KESSLER TOPAZ

Bulletin

Summer 2011

A Quarterly Newsletter for Institutional Investors by Kessler Topaz Meltzer & Check, LLP

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Introducing . . . KESSLERTOPAZ MELTZERCHECK LLP

Effective May 15, 2011, our law firm has changed its name to Kessler Topaz Meltzer & Check, LLP. "Our firm has never been stronger and is poised for continued success. We have an exceptional group of partners, attorneys and professional staff in place to meet our clients' evolving needs and to further establish our leadership position in all of our practice areas, as well as new practice areas we are currently developing", said partner David Kessler. The change in name reflects that Andrew L. Barroway, who shall remain with the Firm as Senior Counsel, is not actively involved in the day-to-day operations or the management of the Firm. "I am proud of what we have accomplished over the past twenty years and am comforted by the fact that the Firm and its clients are in extremely capable hands and wish everyone the best of luck as I continue to transition to a less active role," said Barroway.

The Firm, with over 90 attorneys, represents numerous institutional and individual clients, both domestic and international, and has been at the forefront of class action litigation for over 20 years.

Kessler Topaz Meltzer & Check remains uniquely focused and dedicated to advocating and protecting the rights of investors, employees and consumers worldwide.

Foreign Exchange Trading: Secret Profits and Hidden Losses

Naumon Amjed, Esquire and Ryan Degnan, Esquire

Custodial banks' foreign exchange ("FX") trading practices have recently drawn scrutiny from state attorneys general, public and private pension funds, and the financial media for manipulating FX rates charged to the banks' clients. In short, custodial banks offer FX trading services to allow their clients to convert currencies in order to buy and sell foreign securities and to engage in other transactions. As detailed below, however, custodial banks have come under fire for the alleged practice of secretly charging their clients less favorable FX rates than those actually incurred by the bank when the FX trade is executed. Details about the banks' practices have come from lawsuits, including several whistleblower (or *qui tam*) actions filed on behalf of state funds in California, Virginia and Florida.[1] The actions generally allege that custodial banks execute trades at one rate but charge clients a different (less favorable) rate based on post-trade

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[1] A *qui tam* action is a lawsuit brought by a private individual (also known as a relator) to recover losses on behalf of a public entity. *Qui tam* actions have been codified by federal and state "false claims" statutes. These statutes typically require the relator to file the action under seal to allow the state an opportunity to review the allegations, conduct an investigation, and determine whether to proceed in the state's name. *Qui tam* actions only seek to recover losses for funds identified by the relators. They do not seek to recover losses for all clients of a custodial bank.

520-M

Kessler Topaz Taking Mexican Mining Giant to Trial in *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*

James H. Miller, Esquire

Kessler Topaz serves as co-lead counsel in a stockholder derivative action scheduled for trial in June 2011, where the Firm seeks to recover more than $1 billion in damages on behalf of Southern Peru Copper Corporation.[1] Southern incurred these damages as a result of a 2004 self-interested transaction between Southern and its controlling stockholder, Mexican mining giant Grupo Mexico (the "Transaction"). In the Transaction, Plaintiff alleges that Southern's board of directors caved to the will of its controlling stockholder when it overpaid by more than 24 million shares of its common stock to acquire Grupo Mexico's Mexican mining assets held through Grupo Mexico's subsidiary, Minera Mexico. The trial will be a rare opportunity for the Firm to ensure that majority-controlled public corporations are not manipulated for their controller's benefit.

The Transaction

At the beginning of 2004, Grupo Mexico controlled both Southern and Minera Mexico; it owned 54% of Southern and 99% of Minera Mexico. Southern was primarily a copper mining company with operations located in Peru. It was financially sound, with strong cash flow and essentially no debt. Its shares paid regular quarterly dividends, and Southern was poised to benefit substantially from rising copper prices.

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[1] The action is entitled *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*, Consol. C.A. No. 961-VCS, and is presently pending before the Honorable Leo E. Strine, Jr., Vice Chancellor of the Delaware Court of Chancery. Southern Peru changed its name to Southern Copper Corporation in 2005.

The Supreme Court Reaffirms Its Flexible View of Materiality in Securities Fraud Suits – a Review of *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. __, 131 S. Ct. 1309 (2011)

Michelle M. Newcomer, Esquire

To plead a claim for securities fraud under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, plaintiffs must specifically allege: (1) a misstatement or omission of a fact necessary to render the defendants' other statements, not misleading; (2) that the misstatement or omission was material; (3) the defendants acted with scienter, *i.e.*, knowing or extreme reckless conduct; (4) the misstatement or omission caused plaintiffs' losses; and (5) damages. On March 22, 2011, the United States Supreme Court handed securities fraud plaintiffs a decisive victory on how to plead the elements of materiality and scienter in securities fraud cases involving product safety, when it decided the appeal in *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. __, 131 S. Ct. 1309 (2011). In a unanimous opinion the Court affirmed the opinion of the Ninth Circuit and held that: (1) reports showing a plausible causal link between a drug and an adverse health event may be material, requiring disclosure to investors under the securities laws, and (2) knowledge of such events may be used to show that a defendant acted with scienter, even if the reports are not sufficiently numerous to establish a statistically greater risk for the adverse event. Thus, it held that plaintiffs may rely on non-statistically significant adverse events to establish the elements of materiality and scienter in pleading claims under Section 10(b) and Rule 10b-5, against pharmaceutical companies for damages caused by alleged misrepresentations and omissions regarding the safety of their products.

In so ruling, the Supreme Court expressly rejected the bright-line rule argued for by Matrixx and applied by courts in the Second and Third Circuits that isolated adverse event reports that do not show a statistically significant increased risk for the adverse event are immaterial as a matter of law and, thus, need not be disclosed to investors. *Compare Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153, 157 (2d Cir. 1998) (*Carter-Wallace I*); *In re Carter-Wallace, Inc., Sec. Litig.*, 220 F. 3d 36 (2d Cir. 2000) (*Carter-Wallace II*); *Oran v. Stafford*, 226 F.3d

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FIXED INCOME FREE FOR ALL: Kessler Topaz Pursues Direct Claims on Behalf of Union Pension Funds to Recover Fixed Income Losses Caused by Wachovia

Peter H. LeVan, Jr. Esquire and Shannon O. Braden, Esquire

The recent mortgage crisis and overall market volatility did not occur overnight. To the contrary, all signs pointed to a global economic recession as early as 2006. By that time, there were numerous bankruptcy filings in the finance sector; major dislocations in credit markets worldwide; dramatic increases in expectations of volatility; rapidly deteriorating employment markets in the United States and Europe; and consumer stress in the housing markets. And that was just the beginning. Major global events in 2007 and early 2008 continued to warn of the impending economic recession. Central Banks around the world cut lending rates in a futile effort to increase liquidity to credit markets; unemployment rates locally, regionally and nationally increased to generational highs; and the Chicago Board of Options Exchange Volatility Index, a well-recognized measure of market expectations and investor sentiment, more than doubled during this period.

Unfortunately, many financial institutions failed to heed such clear warning signs. Wachovia Bank, N.A., now Wells Fargo Bank, N.A., was one such institution. Its imprudent investment decisions caused several Local 464A United Food and Commercial Workers Union funds to suffer substantial losses in their fixed income accounts (collectively, Funds). Through the use of an alternative fee arrangement, Kessler Topaz Meltzer & Check, LLP has been diligently litigating a direct (non-class) case against Wachovia and its subsidiaries, Evergreen Investment Management Company, LLC and

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The Question of Auditor Primary Liability for Misstatements in Audited Financial Statements: The Ninth Circuit's *New Mexico* Decision

Alessandra C. Phillips, Esquire

The U.S. Court of Appeals for the Ninth Circuit recently issued an important decision addressing whether auditing firms can be primarily liable for misstatements contained in audited financial statements, a topic many courts are reluctant to rule upon. In *New Mexico Investment Council v. Ernst & Young LLP* (9th Cir. Apr. 14, 2011), shareholders alleged that Ernst & Young were involved in Broadcom's stock options backdating scheme from 2000-2006. The 9th Circuit upheld plaintiffs' allegations and in reversing the district court, the Appeals Court held that plaintiffs' allegations of scienter were sufficient to state a claim.

Background

The *New Mexico* case stems out of a securities class action complaint against Broadcom Corporation, certain Broadcom officers and directors, and Broadcom's auditor E&Y, for a fraudulent $2.2 billion stock option backdating scheme. Plaintiffs alleged that E&Y, as Broadcom's auditor, violated the Securities Exchange Act of 1934 by issuing unqualified audit opinions attesting to the validity of Broadcom's financial statements while it knew of, or recklessly disregarded, Broadcom's fraudulent backdating actions.

Between 2000 and 2006, Broadcom, a semiconductor company with revenues in excess of $2.5 billion in 2006, fraudulently overstated its net earnings and understated its compensation expense by more than $2.2 billion, due to the improper accounting of backdated stock options. Broadcom engaged in an improper stock option backdating scheme that required the company to restate its financial statements in January 2007 for the fiscal years 1998 to 2005 (the "Restatement'). The Restatement acknowledged that Broadcom had improperly accounted for $2.2 billion in income, largely due to improper option backdating, and every financial statement, and quarterly and annual report issued during the time period covered by the Restatement was false and misleading. In connection with a SEC civil securities fraud investigation, Broadcom agreed to pay a civil penalty of $12 million, and its officers and directors faced civil and criminal charges.

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Institutional Investor FORUMS

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3RD ANNUAL

Evolving Fiduciary Obligations of Pension Plans

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Wielding New Shareholder Rights and Investment Strategies to Meet Plan Objectives

There is broad agreement that many of the investment models and ideas on which institutions have relied for decades are flawed and insufficient for ensuring that established goals can be met. Add in corporate governance and other shareholder engagement concerns, and the bar is raised for plans struggling to develop strategies and actions that are both practical and have a high probability of success.

Investing institutions find themselves at a crossroads because contrasting trends involving shareholder rights and the lack of clarity on adjusting investment programs to meet current and future commitments, compounded by the continuing unstable economic outlook. On the one hand, action is demanded but the limits on how to respond are still being tested and the outcomes remain unknown. On the other hand, institutions are obliged to take action, to make decisions that cannot wait in order to ensure they are discharging their duties in a timely manner and within acceptable fiduciary guidelines.

Now in its third year, Institutional Investor's **The Evolving Fiduciary Obligations of Pension** Plans roundtable will provide a comprehensive examination of the vital issues that plan sponsors and their legal advisors must understand in order to properly fulfill their roles as fiduciaries and as shareholders. Co-hosted by Kessler Topaz Meltzer & Check, LLP, this one-day event will offer valuable insights into the ways in which fiduciaries can be most effective in engaging with the management of portfolio companies. We will review the key legal decisions and trends investors should be aware of, and discuss the ideas shaping the strategies under consideration by leading institutions in order to obtain superior investment results.

Our audience of senior pension fund executives, their legal advisors, and other investment professionals will have an opportunity to hear from a number of their peers and outside experts as well as to share insights and experiences regarding the most critical fiduciary issues they face today. Participants will be provided with impartial perspectives on how fiduciaries can optimally meet their objectives and avoid difficulties, as well as receive timely information and guidance on various investment strategies and legal options.

❒ **Yes, I would like to attend** the Evolving Fiduciary Obligations meeting (no registration fee required)

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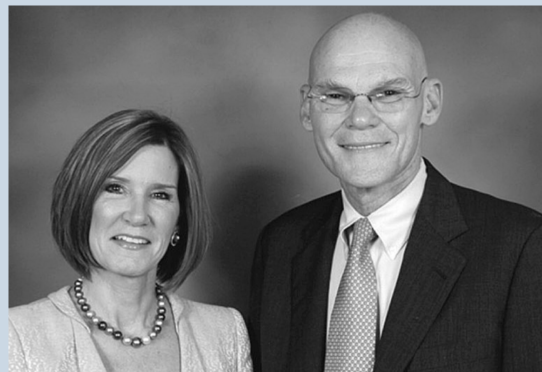
Mary Matalin and James Carville



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"It's Not My Job": The Supreme Court Will Decide Whether Plaintiffs Must Establish Loss Causation in Order to Certify a Class Action Under *Section 10(b) of The Securities Exchange Act of 1934*

Naumon Amjed, Esquire and Ryan Degnan, Esquire

On April 25, 2011, the Supreme Court of the United States heard oral argument in *Erica P. John Fund, Inc. v. Halliburton Co.*, No. 09-1403. The issue before the Court is the Fifth Circuit's requirement that plaintiffs "establish loss causation in order to trigger the fraud-on-the-market presumption" at the class certification stage of litigation asserting claims under Section 10(b) of the Securities Exchange Act of 1934.[1] The Fifth Circuit's requirement imposes a significant hurdle to the prosecution of investors' claims and is inconsistent with other circuit courts and has been specifically criticized by the Seventh Circuit.

Reliance in Class Actions:

Section 10(b) is the general anti-fraud provision under the federal securities laws. In order to assert a claim under Section 10(b) the following elements must be pled: "(1) a material misrepresentation (or omission); (2) scienter, i.e., a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as 'transaction causation;' (5) economic loss; and (6) 'loss causation,' i.e., a causal connection between the material misrepresentation and the loss."[2]

The reliance element requires plaintiffs to have relied on the defendants' fraud when trading a security. Proving that each member in a class (which may number in the many thousands) relied on the defendants' fraud would undermine the efficiencies class litigation seeks to achieve. In order to address the reliance element, federal courts have developed legal doctrines that serve as substitutes for actual reliance under Section 10(b). One such reliance substitute is the fraud-on-the-market doctrine. The fraud-on-the-market doctrine finds its roots in the Supreme Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) ("*Basic*"). If the doctrine is triggered, investors are not required to prove that they actually read and relied upon defendants' misstatements before making investment decisions. Rather, the doctrine ***presumes*** that the actionable misstatements are incorporated into the price of a security ***if*** that security is traded in an efficient market. In essence, plaintiffs are entitled to rely on the market's reliance on defendants' misstatements and omissions. As explained below, the Fifth Circuit's decisions now before the Court adds a step to the analysis by requiring plaintiffs to ***prove*** defendants' misstatements impacted the price of a stock (loss causation) in order to trigger the fraud-on-the-market doctrine. In essence, plaintiffs are required to prove an element under Section 10(b) at the class certification stage in order to have the opportunity to present their case to a jury.

The Case Below:

In the underlying case, the lead plaintiff alleged that defendant Halliburton Co. ("Halliburton") and its officers made false and misleading statements that understated the company's exposure to asbestos liabilities, overstated its revenue, and overstated the benefits of a merger. When the lead plaintiff moved for class certification, defendants argued that the plaintiff failed to demonstrate that the fraud-on-the-market presumption was applicable to plaintiff's claims because there was no evidence of statistically significant price movements in response to the false statements or the alleged corrective disclosures. In the absence of the fraud-on-the-market presumption, the lead plaintiff would need to establish reliance on an individualized basis — thereby making the class action unsuitable for class certification under Federal Rule of Civil Procedure 23.

The district court agreed with defendants and held that "[p]laintiffs who seek class status by showing collective reliance through the [fraud-on-the-market] presumption must show that the defendant made public, material misstatements, that the stocks traded in an efficient market, and that the stock price was actually affected by the purported fraud."[3] Additionally, the district court required plaintiffs to "show that false, non-confirmatory positive statements caused a positive effect on the stock price [or] (1) that an alleged corrective disclosure causing the decrease in price is related to the false, non-confirmatory positive statement made earlier, and (2) that it is more probable than not that it was this related corrective disclosure, and not any other unrelated negative statement, that caused the stock price decline."[4]

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[1] *See Archdiocese of Milwaukee Supporting Fund v. Halliburton Co.*, 597 F.3d 330, 335 (5th Cir. 2010) ("*Halliburton*").

[2] *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (citations omitted).

[3] *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 2008 U.S. Dist. LEXIS 89598, at *17 (N.D. Tex. Nov. 4, 2008) (citations omitted).

[4] *Id.*

The Rights & Responsibilities
of Institutional Investors

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Turning Words Into Action

For 7 years, *The Rights & Responsibilities of Institutional Investors* meeting has offered objective analysis of the issues facing active owners and provided insightful examination of the vital issues confronting European investors. During those years, the dialog has both deepened and broadened.

We are pleased to announce that the 2012 meeting will endeavor to address both sets of issues facing investors today: ensuring that institutions have the means to exercise their full rights as shareholders and yet also have the information and the tools they need to meet their unique investment objectives. In its simplest form this goal means that we will be offering parallel tracks of sessions over the course of this single day meeting, but more importantly it means addressing the full, broad spectrum that pension plans and their managers and advisors are confronting. For example, what are the investment practices and strategic guidelines that will help institutions achieve their investment and risk management objectives while exercising their fiduciary duties, including benefiting from responsible investment practices and active engagement.

In 2012, *The Rights & Responsibilities of Institutional Investors,* again co-sponsored by Institutional Investor and Kessler Topaz Meltzer & Check, LLP, will offer investment, compliance and legal officers from European public pension and insurance funds and mutual fund companies the information they require on how to turn principles into sound fiduciary and investment practice.

☐ **Yes,** I am interested. Please send me more information about The Rights & Responsibilities of Institutional Investors.

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Foreign Exchange Trading: Secret Profits and Hidden Losses *(continued from page 1)*

movements in FX prices. By manipulating FX rates without their clients' knowledge, custodial banks stood to generate hundreds of millions of dollars in secret profits at the expense of the banks' clients. FX trading is big business and large custodial banks such as State Street Corporation ("State Street"), The Bank of New York Mellon Corporation ("BNY Mellon"), and Northern Trust Corporation ("Northern Trust") earn approximately 7%-12% of their annual revenue from FX trading.[2]

To date, three *qui tam* actions alleging improper FX trading practices at custodial banks have been unsealed. Additionally, two class actions, including one filed by Barroway Topaz, have been filed against custodial banks by pension and retirement funds. We briefly discuss these actions below.

Qui Tam Actions and State Investigations

The first *qui tam* action to be unsealed against a custodial bank, *The People of the State of California v. State Street Corp., et al.*, alleged that State Street "raided the custodial accounts" of CalPERS and CalSTRS, "in a total amount exceeding $56 million, by fraudulently pricing foreign currency ('FX') trades State Street executed for the pension funds."[3] Specifically, the California Attorney General (who is leading California's action), alleges that State Street overcharged the funds by manipulating the actual FX rates incurred by State Street when executing the pension funds' trades. Moreover, State Street is alleged to have disguised its conduct by entering false FX rates into State Street's reporting system and then supplying the pension funds with reports that lacked time stamps. Providing time stamps would allow the funds to verify that the rate charged by the bank was consistent with the prevailing bid/ask spread at the time of the FX trade. Jerry Brown, then California's Attorney General and now California's Governor, called State Street's practices an "unconscionable fraud."[4]

Earlier this year, two similar *qui tam* actions against BNY Mellon were unsealed. First, on January 21, 2011, *Commonwealth of Virginia, ex rel. FX Analytics v. The Bank of New York Mellon Corp.*, was unsealed after Virginia's Attorney General intervened in the *qui tam* action filed in that state.[5] The complaint, which seeks $150 million in damages, alleges that BNY Mellon intentionally charged several Virginia retirement funds false FX rates for transactions executed on behalf of the funds. Like State Street, BNY Mellon is alleged to have priced trades in a manner designed to allow the custodial bank to secretly profit from the spread between the actual FX rates paid by the bank and the false FX rates charged to clients. In discussing his decision to intervene in the action, Virginia's Attorney General, Ken T. Cuccinelli II, stated that "[b]ased on the information the whistleblower provided and the information developed using the investigatory tools authorized in [Virginia's Fraud Against Taxpayers Act], [he] determined that it was prudent to intervene in the case and protect the interests of the retirement fund beneficiaries."[6]

While setting forth similar allegations, the second unsealed *qui tam* action against BNY Mellon, *State of Florida, ex rel. FX Analytics v. The Bank of New York Mellon Corp.*, provided further details surrounding BNY Mellon's FX trading practices.[7] Specifically, the complaint details the steps BNY Mellon took to execute and conceal trades at post-execution rates. Most notably, the complaint revealed that BNY Mellon used a foreign-exchange computer system called "Charlie" and daily "reconciliation" calls between BNY Mellon's FX transaction desks to coordinate the selection of FX rates charged to clients.

Recognizing that custodial banks' FX practices may have resulted in similar harm to their funds, other states have begun to investigate FX trading practices. Both Massachusetts and North Carolina have publicly indicated that they are investigating the FX transactions executed by their custodial banks — State Street and BNY Mellon.[8] Additionally, certain reports suggest that New York may be investigating BNY Mellon's FX practices.[9]

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[2] *See* Erin McCarthy and David Benoit, *Shift In FX Trading Seen Damaging Banks' Revenues — Report*, The Wall Street Journal (Feb. 8, 2011); Steve Daniels, *Fee fracas imperils profitable currency trading business for Northern Trust*, Chicago Business (Feb. 14, 2011).

[3] *The People of the State of California v. State Street Corp., et al.*, Case No. 34-2008-8457-CU-MC-GDS, p. 2 (Cal. Superior complaint in intervention filed Oct. 20, 2009).

[4] Eric Dash, *State Street Bank Accused of Fraud by California*, The New York Times (Oct. 20, 2009).

[5] *Commonwealth of Virginia, ex rel. FX Analytics v. The Bank of New York Mellon Corp.*, No. CL-2009-15377 (Va. Cir. unsealed Jan. 21, 2011); *see also* Rosalind S. Helderman, *Cuccinelli intervenes in suit alleging pension fraud*, The Washington Post (Jan. 27, 2011).

[6] Rosalind S. Helderman, *Cuccinelli intervenes in suit alleging pension fraud*, The Washington Post (Jan. 27, 2011).

[7] *State of Florida, ex rel. FX Analytics v. The Bank of New York Mellon Corp.*, No. 2009-ca-4140 (Fla. Cir. unsealed Feb. 7, 2011).

[8] *See* Ross Kerber, *Massachusetts probing forex at State Street*, Reuters (Apr. 29, 2011); Ross Kerber and Dan Levine, *North Carolina might sue banks over Forex trading*, Reuters (Apr. 26, 2011).

[9] *See* Carrick Mollenkamp and Lingling Wei, *BNY Mellon Faces Forex Suit in New York*, The Wall Street Journal (Feb. 22, 2011).

Kessler Topaz Taking Mexican Mining Giant to Trial in *In re Southern Peru Copper Corporation Shareholder Derivative Litigation* *(continued from page 2)*

Minera Mexico was a different story. The Mexican copper mining company was debt-ridden, and its cash flow was tied up in debt repayments and thus not available to fund growth. Unwilling to fund Minera Mexico's growth, Grupo Mexico conceived a plan by which Southern would acquire Minera Mexico in exchange for Southern stock. Southern's cash could then be used to fund Minera Mexico's growth, and Grupo Mexico would receive tens of millions of shares of valuable Southern common stock.

On February 3, 2004, Grupo Mexico proposed to the Southern board of directors that Southern acquire Minera Mexico. Grupo Mexico proposed that Minera Mexico's value was approximately $3.1 billion, and that Southern pay approximately 72 million Southern shares to acquire Minera Mexico. Grupo Mexico calculated the number of Southern shares it wanted by dividing $3.1 billion by Southern's then-current market price.

In response, Southern formed a "Special Committee" of purportedly independent directors to consider Grupo Mexico's proposal. After more than 8 months of purported negotiation, the Special Committee essentially capitulated to Grupo Mexico's original demand. On October 21, 2004, the Special Committee approved the Transaction by which Southern agreed to acquire Minera Mexico from Grupo Mexico in exchange for 67.2 million shares of Southern common stock. These shares were worth exactly what Grupo Mexico demanded 8 months earlier: $3.1 billion.

Plaintiff alleges that Minera Mexico was worth approximately $1 billion less than what Southern agreed to pay Grupo Mexico, and that the Transaction was thus totally unfair to Southern and its public stockholders.

The Litigation

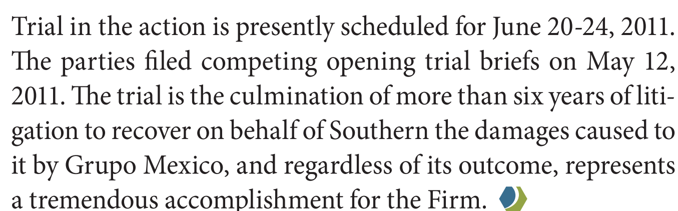
After filing its initial complaint in the Delaware Chancery Court (Southern is a Delaware Corporation), Kessler Topaz engaged in nearly five years of document and deposition discovery. Numerous defendants and related third-parties — including financial advisors to Grupo Mexico and the Special Committee, and additional experts retained by the Special Committee — produced hundreds of thousands of pages of documents. Following the production of these documents, Kessler Topaz traveled throughout the United States, Mexico, and Peru to take depositions of defendants and their advisers.

After discovery concluded, on June 30, 2010, Kessler Topaz filed a motion for summary judgment seeking to resolve the case in Southern's favor before trial. Kessler Topaz argued that the Transaction was not "entirely fair" to Southern as a result of the $1 billion overpayment and the disloyal negotiation process employed by the Special Committee.[2] Grupo Mexico and certain related defendants opposed Kessler Topaz's summary judgment motion, and argued that Kessler Topaz should bear the burden of demonstrating that the Transaction was not entirely fair to Southern. The Special Committee members also opposed Kessler Topaz's summary judgment motion, and argued they should be dismissed from the action pursuant to Delaware's statutory director indemnification provision because they did not breach their fiduciary duty of loyalty to Southern.[3]

A hearing on the motions for summary judgment was held on December 21, 2010. Although Vice Chancellor Strine denied Kessler Topaz's motion for summary judgment, he expressed skepticism regarding the fairness of the Transaction. He called defendants' financial analysis of the Transaction "alchemy," and stated that "there are some fairly basic questions, fundamental questions, about whether the special committee, however well-intentioned, actually simulated genuine arm's-length bargaining" with Grupo Mexico. Accordingly, the Vice Chancellor also denied Grupo Mexico's motion and held that Grupo Mexico must demonstrate at trial that the Transaction was entirely fair to Southern.[4]

The Trial

Trial in the action is presently scheduled for June 20-24, 2011. The parties filed competing opening trial briefs on May 12, 2011. The trial is the culmination of more than six years of litigation to recover on behalf of Southern the damages caused to it by Grupo Mexico, and regardless of its outcome, represents a tremendous accomplishment for the Firm.



[2] As the controlling stockholder of both Southern and Minera Mexico, Grupo Mexico stood on both sides of the Transaction. Under such circumstances, the transaction must be "entirely fair" to the company and its minority stockholders. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). This heightened standard requires that the transaction be fair in terms of both price and process. *Id.* at 711. It is the burden of the defendants to demonstrate that the transaction is entirely fair. *Id.* at 710; *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985).

[3] *See* 8 Del. C. § 102(b)(7) (directors of Delaware corporations are insulated for monetary damages in connection with breaches of the fiduciary duty of care, but can be held financially liable for breaches of the fiduciary duty of loyalty).

[4] Vice Chancellor Strine did dismiss the Special Committee members from the action, finding that they did not breach their fiduciary duty of loyalty, but held that whether the Special Committee fulfilled their fiduciary duty of care would be heavily scrutinized at trial.

FIXED INCOME FREE FOR ALL: Kessler Topaz Pursues Direct Claims on Behalf of Union Pension Funds to Recover Fixed Income Losses Caused by Wachovia *(continued from page 3)*

Tattersall Advisory Group (collectively, Wachovia), on behalf of the Funds to recover the substantial fixed income losses caused by Wachovia's imprudent conduct.

Historical Expectation of Risk

Wachovia and its predecessors have acted as the Funds' discretionary investment manager for more than 50 years, exercising sole discretion over investment of the Funds' assets consistent with the applicable investment guidelines and its fiduciary obligations. Wachovia delegated management of the Funds' fixed income assets to Evergreen, which in turn delegated such management to Tattersall, each of which are affiliated with Wachovia. Tattersall directly invested the Local 464A UFCW Pension Fund's fixed income assets as an individually managed account while the remaining Funds' fixed income assets were invested in the Evergreen Core Bond Fund, a mutual fund then managed by Tattersall. Tattersall managed both the Pension Fund's fixed income individual account and the Core Bond Fund using the same investment strategies and similar sector allocations.

From the start of the long relationship and continuing until mid-2007, Wachovia consistently managed the fixed income assets of the Funds in a safe and conservative manner, generating fixed income returns that closely tracked the Lehman Aggregate Bond Index, now known as the Barclay's Capital Aggregate Bond Index, to which the Funds were benchmarked. For many years Wachovia managed the Funds' fixed income assets using conservative investment strategies and a portfolio composition that closely tracked the benchmark index.

Fundamental Investment Strategy Shift

Beginning in mid-2007, however, Wachovia — unbeknownst to the Funds — made a number of significant and fundamental shifts in investment strategy that drastically and imprudently altered the Funds' historical fixed income portfolio allocations, causing those portfolios to deviate dramatically from the benchmark index they had so closely tracked for years. Specifically, Wachovia began dramatically decreasing the Funds' existing holdings in short-term, high-quality and low-risk debt instruments (such as U.S. Treasury securities and mortgage securities issued by Fannie Mae and Freddie Mac that carry little to no credit risk) in order to materially increase the Funds' holdings in high-risk, non-agency residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS) and collateralized mortgage obligations (CMOs). Many of the new high-risk investments made by Wachovia were "off index" in nature and thus were not at all representative of the benchmark index the Funds' portfolios were designed to track.

During the remainder of 2007 and through 2008, Wachovia continued to hold — and in fact *increased* the Funds' exposure

(continued on page 12)

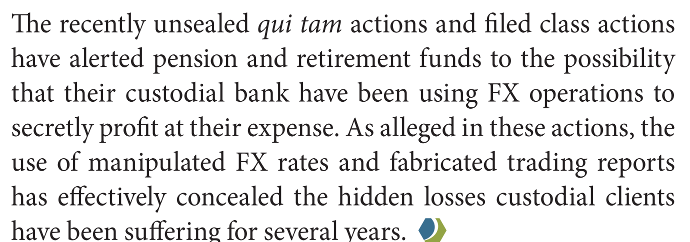
Foreign Exchange Trading: Secret Profits and Hidden Losses *(continued from page 7)*

Class Actions

Individual pension and retirement funds have filed actions seeking to recoup losses resulting from their custodial banks' FX trading practices. In the last few months, two class actions concerning FX trading have been filed against State Street and BNY Mellon. First, in February 2011, the Arkansas Teacher Retirement System filed a class action complaint against State Street.[10] The complaint effectively mirrored the allegations set forth in the California action and seeks recovery of improperly obtained proceeds from State Street's FX trading practices. Second, Barroway Topaz is representing the Southeastern Pennsylvania Transportation Authority ("SEPTA") in its class action against its custodial bank, BNY Mellon.[11] Specifically, SEPTA seeks the recovery of hidden profits BNY Mellon generated from charging clients FX rates based on post-trade movements in the FX market.

Conclusion

The recently unsealed *qui tam* actions and filed class actions have alerted pension and retirement funds to the possibility that their custodial bank have been using FX operations to secretly profit at their expense. As alleged in these actions, the use of manipulated FX rates and fabricated trading reports has effectively concealed the hidden losses custodial clients have been suffering for several years.



[10] *See Arkansas Teacher Retirement System v. State Street Corp., et al.*, Case No. 11-cv-10230 (D. Mass. Feb. 2, 2011).

[11] *See Southeastern Pennsylvania Transportation Authority v. The Bank of New York Mellon Corp.*, Case No. 11-cv-1628 (E.D. Pa. Mar. 7, 2011).

The Supreme Court Reaffirms Its Flexible View of Materiality in Securities Fraud Suits – a Review of *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. __, 131 S. Ct. 1309 (2011)

(continued from page 2)

275 (3d Cir. 2000), *with Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167, 1178-80, 1183 (9th Cir. 2009). As such, it resolved a cavernous split among the circuit courts, as to the strength of evidence required to plead materiality and scienter, in favor of the more liberal standard applied by the Ninth Circuit.

Further, the Supreme Court reiterated the flexible approach to materiality that it first announced in *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). In *Basic*, the Court held that materiality "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." 485 U.S. at 231-32 (internal quotation marks and citations omitted)). In *Matrixx*, the Court likewise held that the materiality of adverse event reports must be assessed in light of the factual circumstances at issue. *See id.* at 1321. To this end, it emphasized that in as much as Section 10(b) and Rule 10b-5 do not impose upon publicly traded companies a duty to disclose all material information, if a company's public statements tout the safety of a product, internal information to the contrary may have to be disclosed. *See id.* at 1321-22. The Court's holding, thus makes clear, that the materiality of non-statistically significant adverse event reports will depend on the content of the reports, considered against the affirmative statements made by a company.

The *Matrixx* decision is likely to have a sweeping impact on both pending and future litigation. To illustrate its impact, we first consider the *Matrixx* case in detail.

Matrixx Initiatives

Matrixx Initiatives, Inc. markets and sells a line of cold remedy products under the brand name Zicam. Zicam Cold Remedy, the nasal spray and gel line of Zicam products, allegedly accounted for approximately 70 percent of Matrixx's sales during the Class Period. 131 S. Ct. at 1314. The plaintiffs alleged that during the Class Period, Matrixx improperly: (1) denied statements that Zicam caused anosmia (loss of small) as "completely unfounded and misleading" and stated that "[i]n no clinical trial of intranasal zinc gluconate gel products has there been a single report of lost or diminished olfactory function"; and (2) claimed that Matrixx was "poised for growth" and that it expected revenues to "be up in excess of 50%." *Id.* at 1314-16. These statements were materially misleading, the plaintiffs alleged, because they failed to disclose: (1) that Matrixx received reports of anosmia in patients taking Zicam Cold Remedy; (2) a study presentation by a University of Colorado doctor regarding these incidents and "Zicam Induced Anosmia"; (3) research and reports of "previous studies linking zinc sulfate to loss of smell," and "demonstrating that intranasal application of zinc could be problematic"; and (4) two products liability suits against Matrixx alleging that Zicam had damaged the plaintiffs' sense of smell. *Id.*

Matrixx moved to dismiss the plaintiffs' complaint under *Carter-Wallace*, arguing that plaintiffs had failed to adequately plead the elements of materiality and scienter because they failed to allege a statistically significant connection between Zicam and anosmia. *Id.* at 1317. The District Court granted Matrixx's motion, stating that the plaintiffs had failed to allege a "statistically significant correlation between the use of Zicam and anosmia so as to make failure to public[ly] disclose complaints and the University of Colorado study a material omission." *Id.* (citation omitted). The District Court also found that the plaintiffs had failed to adequately plead scienter, because it did not allege that Matrixx disbelieved its statements about Zicam's safety or that any of the defendants profited or attempted to profit from these statements. *Id.*

The plaintiffs appealed and the United States Court of Appeals for the Ninth Circuit reversed, holding that the plaintiffs sufficiently alleged materiality and scienter. *Siracusano v. Matrixx Initiatives, Inc.*, 585 F. 3d 1167 (9th Cir. 2009). Specifically, the circuit court observed that "[t]he determination [of materiality] requires delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts and the significance of those inferences to him," and held that the District Court erred in requiring statistical significance to establish materiality and that the complaint adequately alleged information regarding the possible link between Zicam and anosmia that would have been significant to a reasonable investor. *Id.*, at 1178-80 (quoting *Basic*, 485 U.S. at 236). The Ninth Circuit also held that "[w]ithholding reports of adverse effects of and lawsuits concerning the product responsible for the company's remarkable sales increase is an extreme departure from the standards of ordinary care, giving rise to a strong inference of scienter." *Id.*, at 1183 (internal quotation marks omitted). Matrixx petitioned the Supreme Court to take certiorari review, which the Supreme Court granted. *Matrixx Initiatives, Inc. v. Siracusano*, 560 U.S. ___, 130 S. Ct. 3411 (2010).

As noted above, the Supreme Court affirmed the Ninth Circuit. In so ruling, it rejected Matrixx's argument for the adoption of a bright-line rule that anything less than a statistically significant number of adverse events are immaterial to investors, as a matter of law. It further noted that Matrixx's argument rests on the flawed premise that statistical significance is the only reliable indication of causation between a drug and an adverse effect. *Matrixx*, 131 S. Ct. at 1319. Quite to the contrary, citing an *Amici Curiae* brief submitted by

Kessler Topaz on behalf of certain Medical Researchers and in support of Respondent Siracusano, the Supreme Court noted that medical experts, researchers and the FDA rely on evidence other than statistically significant reports in assessing and establishing an inference of causation and in taking regulatory action. *See id*., 131 S. Ct. at 1319-21 (quoting the Brief of *Amici Curiae* by Medical Researchers in Support of Respondents Urging Affirmance).[1] Likewise, it noted that courts frequently permit expert testimony on causation based on evidence other than statistical significance. *See id*. at 1319. "Given that medical professionals and regulators act on the basis of evidence of causation that is not statistically significant," the Court noted, "it stands to reason that in certain cases reasonable investors would as well." *Id*. at 1321. The Court further noted that the issue of whether a company's internal adverse event reports are material depends largely on the Company's public statements. *See id*. at 1321-22. Under the Court's reasoning, if a company, for example, says nothing about the safety of its product, internal adverse event reports that are not statistically significant, likely will be deemed immaterial, not requiring disclosure. Conversely, if a company publicly touts the safety of its product, the omitted reports are more likely to be deemed material, requiring disclosure to the market.

Applying these principles to the facts before it, the Supreme Court concluded that the plaintiffs had adequately pleaded the materiality of the omitted information. *See id*. at 1322. Specifically, it noted that Matrixx: (1) received information from three medical professionals and researchers about more than 10 patients who had lost their sense of smell after using Zicam, (2) knew that two researchers had presented their findings about a causal link between Zicam and anosmia, and (3) had been made aware of previous studies demonstrating a biological causal link between intranasal application of zinc and anosmia. *Id*. This information, it held, revealed a plausible causal relationship between Zicam Cold Remedy and anosmia. *See id*. at 1323. Consumers, it further found, likely would have viewed this risk as substantially outweighing the benefit of using the product. *See id*. And, because Zicam Cold Remedy allegedly accounted for 70 percent of Matrixx's sales, the Court held that the complaint alleges facts suggesting a significant risk to the commercial viability of Matrixx's leading product. *See id*. As such, the Court concluded it "substantially likely that a reasonable investor would have viewed this information as having significantly altered the total mix of information made available" and, thus, could not be deemed immaterial as a matter of law. *Id*. (internal quotation marks omitted).

The Court also rejected Matrixx's argument that scienter could not be established because of the lack of statistically significant adverse event reports. *Id*. at 1324. Rather, it found that plaintiffs adequately alleged that after receiving the adverse event reports suggesting a causal link between Zicam and anosmia, Matrixx hired a consultant to review the product for safety and convened a panel of physicians and scientists to respond to the University of Colorado doctor's presentation suggesting a causal connection between Zicam and anosmia. *See id*. These allegations, it held, combined with allegations that Matrixx issued a press release suggesting that Zicam does not cause anosmia, when it had not conducted any studies on anosmia at the time, gave rise to a cogent and compelling inference that Matrixx elected not to disclose the adverse event reports because it knew they would likely impact the market for Zicam. *See id*. 1324-25.

The Implications of Matrixx

As set forth above, the Supreme Court's decision in *Matrixx* is likely to have a sweeping impact on pending and future securities fraud suits. First, as a practical consequence of *Matrixx*, pharmaceutical and life sciences companies may make fewer or more tailored disclosures regarding the safety of their products. Indeed, whereas *Matrixx* intimates that the materiality of non-statistically significant adverse event reports depends on the affirmative statements a company makes, it is likely that companies will be less inclined to make affirmative, boastful disclosures regarding the safety of their products. Nevertheless, when these companies do speak, it is reasonable to believe that they will be more forthcoming in representing safety and efficacy results related to its products.

Second, it is reasonable to presume that in light of *Matrixx*, courts will be less likely to dismiss securities fraud suits against pharmaceutical and life sciences companies at the pleading stage for failing to plead the existence of statistically significant adverse event reports that investors would find material.

Finally, the *Matrixx* Court's recognition that non-statistically significant evidence may be material to investors lowers the plaintiffs' burden of proof at trial and in raising an issue of fact at summary judgment, particularly with respect to cases previously sustained under the more rigorous standards for pleading materiality applied by courts in the Second and Third Circuits. For example, whereas Second and Third Circuit law required plaintiffs to present sufficient evidence to raise an issue of fact regarding the existence of a statistically significant risk associated with the product, *Matrixx* allows plaintiffs simply to present sufficient evidence to raise an issue of fact that the adverse reports would have been material to investors. This "lowering of the bar" is sure to change the landscape of securities fraud cases in plaintiffs' favor.

[1] At the time Kessler Topaz submitted the Medical Researchers' Amici Curiae brief it was known as Barroway Topaz Kessler Meltzer & Check, LLP.

FIXED INCOME FREE FOR ALL: Kessler Topaz Pursues Direct Claims on Behalf of Union Pension Funds to Recover Fixed Income Losses Caused by Wachovia *(continued from page 9)*

to — these speculative and high-risk investments during a time of heightened market duress, when virtually all investors, including other fixed income fund managers, were making a "flight to quality" by moving towards more stable, high-quality and low-risk investments. As late as December 2008, at the height of the financial crisis, 57% of the Local 464A UFCW Pension Fund's fixed income portfolio was invested in risky, non-agency RMBS, CMBS, CMOs and corporate sector financial debt. In marked contrast, during this same period, only 11% of the benchmark Index was invested in certain these types of investments.

The Core Bond Fund in which other union funds were invested also began wildly diverging from the benchmark index during this period. From January 1994 through June 2007, the Core Bond Fund's tracking error — an industry-recognized measure of how closely a portfolio follows an index to which it is benchmarked — was only 0.48%, which was a strong indication of how closely it followed the benchmark index. In striking contrast, during the period of July 2007 through December 2008, the tracking error of the Core Bond Fund exploded to 11.07% — an increase of more than 2200%. These figures clearly and demonstrate that the Core Bond Fund deviated substantially and materially from the benchmark index during this time.

Wachovia's undisclosed decision to materially alter the investment strategy and portfolio composition of the Funds effectively rendered the benchmark index a nullity. By materially overweighting the Local 464A UFCW Pension Fund in high-risk securities by more than 45% of the portfolio, and by increasing the tracking error of the remaining Funds by more than 2200% over an eighteen month period, Wachovia did more than simply "deviate" from the benchmark; it essentially managed the Funds without regard to the benchmark at all. Wachovia's shift away from the stable, secure and high-quality instruments in which the Funds had been traditionally invested in favor of investing in and holding high-risk assets was not only in contravention of the benchmark index, but also violated the applicable investment guidelines and was patently imprudent by significantly and unlawfully increasing the risk to the Funds.

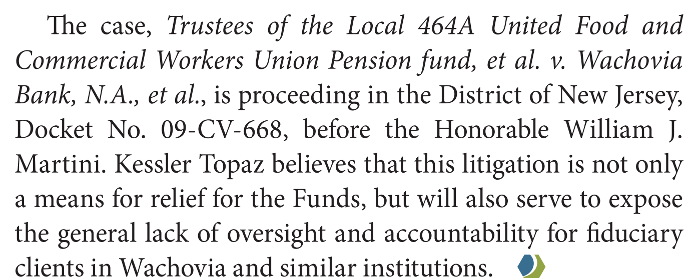
The Fallout

As a result of Wachovia's imprudent investment decisions, the Funds suffered substantial losses. Between December 2005 and December 2008, the Local 464A UFCW Pension Fund lost more than half its value while the Core Bond Fund — a fixed income mutual fund — suffered an astonishing loss of more than 25% of its value. Notably, during this same time period, the benchmark index was up by more than 18%. The losses sustained by the Funds were not the result of general market forces but instead were a direct result of Wachovia's general failure to heed the warning signs of the impending global economic recession and its decision to starkly deviate from its long history of conservative investment strategies by imprudently overweighting the Funds' fixed-income portfolios in illiquid and high-risk non-agency RMBS, CMBS, CMOs and financial sector corporate debt while underweighting the Funds' exposure to high-quality and low-risk treasuries and government agency securities. Rather than comply with its fiduciary obligations under the Employee Retirement Income Security Act of 1974 and the common law, Wachovia — in violation of the applicable investment guidelines and in contravention with its own representations to the Funds — directly exposed the Funds' fixed income portfolios to the volatility of the blighted mortgage market at precisely the time that mortgage defaults were skyrocketing and numerous mortgage lenders were facing dire financial conditions.

Our Allegations

Kessler Topaz represents the Trustees of the Local 464A UFCW Union Funds. Plaintiffs assert claims for relief under ERISA and common law fiduciary principles and notably, neither Wachovia nor its subsidiaries, Evergreen and Tattersall, deny that they were fiduciaries of the Funds. Specifically, Plaintiffs argue that Wachovia and its subsidiaries breached their fiduciary obligation under ERISA Sections 404 and 405 to prudently and loyally managed the Funds' fixed income assets by (a) failing to invest the Funds' fixed income assets in accordance with the Funds' conservative investment guidelines; (b) failing to continuously monitor the Funds' fixed income investments to ensure that they remained prudent through the period of the investment; and (c) failing to provide complete and accurate information to Plaintiffs concerning the marked change in the investment strategy of the Funds and the true level of risk associated with that strategy. Plaintiffs also assert a claim for failure to adequately appoint and monitor other fiduciaries in violation of ERISA Section 404 as well as a common law claim for breach of contract.

The case, *Trustees of the Local 464A United Food and Commercial Workers Union Pension fund, et al. v. Wachovia Bank, N.A., et al.*, is proceeding in the District of New Jersey, Docket No. 09-CV-668, before the Honorable William J. Martini. Kessler Topaz believes that this litigation is not only a means for relief for the Funds, but will also serve to expose the general lack of oversight and accountability for fiduciary clients in Wachovia and similar institutions.



The Question of Auditor Primary Liability for Misstatements in Audited Financial Statements: The Ninth Circuit's *New Mexico* Decision *(continued from page 3)*

The Plaintiffs' complaint alleged that E&Y was complicit in a stock option backdating scheme involving options to purchase over 239 million shares of Broadcom stock between 1998 and 2005. E&Y, as auditor to Broadcom, plaintiffs alleged, knew of, or was deliberately reckless in not knowing that the unqualified 2005 Opinion was materially false and misleading due to the backdating scheme. The 2005 Opinion covered three years of Broadcom's statements, and stated that the financial statements represented the consolidated financial position of Broadcom fairly, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). The 2005 Opinion also stated that E&Y had performed the audit in connection with generally accepted accounting standards ("GAAS").

The U.S. District Court for the District for the Central District of California granted E&Y's motion to dismiss the complaint, finding that the Consolidated Amended Class Action complaint did not adequately plead scienter against E&Y. Shareholders appealed.

The Court's Analysis of Scienter

On appeal, plaintiffs contended that they had adequately pled scienter against E&Y sufficient to survive a motion to dismiss. The Ninth Circuit agreed, and set forth the standard for scienter under 15 U.S.C. 78u-4(b)(2)(A). It disagreed with the District Court that scienter allegations against accountants or auditors carry a heavier burden, cautioning that the Circuit Court had previously advised against developing separate rules of thumb for each type of scienter allegation. Instead, the Ninth Circuit applied the two-part inquiry for scienter set forth in *Zucco Partners, LLC v. Digimarc Corporation*[1], to determine whether any of the allegations, standing alone, are sufficient to create a strong inference of scienter, and, if no individual allegation is sufficient, a "holistic review of the same allegations to determine whether the allegations combine to create a strong inference of intentional conduct or deliberate recklessness.[2]

Plaintiffs' allegations centered around three events: (1) a large grant of options on May 26, 2000 for which E&Y was given no documentation; (2) E&Y knew that options were granted in 2001 during a period when Broadcom's compensation committee did not have a quorum due to the death of one of its members; and (3) In 2003, E&Y was directly involved with corrective reforms to Broadcom's prior options practices, yet did not question prior grants. The Circuit Court held that these factual allegations were each sufficient to support an inference of scienter by E&Y, and that while no holistic review was therefore necessary, that the allegations certainly supported an inference of scienter when viewed collectively with plaintiffs' other allegations.

The Court discussed the facts surrounding the May 2000 options grant, and noted that typically, pleading sufficient facts to support an inference of scienter by an outside auditor is difficult because these auditors may have more limited information than, for example, company executives who oversee the audit. The Ninth Circuit also acknowledged the comment in *In re Countrywide Fin. Corp. Sec. Litigation* that auditors exercise complex professional judgments unsuited for second-guessing by the court.[3] The Court cited to the "red flag" doctrine set forth in *In re Enron Corporation Securities, Derivative, and ERISA Litigation*[4] to guide its inquiry into the GAAP and GAAS inquiries, noting "the more facts alleged that should cause a reasonable auditor to investigate further before making a representation, the more cogent and compelling a scienter inference becomes."[5] After a discussion of the facts connected to the May 2000 options grant, the Court noted that the complaint alleged more than negligence, and that E&Y, as the company's auditor, owed its ultimate allegiance to the company creditors and stockholders, as well as the investing public. E&Y provided the highest level of assurance to those parties when it offered an unqualified or clean audit opinion in the 2005 Opinion.

The Ninth Circuit then analyzed E&Y's conduct during the period in 2001 when the Broadcom compensation committee did not have a quorum due to the death of a member. Citing to the facts that E&Y allegedly accepted unsigned draft minutes and later documentation that could not have been valid, the Court found plaintiffs provided an inference of scienter at least as compelling as any opposing innocent inference offered by E&Y. Indeed, the Court remarked that the failure of E&Y to follow up on the grant approvals and to sign off months later with false documentation "sufficiently pleads an audit so deficient that the audit amounted to no audit at all.[6] The Court also noted that the magnitude of the GAAP and GAAS violation was not sufficient alone to support a finding of scienter, large violations can play a role in finding scienter.[7]

Finally, the Court examined E&Y's involvement in the 2003 corrective reforms, and the remaining scienter allegations. The Court found that the allegations strongly suggested that E&Y knew of and participated in the corrective reforms to address

(continued on page 15)

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[1] 552 F.3d 981 (9th Cir. 2009).

[2] *Zucco*, 552 F.3d at 991-92.

[3] 588 F.Supp.2d 1132, 1197 (C.D. Cal. 2008).

[4] 235 F. Supp. 2d 549, 673-85 (S.D. Tex. 2002).

[5] *New Mexico*, __F.3d__ at *6 (9th Cir. Apr. 14, 2011)(internal citations omitted).

[6] *Id.* at *9.

[7] *Id.* (internal citations omitted).

"It's Not My Job": The Supreme Court Will Decide Whether Plaintiffs Must Establish Loss Causation in Order to Certify a Class Action Under *Section 10(b) of The Securities Exchange Act of 1934* *(continued from page 5)*

On appeal, the Fifth Circuit affirmed the district court's ruling and "conclude[d] that Plaintiff has failed to meet this court's requirements for proving loss causation at the class certification stage."[5] Relying upon the Fifth Circuit's 2007 opinion in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.,* 487 F.3d 261 (5th Cir. 2007), the *Halliburton* court held that loss causation must be demonstrated "at the class certification stage by a preponderance of all admissible evidence" in order to trigger the fraud-on-the-market presumption of reliance.[6] Additionally, *Halliburton* confirmed that the district court had articulated the proper burden of proof on plaintiffs with respect to loss causation.[7]

The ruling in *Oscar* is a departure from every other court of appeals. The Seventh Circuit went as far as to comment that "[*Oscar*] represents a go-it-alone strategy."[8] Indeed, the Second Circuit and the Third Circuit have also rejected the standard set forth in *Oscar*.[9] The split among the circuit courts made *Halliburton* ripe for review by the Supreme Court.

Oral Argument:

The Supreme Court held oral argument in *Halliburton* on April 25, 2011. At oral argument, Chief Justice Roberts began by asking lead plaintiff's counsel whether the existence of an efficient market, a component of the fraud-on-the-market presumption, could be challenged at the class certification stage. When lead plaintiff's counsel indicated it could be disputed, Justices Kagan and Alito immediately followed with questions seeking clarity as to why the existence of an efficient market could be challenged at the class certification stage but other elements of the fraud-on-the-market presumption such as materiality and price impact could not be disputed. Lead plaintiff's counsel argued that a footnote in *Basic* indicated that only efficiency of the market could be challenged—a notion for which Justice Alito expressed concern. Lead plaintiff continued with what would become its central argument: the existence of an efficient market can be rebutted "[b]ecause if there's no efficient market, then individualized issues are going to predominate" ***but*** loss causation is a class-wide merits issue because "if there's no loss causation, there's no cause of action."

Next, the United States, in support of lead plaintiff's position, argued that the Fifth Circuit's holding was in error for three reasons: first, the lower court conducted a merits inquiry that was not tied to the Rule 23 requirements; second, the lower court required lead plaintiff to prove a presumption; and third, the lower court confused the distinct elements of loss causation and reliance. The government stressed that loss causation stands and falls on a class-wide basis and should not be subject to rebuttal at the class certification stage. Justice Kennedy questioned whether the rule really is as simple as "because the issue is on a classwide basis, it can't be challenged at the class certification stage." The government, consistent with lead plaintiff's position, also argued that loss causation, even if it is later proven to not exist, is a common issue that is to be decided with other merits issues at other stages of the litigation.

Justice Scalia pressed a line of questioning which suggested that the issue before the Court was not as simple as it appeared at the outset. Justice Scalia suggested that if plaintiffs "show[ed] that there was a correction of what [they] alleged was a misstatement and the market went down" then the existence of an efficient market would be a common question for the class. The government was quick to point out that Justice Scalia's reverse approach was inconsistent with the holding in *Basic* requiring plaintiffs to prove the existence of an efficient market before obtaining the presumption. Justice Scalia, hinting at the fact that the two approaches boil down to a question of class-wide issues, replied "I know that. I'm just saying that seems to me it's a crazy way to run a railroad."

Predicting the fall of the Fifth Circuit precedent in *Oscar*, defendants' counsel was quick to concede that defendants were not defending *Oscar*'s language requiring proof of loss causation. Rather, defendants argued that "because *Basic* says . . . any showing that severs the link between the misrepresentation and the stock price defeats the presumption" defendants are entitled to rebut the fraud-on-the-market presumption by showing that there was no price impact. When Justice Kagan

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[5] *Halliburton*, 597 F.3d at 344.

[6] *Id.* at 335.

[7] *Id.* at 337 ("[T]he district court correctly summed up Plaintiff's burden in this case by stating that because Plaintiff presented no evidence that a false, non-confirmatory positive statement caused a positive effect on the stock price, Plaintiff would have to show '(1) that an alleged corrective disclosure causing the decrease in price is related to the false, non-confirmatory positive statement made earlier, and (2) that it is more probable than not that it was this related corrective disclosure, and not any other unrelated negative statement, that caused the stock price decline.'").

[8] *Schleicher v. Wendt*, 618 F.3d 679, 687 (7th Cir. 2010)

[9] *See In re DVI, Inc. Sec. Litig.*, 2011 U.S. App. LEXIS 6302, at *31-32 (3d Cir. 2011); *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 479, 483 (2d Cir. 2008).

asked for clarification as to whose burden it was to show price impact, defendants conceded that it is their burden should they decide to challenge the fraud-on-the-market presumption.

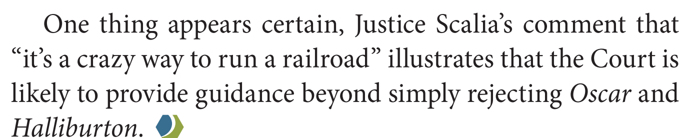
The remainder of the argument concerned whether defendants' ability to rebut price impact is itself impermissible at the class certification stage. For example, when defendants asserted that a defendant could offer an expert to establish that there was no price impact, Justice Kagan expressed that such proof "suggest[s] that the [fraud-on-the-market] presumption isn't worth much in your world . . . and the plaintiffs have to actually prove their case at that very early stage . . . ." Then, Justice Breyer introduced a hypothetical that appeared intended to illustrate the purpose of presumptions. Specifically, Justice Breyer challenged defendants' position and noted that "what you're just saying in terms of whether the revelation lowered the price has nothing to do with the question of what happened to the typical person . . . [i]t has to do with whether anybody was hurt [and] that has nothing to do with the certification stage."

What to Expect:

With the clearly stated requirement in *Halliburton* and *Oscar* that plaintiffs must establish loss causation at class certification receiving no support, even from defendants' counsel, it would not be surprising to see the Fifth Circuit's standard reversed. As such, the key focus of the pending opinion will likely concern whether a defendant can rebut the fraud-on-the-market presumption at the class certification stage by challenging price impact or whether a defendant may only challenge the existence of an efficient market.

While the Supreme Court's questioning suggests that the Court could go either way, our reading of the argument suggests that the Justices appear disinclined to weaken the fraud-on-the-market presumption set forth in *Basic*. Specifically, Justices Kagan and Ginsburg appeared particularly troubled by the fact that allowing rebuttal of price impact could require plaintiffs to "prove their case" and would leave very few issues for trial. Additionally, Justice Breyer's comments appear to support plaintiffs' argument that it is not appropriate to resolve common issues at the class certification stage. Moreover, Justice Scalia recognized that allowing price impact instead of loss causation may be one in the same and may result in a "Pyrrhic Victory" for plaintiffs. On the other hand, however, Justice Alito expressed skepticism for relying upon a solitary footnote in *Basic* for the notion that only the existence of an efficient market could be challenged and Justice Sotomayor appeared sympathetic to the possibility that evidence of an absence of price impact could reasonably go to the question of whether an efficient market exists.

One thing appears certain, Justice Scalia's comment that "it's a crazy way to run a railroad" illustrates that the Court is likely to provide guidance beyond simply rejecting *Oscar* and *Halliburton*.

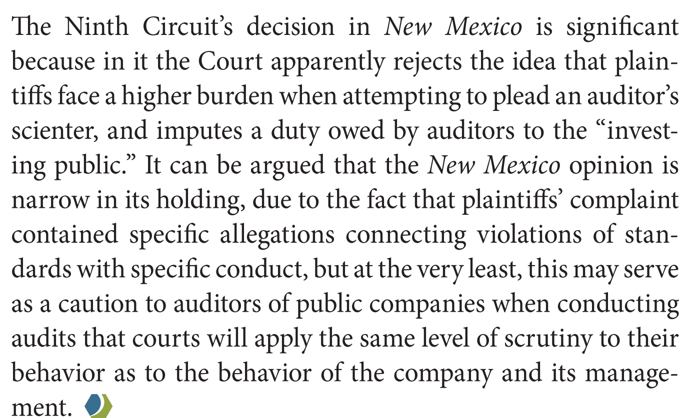


The Question of Auditor Primary Liability for Misstatements in Audited Financial Statements: The Ninth Circuit's New Mexico Decision *(continued from page 13)*

improper stock option grants, but made no communication nor took action until the Restatement, and that this scenario survived a motion to dismiss. As to the other allegations of scienter, the Court held that they supported an inference that the auditor's actions fell far short of the standard expected of a public company auditor.[8] The Ninth Circuit did give some guidance to how such allegations should be pleaded with particularity, which is required at the pleading stage — noting that it was insufficient for plaintiffs to cite to GAAS standards without an explanation of how the defendant recklessly or knowingly violated those standards. In this regard, the Court praised plaintiffs, noting they had not simply cited standards in connection with vague claims but rather had pled specific allegations of how or why the auditor should have investigated insufficient or missing documentation.

Conclusion

The Ninth Circuit's decision in *New Mexico* is significant because in it the Court apparently rejects the idea that plaintiffs face a higher burden when attempting to plead an auditor's scienter, and imputes a duty owed by auditors to the "investing public." It can be argued that the *New Mexico* opinion is narrow in its holding, due to the fact that plaintiffs' complaint contained specific allegations connecting violations of standards with specific conduct, but at the very least, this may serve as a caution to auditors of public companies when conducting audits that courts will apply the same level of scrutiny to their behavior as to the behavior of the company and its management.



[8] *Id.* at *10.

Calendar of Upcoming Events

National Association of Public Pension Attorneys Legal Education Conference

June 22 – 24, 2011

Renaissance Seattle Hotel — Seattle, Washington

FPPTA Annual Conference

June 26 – 29, 2011

Renaissance Sea World Resort — Orlando, Florida

Bridgeport's Eleventh Annual Class Action Litigation Conference the Future of Class Actions

August 11 – 12, 2011

San Francisco, California

The class action landscape has changed. *AT&T Mobility LLC v. Concepcion* and *Dukes vs. Wal-Mart* are game changers. This program will cover the latest developments in the law of federal class actions and California class actions as well as procedural advice from leaders in the field. This timely conference will include a discussion of the impact of *AT&T Mobility LLC v. Concepcion* and *Dukes vs. Wal-Mart* as well as *Hydrogen Peroxide* and *In re Tobacco II* decisions, the trend towards "rigorous analysis' under Rule 23, Daubert challenges at the certification stage and other emerging topics. Kessler Topaz partner Ramzi Abadou is part of the speaking faculty.

International Corporate Governance Network 2011 Annual Conference

September 12 – 14, 2011

Pullman Montparnasse — Paris, France

The 2011 Annual Conference will take place at the Pullman Montparnasse on September 12-14, 2011 and is hosted by Paris Europlace. The event is organised back to back with our conference partner UNPRI whose event will be held on September 15-16, also at the Pullman Montparnasse.

European Investment Roundtable

September 12 – 14, 2011

Sheraton — Stockholm, Sweden

Institutional Investor's European Investment Roundtable is one of the world's leading forums for heads of pension funds and is in 10th Anniversary year this year. This autumn meeting brings together senior officials from Europe's most prominent pension and insurance funds for an off the record discussion of the most important investment topics of the day.

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