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SOUTHERN DISTRICT CIVIL PRACTICE ROUNDUP

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Private Securities Litigation Reform Act: Litigation Developments

EVEN WITH THE current legal fury directed at alleged perpetrators of corporate malfeasance, the Private Securities Litigation Reform Act (PSLRA) remains a formidable obstacle to plaintiffs seeking to recover for securities fraud. Numerous recent cases from the U.S. District Court for the Southern District of New York, the epicenter of securities fraud litigation, illustrate that the pleading requirements and automatic discovery stay provision of the PSLRA have real teeth. These requirements impose significant limitations on whether, how and against whom plaintiffs may proceed and offer substantial protection to all securities fraud defendants, but particularly to those whose actions were on the fringes of the alleged misconduct.

Pleading

The elements of securities fraud are that in connection with the purchase or sale of securities: (1) the defendant made a materially false statement or omission; (2) with scienter; and (3) that the plaintiff's reliance on the defendant's actions caused the plaintiff's injury.

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While the PSLRA did not change these elements, as Southern District Judge Harold Baer Jr. noted in a decision filed in *Pfeiffer v. Goldman, Sachs & Co.*,[1] it "created a tall hurdle for a plaintiff" to the extent that it requires plaintiffs to allege particular facts in support of each of these elements.

a. False Statements or Omissions. To survive a motion to dismiss, a complaint under the PSLRA must identify each allegedly misleading statement, and must also "specify … the reason or reasons why the statement is misleading. …"[2] This latter requirement proved fatal to the plaintiffs' complaint in *AIG Global Securities Lending Corp. v. Banc of America Securities LLC*.[3] Plaintiffs, who had invested in securities backed by a retail furniture dealer's installment sales contracts, sued the underwriters from whom they had purchased those securities after the furniture company declared bankruptcy and ceased its collection activities on the installment contracts. Although the plaintiffs identified, in "significant detail," more than 30 separate statements by the defendants that the plaintiffs contended fraudulently represented different aspects of the furniture company's collection apparatus, Southern District Judge John G. Koeltl held that the complaint failed to allege, "in any specific sense," why the representations were false. He found that the plaintiffs' broad allegations that the company lacked a centralized billing system and had no reasonable means of monitoring the collections practices of its individual stores fell short of the requisite specificity because the complaint did not establish the inaccuracy of any of the specific statements identified by the plaintiffs. He found similarly deficient allegations that certain back-up servicing plans were falsely conveyed to investors based solely on the fact that the back-up servicer failed to perform the duties it had agreed to undertake. Quoting the U.S. Court of Appeals for the Second Circuit's decision in *Mills v. Polar Molecular Corp.*,[4] he noted that "[t]he failure to carry out a promise made in connection with a securities transaction is normally a breach of contract [and] does not constitute fraud unless, when the promise was made, the defendant secretly knew that he could not perform."

b. Scienter. The PSLRA's scienter requirement continues to be one of the major stumbling blocks for securities fraud plaintiffs. Under the PSLRA, which raised the nationwide pleading

standard but codified the standard previously in effect in the Second Circuit, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind" for each alleged act or omission. That strong inference can be established in one of two ways. First, a plaintiff may allege facts showing that the defendant had both motive and opportunity to commit the fraud. "Motive" entails concrete benefit to the defendant that differs in some way from the motives possessed by other corporate insiders,[5] or from a company's general desire to maintain a high bond or credit rating.[6] Moreover, "[w]hile the simple purchase of one company by another may not ordinarily provide a sufficient allegation of a motive to commit fraud, a sustained and extensive plan to grow by acquisition, particularly through scores of acquisitions paid for with a company's stock," may be sufficient to establish motive.[7] Opportunity consists of the "means and likely prospect of achieving concrete benefits by the means alleged."[8]

The second method of pleading scienter is to allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. This can be achieved through allegations showing that a defendant's conduct was "highly unreasonable, representing an extreme departure from the standards of ordinary care … to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."[9]

Courts have found allegations of recklessness sufficient when plaintiffs specifically allege that defendants knew or had access to information contradicting their public statements, failed to check information that they had a duty to monitor, or ignored obvious signs of fraud.[10] *In re WorldCom, Inc. Securities Litigation*[11] is a recent case in point. Southern District Judge Denise L. Cote found that investors in the bankrupt telecommunications giant WorldCom had adequately pleaded scienter against Arthur Andersen, the company's auditors. She held that "[a]lthough the size of the fraud alone does not create an inference of scienter, the enormous amounts at stake coupled with the detailed allegations regarding the nature and extent of WorldCom's fraudulent accounting and Andersen's failure to conduct a thorough and objective audit create a strong inference that Andersen was reckless in not knowing that its audit opinions materially misrepresented WorldCom's financial state."

The PSLRA has provisions for automatic stays of discovery during a motion to dismiss private claims under the 1933 Securities Act or 1934 Securities Exchange Act.

Judge Cote found, however, that the allegations against the two Andersen "engagement partners" for the WorldCom account were insufficient because the complaint alleged no specific details against the two individuals and merely implied that if Andersen was reckless, the engagement partners must also have been reckless. The absence of specific allegations concerning when and how particular defendants became aware of the falsity of their representations also resulted in dismissal of the securities fraud claims in *Marcus v. Frome*.[12] Judge Koeltl held in that case that although the complaint was "replete with allegations of when the plaintiffs became aware of the allegedly false representations … [it was] devoid of allegations as to when or how the defendants became aware of the falsity of the representations" and thus contained no allegation of reckless conduct that could establish scienter under the PSLRA.

Judge Cote also filed a decision in *In re Interpublic Securities Litigation*[13] stressing that there must be a link between the conduct leading to the inference of scienter and the fraud that caused the loss. In that case, the complaint contained detailed allegations that two of the individual defendants knew about fraud occurring at two of the defendant's subsidiaries. Judge Cote held that even though the complaint's recitations would support a finding of strong pressure from corporate management to falsify the subsidiaries' financial reports, the bulk of the $180 million restatement which formed the basis of the alleged securities fraud was unrelated to the improprieties at the subsidiaries about which the individual defendants were allegedly aware.

c. Loss Causation. Not only must the complaint allege a link between a defendant's scienter and the alleged fraud, but it must also link the fraud and the loss suffered by the plaintiff. Loss causation was at the heart of a stinging opinion written this summer by Southern District Judge Milton Pollack dismissing, with prejudice, the complaint in *In re Merrill Lynch & Co.*[14] The plaintiffs in that action sought to recover for losses suffered in connection with their investments in two Internet companies for which Merrill Lynch analysts had issued favorable reports. They alleged that the analysts misrepresented their true opinions concerning the stocks and failed to disclose conflicts of interest generated by the close ties between Merrill Lynch's investment banking business and the companies being rated. Noting that the PSLRA had codified the loss causation requirement which had previously been a creature of case law, he found that "[t]here are simply no allegations in the complaints, much less particularized allegations of fact, from which this Court could conclude that it was foreseeable that the alleged non-disclosures of conflicts

would cause the harm allegedly suffered by plaintiffs as a result of the bursting of the Internet bubble." He concluded that it was "beyond doubt" that the plaintiffs "brought their own losses upon themselves when they knowingly spun an extremely high-risk, high stakes wheel of fortune."[15]

Stay of Discovery

The PSLRA contains parallel provisions providing for an automatic stay of discovery during the pendency of a motion to dismiss private claims brought under either the 1933 Securities Act or the 1934 Securities Exchange Act.[16] Discovery is permissible while a motion to dismiss is pending only if the court finds, upon the motion of a party, that "particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." The automatic stay or, more particularly, its exceptions, have generated considerable litigation over the past year. Just Cote authorized a partial lifting of the stay in WorldCom, finding that the plaintiffs in the securities fraud class actions should be able to obtain access to documents that had already been or were about to be provided to regulators and prosecutors and other public and private entities in multiple related proceedings.[17]

Judge Cote began by noting that the automatic stay was intended to deter plaintiffs from filing frivolous lawsuits in the hope of extracting settlements from defendants anxious to avoid the expense of discovery and to prevent plaintiffs from using discovery to locate factual support for otherwise inadequately substantiated complaints. She found that the lead plaintiff's request to lift the automatic stay contravened neither of these rationales. Rather, she found that the unique circumstances of that case required production of the documents in question to avoid undue prejudice to the plaintiff class. Judge Cote observed that, without access to documents already made available to the government, to WorldCom's creditors in the bankruptcy proceeding, and likely soon to be in the hands of other private plaintiffs, the lead plaintiff in the securities cases "would be prejudiced by its inability to make informed decisions about its litigation strategy in a rapidly shifting landscape." She concluded that particularly because the private parties were likely to be conducting settlement negotiations in the near future, the securities plaintiffs, who would be the only parties without access to the documents, would be severely disadvantaged.

Absent such compelling circumstances, other courts have been unwilling to lift or modify the stay. They have rejected unsubstantiated claims that immediate discovery is necessary to prevent a defendant from shielding itself from liability,[18] or avoid compromising plaintiffs' position in settlement.[19] They have also declined to lift the stay based on the asserted need to preserve critical documents,[20] at least in part because the PSLRA itself imposes on all parties an obligation to preserve documents during the pendency of the stay.[21]

In *ATSI Communications, Inc. v. The Shaar Fund, Ltd.*,[22] Southern District Judge Lewis A. Kaplan made clear that the stay applies to discovery from non-parties as well as from parties, and that a plaintiff could not do an end-run around the automatic stay by conducting discovery in another case in order to obtain information about a defendant who had filed a motion to dismiss. Plaintiffs' counsel in *ATSI Communications*, who was also representing separate plaintiffs in another Southern District action against different defendants, served subpoenas on third parties in the other action, seeking information about the trading and market making practices of the defendants in *ATSI Communications*. Judge Kaplan expressed skepticism concerning the plaintiffs' proffered rationale for these subpoenas, but concluded that he did not need to resolve whether they were actually intended as a vehicle to conduct discovery in the case before him. He ordered plaintiffs' counsel to disclose copies of all subpoenas they had issued in any case concerning the defendants as well as any materials obtained through those subpoenas, keeping open the question of whether they would be permitted to use any of those materials in their litigation against the defendants until such time as they sought to rely on them.

(1) 2003 WL 21505876 (SDNY July 1, 2003).

(2) 15 USC §78u-4(b)(1). See also *Novak v. Kasaks*, 216 F3d 300 (2d Cir. 2000).

(3) 254 FSupp2d 373 (SDNY 2003).

(4) 12 F3d 1170 (2d Cir. 1993).

(5) *Novak v. Kasaks*, 216 F3d 300.

(6) *Rothman v. Gregor*, 220 F3d 81 (2d Cir. 2000).

(7) *In re Interpublic Securities Litigation*, 2003 WL 21250682 (SDNY May 29, 2003).

(8) *Novak v. Kasaks*, 216 F3d 300.

(9) *Rothman v. Gregor*, 220 F3d 81.

(10) See, e.g., *Novak v. Kasaks*, 216 F3d 300; *Kalnit v. Eichler*, 264 F3d 131 (2d Cir. 2001).

(11) 2003 WL 21488087 (SDNY June 25, 2003).

(12) 2003 WL 21800966 (SDNY Aug. 5, 2003).

(13) 2003 WL 21250682.

(14) 2003 WL 21500293 (SDNY June 30, 2003).

(15) See also *Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, 2003 WL 22053957 (2d Cir. Sept. 4, 2003).

(16) 15 USC §77z-1(b)(1) (1933 Act); 15 USC §78u-4(b)(3) (1934 Act).

(17) *In re WorldCom, Inc. Securities Litigation*, 234 FSupp2d 301 (SDNY 2002)

(18) *Rampersad v. Deutsche Bank Securities Inc.*, 2003 WL 21074094 (SDNY May 9, 2003).

(19) *In re AOL Time Warner, Inc. Securities & "ERISA" Litigation*, 2003 WL 21729842 (SDNY July 25, 2003).

(20) Id.; *In re Vivendi Universal, S.A., Securities Litigation*, 2003 WL 21035383 (SDNY May 6, 2003).

(21) 15 USC §77z-1(b)(2); 15 USC §78u-4(b)(3)(C)(i).

(22) 2003 WL 1877227 (SDNY April 9, 2003).