunity from suit that the court had given with another hand. Justice Samuel A. Alito Jr. intimated as much when he asserted that, under a broad reading of "make," outside counsel would also be liable for any misstatements. Chief Justice John G. Roberts Jr. and Justice Antonin Scalia did not hide their view that the only source possessing authority to make statements in the prospectus was JCG, the issuer, whereas JCM's role was akin only to a speechwriter. By contrast, the tenor of the questions posed by Justices Ruth Bader Ginsburg, Sonia Sotomayor, and Elena Kagan suggested that they all supported the 4th Circuit's judgment.

On June 13, the court reversed the 4th Circuit in a 5-4 decision. Justice Clarence Thomas authored the majority opinion, which was joined by the other so-called "conservative" justices — Scalia, Roberts, Alito and Kennedy. In the key passage of the opinion, Thomas wrote:

"For 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. One who prepares or publishes a statement on behalf of another is not its maker."

The majority expressed concern that a broader definition of "make" would eviscerate prior holdings in which the court had expressly foreclosed private rights of action under Rule 10b-5 against aiders and abettors: "A broader reading of 'make,' including persons or entities without ultimate control over the content of a statement, would substantially undermine *Central Bank* [holding that Rule 10b-5's private right of action does not include suits against aiders and abettors]."

Picking up on the analogy from oral argument, Thomas noted:

"This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit — or blame — for what is ultimately said."

Justice Stephen G. Breyer wrote the dissenting opinion — joined by Ginsburg, Sotomayor and Kagan — in which he endorsed a more fact-specific inquiry that would permit, under circumstances like those here, a finding that a third party "made" statements contained in a firm's prospectus despite its lack of ultimate authority.

Two out of Three

As Meatloaf crooned, "Two out of three ain't bad," and plaintiffs' securities fraud lawyers did score two victories at the Supreme Court this term. For that, they should feel good. The celebration should be muted, though, because their loss in *Janus Capital* may prove to be the most impactful opinion of the term in this area. •

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