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FINRA and Regulatory Notice 14-40 Requirements
By Dominick F. Evangelista, Regina Pepe Martorana, and Heather Murphy

On October 9, 2014, the Financial Industry Regulatory Authority (FINRA) issued Regulation Notice 14-40 concerning non-disclosure provisions in FINRA arbitration confidentiality agreements and settlement agreements. While Notice 14-40 purports to be a “reminder” to firms as to the acceptable parameters of non-disclosure provisions used in FINRA arbitrations, it goes a step further than prior FINRA guidance. Firms are now required to explicitly notify signatories that confidentiality provisions do not limit their ability to initiate contact with regulators. FINRA’s prior guidance on this topic was far more limited: It only required that confidentiality provisions state that they do not prevent a party from responding to a regulator upon inquiry. Firms must now review their confidentiality provisions in light of this new guidance.

FINRA’s Prior Guidance on Confidentiality Provisions
FINRA, and its predecessor the National Association of Securities Dealers (NASD), has long been concerned that a member’s use of confidentiality clauses could have a negative effect on regulatory investigations and enforcement actions. Nearly 30 years ago, the NASD issued Notice 86-36 after finding that customers who had signed releases to settle arbitration complaints were reluctant to cooperate with NASD investigations out of fear that cooperation was a violation of the confidentiality clause. At that time, the NASD made clear that it was a violation of the NASD Rules of Fair Practice for a member to use a confidentiality provision to limit or impede a NASD investigation. See also NASD Regulatory and Compliance Alert (June 1994), at 14.

A decade later, the NASD issued Notice 95-87, which advised members to review and correct FINRA arbitration agreements that contained confidentiality clauses that prohibited or discouraged parties from disclosing the settlement terms and/or underlying facts of the dispute to the NASD or any securities regulator upon inquiry. This notice was issued as a result of a series of NASD examinations and a special survey that was conducted to determine if confidentiality clauses were too broad and thus limiting investigations. For the first time, the NASD advised that a “violative confidentiality clause is one that prohibits or inhibits the customer or other person from disclosing the settlement terms (and the underlying facts of the dispute), upon inquiry, to a securities regulator, such as the NASD, or imposes conditions on such disclosure.” The notice concluded by stating that failure to include such a provision constituted “a serious violation of just and equitable principles of trade.” See also NASD Regulatory and Compliance Alert (July 1995).

In June 2004, the NASD issued their now penultimate notice on the issue. Notice 04-44 was issued to remind members of what constitutes permissible non-disclosure provisions in confidentiality clauses. The NASD advised that upon review it had found several examples of impermissible language in confidentiality provisions, including language requiring customers to withdraw complaints from regulators and/or providing affidavits to regulators that contradicted
prior statements; prohibiting the customer from testifying before a regulator; or requiring that prior notice be given to the member firm before the customer provided testimony to a regulator. Notice 04-44 reiterated the requirement that confidentiality provisions “expressly authorize the customer or other person to respond, without restriction or condition, to any inquiry regarding the settlement or its underlying facts to a regulator, including NASD.”


Notice 14-40 states that it is a “reminder” to members regarding acceptable confidentiality provisions. Yet this notice goes decisively further than FINRA’s prior guidance. Notice 14-40 expands on the prior guidance in requiring that all parties be explicitly advised of their right to initiate contact with a regulator about the facts and circumstances of the case, regardless of a governing non-disclosure agreement.

Notice 14-40 begins by reminding firms that they cannot use confidentiality provisions with customers or individuals in FINRA arbitrations that impede or have the potential to limit regulatory investigations and enforcement actions. It then states that “confidentiality provisions also cannot be used to prohibit or restrict an individual from initiating communications directly with FINRA or other securities regulators regarding the settlement terms or underlying facts of a dispute, regardless of whether the individual has received an inquiry from such regulatory authority regarding the dispute.” (Emphasis added)

Notice 14-40 then takes this guidance one step further: “Confidentiality provisions in settlement agreements should be written to expressly authorize, without restriction or condition, a customer or other person to initiate direct communications with” FINRA or any other regulator. The notice concludes that any limit on a person’s ability to communicate with FINRA, the SEC, any self-regulatory organization or any state or federal regulatory authority regarding settlements or the underlying facts in any dispute is inconsistent with just and equitable principles of trade and constitutes a violation of FINRA Rule 2010.

This expansion of a member’s obligations with respect to confidentiality clauses is reflected by the suggested confidentiality clause language FINRA provided in its various notices. In 1995, the NASD suggested the following language for settlement agreements:

Any non-disclosure provision in this agreement does not prohibit or restrict you (or your attorney) from responding to any inquiry about this settlement or its underlying facts and circumstances by the Securities and Exchange Commission (SEC), the National Association of Securities Dealers, Inc. (NASD) or any other self-regulatory organization.

See FINRA Notice to Members 95-87 (October 1995).

The suggested language for confidentiality clauses in the 2004 notice was verbatim except for the inclusion of the words “or providing testimony” to reiterate that any type of cooperation with
a regulatory body was permissible.

In the latest notice, however, FINRA suggests the following language:

Any non-disclosure provision in this agreement does not prohibit or restrict you (or your attorney) from initiating communications directly with, or responding to any inquiry from, or providing testimony before, the SEC, FINRA, any other self-regulatory organization or any other state or federal regulatory authority, regarding this settlement or its underlying facts.

See FINRA Notice to Members 14-40 (October 2014).

This slight change in language emphasizes the import of Notice 14-40: A clause allowing cooperation with regulators only when asked is no longer sufficient.

**Members Must Review and Change the Language of Confidentiality Clauses**

Regulators have long been concerned that confidentiality provisions were being used to hinder investigations into the conduct of registered firms and individuals. Through Notice 14-40, FINRA has now determined that members must explicitly advise customers or other persons that they are permitted to initiate contact with regulators at any time in regard to the conduct on which the arbitration is based. See also 17 C.F.R. § 240.21F-17 (“No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing or threatening to enforce, a confidentiality agreement…with respect to such communications”). In order to comply with Notice 14-40, member firms must review and revise non-disclosure provisions in confidentiality and settlement agreements to ensure that they explicitly advise signatories that signing the document does not prohibit them from initiating contact with a regulator regarding a settlement or the underlying facts of any dispute.

**Keywords:** litigation, securities, FINRA, Regulatory Notice 14-40

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Dispelling E-Discovery Myths in Internal and Government Investigations

By Amy Hinzmann

Chances are, if you’re a junior to mid-level attorney in a securities litigation practice, you’ve been staffed on a significant internal or governmental investigation, and you’ve been asked to manage the document discovery. You quickly realized that discovery would involve the identification, collection, processing, and review of a massive number of electronic documents—yet you were given little or no training on managing an e-discovery project like this. This article aims to help lawyers in this situation better understand how to execute a high-volume e-discovery project and to accomplish the work on time, at a reasonable cost, and with high quality.

To do that, we’ll take a look at some e-discovery “myths,” and then dispel those myths by examining reality. And we’ll use a hypothetical securities matter as the backdrop:

It’s 3:30 p.m. on the Friday before Labor Day, and your supervising partner appears in your office. You have been assigned to a new internal investigation for an important financial services client. The partner feels certain that the matter will lead to self-reporting, possibly filing a Suspicious Activity Report, and then a full-blown SEC investigation. Your role is to lead the e-discovery portion of the investigation. The partner explains that the client has already collected roughly 1.2 million documents from seven key custodians and expects the firm to complete its work on the investigation two weeks from today. Hard drives with the collected documents are on their way to your office via courier. After canceling your plans for the weekend (“after all, that’s why we call it Labor Day…”), you sit down to consider your options and map out a game plan.

Myth #1: As a junior level practitioner, you have the skill set and knowledge to manage this project—you’re an expert with your MacBook, your smartphone, the firm’s electronic timekeeping system, your Xbox. . .

Reality #1: Regardless of seniority or expertise with day-to-day technology, all lawyers need help understanding e-discovery best practices and can only gain e-discovery experience by handling matters over time.

So what does an inexperienced attorney do in this scenario? First, “know what you don’t know.” Ask for help. That help can come from more experienced lawyers in your firm, the litigation support group at the firm, or from a trusted service provider (more on finding one of those later). Second, draw on the good project management skills you developed working on other types of matters. Identify all the stakeholders in the project, and define everyone’s roles. Establish a protocol for communication. Document all decisions about the project. Finally, don’t be afraid to get your hands dirty. This project will likely require you to use new software and understand cryptic technical jargon. Get ready to dig in and work hard—you will not succeed if you over-
delegate work to more junior associates, contract lawyers, paralegals, and/or litigation support staff.

**Myth #2:** For internal investigations, it’s OK to streamline and shortcut the process.

**Reality #2:** Internal investigations often involve faster timelines and larger quantities of unfiltered data than requests in litigation or from regulators. And you never know when an internal investigation will lead to something bigger. So it’s even more important to develop a defensible process and workflow, then document and follow it.

Why can internal investigations be so complex and difficult to manage? There are several reasons:

- Companies must sometimes self-report suspected issues within a specific timeframe, or often need to meet deadlines for filing current or amended financial statements—all of which puts time pressure on the investigation.
- When you’re looking for a “needle” in these cases—evidence of wrongdoing—the “haystack” of data can be difficult to reduce to a manageable size.
- Time frames often are undetermined. Unlike litigation, where a statute of limitations contains the temporal scope of discovery, in a securities investigation you may not know when key events happened.
- When investigating a potential “bad actor” within an organization, the heightened risk warrants a thorough, no-stone-unturned approach.

**Myth #3:** All e-discovery vendors are the same.

**Reality #3:** The fact is, like any service company, e-discovery vendors have varying levels of expertise and experience. You must establish a relationship of trust and clear communication with your e-discovery vendor for your project to succeed.

Here are a few tips on vetting an e-discovery provider:

- **What does a “typical” project look like?** This is a bit of a trick question—there is no “typical” project. The most credible response from a provider will emphasize that every matter starts with a documented, defensible process. Even “typical” matters encounter problems, but a documented process can help determine what went wrong and why—which is critical if an opposing party or regulator questions your production.
- **How does the vendor staff their cases?** You should come away with a full understanding of who will be staffed on your project. What is each person’s role, and what is their background and experience? Who will be your main point of contact, and how is that person the right fit for the matter?
- **What is the provider’s review tool of choice?** Be aware of vendors who have one proprietary tool that you must use. “One size fits all” is not necessarily a successful model for e-discovery. Look for a company that leverages best-of-breed technologies to
achieve the results you want. Your vendor should listen to your needs and understand your comfort level and sophistication with different tools. They should be able to accommodate your request for a specific technology or, alternatively, recommend a new technology and offer training on the tool for you and your team.

- **Ask for references.** E-discovery vendors rely heavily on word of mouth referrals. Email your firm’s litigation support team and/or litigation team when vetting a new vendor. But keep in mind that people are more likely to give negative feedback than positive, so also request references from the vendor and give them an opportunity to introduce you to clients who have had good experiences. Recognize that e-discovery is an inherently imperfect process: Seek preparedness, reliability, and accountability—not perfection.

Keep in mind that you should follow the same rules when you vet internal litigation support that may be available to you. Not every member of that team has the skills to handle every matter—make sure your project is staffed appropriately.

**Myth #4:** When faced with large volumes of documents to review, “throwing bodies” at the project will help you meet your deadlines.

**Reality #4:** Good project management, including a thoughtful scoping of the project and the resources required to accomplish the work, will enable you to meet document review deadlines with better results and more consistency. A few tips:

- **Start at the end.** At the outset of your project, have a frank discussion with your vendor about the deadline for completion. Be honest about the nature of your deadline: Is it self-imposed? Is the deadline negotiable, so that you can add additional time if you encounter unexpected issues? Or is it a hard deadline imposed by a regulator? If “substantial completion” is required by the deadline, define what that means. Does a deadline for “production” mean that responsive documents must be provided by that date, and a privilege log can be turned over later? Or must the privilege log also be supplied by the deadline?

- **When you’re done, you’re not done.** Remember that even when document review is finished, you are not done—you must build in time for preparing the production, which often can require several days of work. At the beginning of the project, discuss with your vendor the required production format and other necessary deliverables.

- **Before you begin review, develop the substantive strategy.** Rushing into document review without a strategy in place will result in inefficiency and poor quality down the line. Before you start, consider carefully what you are trying to accomplish with the review. What documents are you looking for? Establish the “story” of the case, including relevant dates, parties, and underlying facts. Memorialize your strategy in a concise memorandum. Provide other study guides to the review team if needed—for instance, if a complex financial instrument is at issue, ask the business unit for a summary of how the instrument is structured. What are likely to be the “close calls” separating responsive from non-responsive documents? Are there examples you can provide the review team?
Once you understand the strategy, define the workflow. After the strategy is developed, then you can structure a process to implement it. What decisions will the reviewers make about each document? Will you have confidentiality and privilege coding? Will you require a second-level review for redactions? How will you provide substantive feedback to the review team? What is the quality assurance protocol? Rely heavily on your vendor for help with the workflow creation—that’s why you hired them.

Bigger is (usually) not better. Consistent with your deadline requirements, keep the review team as small as possible. You can always adjust the number of reviewers after you assess the team’s throughput. But smaller teams typically produce more consistent and accurate decisions. The larger the team, the harder it is to effectively supervise the reviewers, provide them with feedback, and keep tight control on the quality and consistency.

In e-discovery, throwing bodies at the project without proper planning will waste time and money. You might as well set your client’s money—and your client relationship—on fire.

Myth #5: Using predictive coding or other forms of technology-assisted review (TAR) will significantly reduce your timeline.

Reality #5: As powerful as these TAR tools are, they will not necessarily save time (or money) in every case.

A few things to keep in mind about using TAR for a document review project:

- **TAR software does not operate with the quick press of a button.** These tools require significant substantive input from attorneys knowledgeable about the case to “train” the system on what is relevant. Just as with manual human review, the process and workflow must be developed and defined. The results of these tools are only as good as the planning and input that goes into them—the classic example of “garbage in, garbage out.”

- **TAR isn’t effective for every document collection.** These software tools rely on an algorithmic analysis of document text. If your document collection is heavy with non-text documents—numeric spreadsheets, for example—the technology will not provide good results. Also, the tools need a minimum quantity of relevant content to “learn” from—if you’re looking for one needle in a haystack, TAR is not a good option to find the needle.

- **Use technology to improve human review rather than replace it.** Even if you decide that you will stick with old-fashioned human review for your matter, consider using TAR in other ways to improve your project. For instance, the technology can be used to prioritize review, so that the documents most likely to be relevant are reviewed first. This can be a huge help with internal investigations, especially when you cannot interview the custodian (because she is no longer with the company or may be the subject of a suspicious activity report and cannot know that she is under investigation).
Technology should be implemented strategically when it can help achieve a well-defined and specific goal in an easier, quicker, and more accurate manner.

**Myth #6**: Traditional search methods such as keywords strings can effectively find documents containing evidence of wrongdoing. And predictive coding tools work even better.

**Reality #6**: In many investigations involving potential violations of securities laws, the evidence you’re looking for simply can’t be found using keyword searches or even the sophisticated predictive coding tools available today.

In internal investigations, often you are trying to assess whether an employee was a bad actor, for how long the bad acts took place, whether there was a systemic negligence in locating problems, and whether other employees can be linked to these actions. It’s almost impossible to train a computer to recognize documentary proof of a bad act because humans generally try to mask their bad actions. Likewise, using specific search terms to find this evidence often is futile, because you don’t know what words and phrases were being used in connection with the wrongdoing. (You certainly wouldn’t expect an employee engaged in insider trading to use the phrase “insider trading” in her emails!) Typically, keyword searches and TAR tools will only shrink the size of the haystack you are searching—the documentary proof you’re looking for is still just a needle in that haystack.

Nevertheless, there are some technologies that can help. For example, software that clusters documents by themes and concepts can be helpful to locate patterns of a custodian speaking in code to hide bad behavior. Social networking analysis can also be helpful; using the example of insider trading again, there are tools that can analyze the frequency and timeline of your suspect communicating with others, which you can then compare to trade dates.

**Myth #7**: All government regulators will resist your use of predictive coding to find and produce documents.

**Reality #7**: If you can demonstrate the effectiveness and defensibility of predictive coding in your matter, many government lawyers—especially those in the SEC and Department of Justice—will at least consider your request to use the technology.

Even within a government regulatory agency, some attorneys will be open to your use of TAR to satisfy a production request. Be patient—if a regulator seems interested in the idea, take the time to train them about the technology and your selected tool. Show them your proposed workflow, and help them understand why the process works and how you can validate it. Don’t make the mistake of being condescending: Many of the staff attorneys at regulatory agencies simply have no access to training on these tools, and they are eager to learn. You can make significant inroads for your client (and your own personal reputation within the agency) by providing that
knowledge.

I hope this examination of some of the “myths” of e-discovery will help you better plan and execute your next significant document review and production for an internal investigation or government request. As unglamorous and tedious as this work can be, it is critical to get it done right, on time, and within budget (another critical consideration that deserves its own separate article). Plus what a great thrill it is to be the lawyer who, against great odds, finds the smoking gun your client needs to identify an instance of securities fraud! (And there will always be another Labor Day to enjoy).

**Keywords:** litigation, securities, e-discovery, internal investigations, government investigations

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The Top 10 Obstacles to Litigating Securities Fraud Claims: Part I
By Peter M. Saparoff and Joel D. Rothman

Introduction
Congress passed the Securities Act of 1933, 15 U.S.C. §§ 77a et seq. (Securities Act), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (Exchange Act, collectively, the Acts) following the 1929 stock market crash that triggered the Great Depression. Prior to the passage of the Securities Act, President Franklin Roosevelt stated, “This proposal adds to the ancient rule of caveat emptor the further doctrine, ‘let the seller also beware.’ It puts the burden of telling the whole truth on the seller.” The Acts were intended to be clear statutes with clear violations.

However, over the past 80 years, both Congress and the courts have significantly weakened the Acts. Paying all due respect to the retiring David Letterman, this article is the first in a two part series that counts down the Top 10 obstacles to successfully litigating securities fraud claims under the Acts.

#10. No Tolling of the Statute of Repose
In Police & Fire Ret. Sys. v. IndyMac MBS, Inc., 721 F.3d 95 (2d Cir. 2013), the Second Circuit recently held that while American Pipe tolling (see Am. Pipe & Constr. Co. v. Utah, 414 U.S. 538, 551 (1974) (holding that filing of class-action lawsuit suspends running of filing deadline for all class members)) applies to the one-year statute of limitation under Section 13 of the Securities Act, 15 U.S.C. § 77k, it does not apply to the three-year statute of repose. The Second Circuit issued a broad holding, which could, in theory, be easily be extended to eliminate tolling of the five-year statute of repose applicable to actions under Section 10(b) of the Exchange Act, 15 U.S.C. § 78, and Rule 10b-5, 17 C.F.R. § 240.10b-5, claims as well.

The Second Circuit’s holding in IndyMac appears to conflict with the Tenth Circuit’s holding in Joseph v. Wiles, 223 F.3d 1155, 1168 (10th Cir. 2000). Perhaps for this reason, on March 10, 2014, the Supreme Court granted certiorari in Public Employees’ Retirement System of Mississippi v. IndyMac MBS, Inc., No. 13-640. However, on September 29, 2014, the Court revoked certiorari as having been improvidently granted. The issue that would have been decided by the Court was whether the filing of a putative class action serves to toll under American Pipe the three-year statute of repose in § 13 of the Securities Act with respect to the claims of putative class members. Thus, at this time, the question remains unanswered (other than in the Second Circuit).

Some potential results of the Second Circuit holding may include institutional investors waiting to file individual actions until after the class action has progressed through discovery. On the other hand, it could also encourage early filings by institutional investors and push institutional investors to opt out of class actions earlier than before.
#9. The Elimination of Transnational Jurisdiction

In matters involving fraud, the circuit courts had developed “conduct” and “effects” tests that permitted U.S. jurisdiction when the defendant’s conduct (or failure to act) occurred within the United States, or, if the conduct occurred abroad, when that conduct caused a substantial effect within the United States. These tests provided investors a domestic forum in cases where a company’s stock traded on a foreign exchange, provided the fraudulent conduct alleged had the requisite nexus to the United States.

In 2010, however, the Supreme Court rejected the “conduct” and “effects” tests. The Court developed a bright-line jurisdictional rule, holding that section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), only applied to “domestic transactions” regardless of where the fraudulent conduct occurred or if the conduct caused effects in the United States. *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2883-84 (2010).

The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 929P(b) & 929Y, 124 Stat. 1376 (2010) (Dodd-Frank Act), amended Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act to partially restore the “conduct” and “effect” jurisdictional tests, but only for enforcement proceedings brought by the Securities Exchange Commission (SEC) or Department of Justice (DOJ), and not for actions brought by private investors.

As a result, investors in companies that conduct substantial business in the United States have no domestic remedy for violations of the Acts if a company’s stock trades only on a foreign exchange.

#8. The Narrowing of What Constitutes Materiality
Although courts usually only dismiss claims made pursuant to Section 11 of the Securities Act and Section 10(b) of the Exchange Act on materiality grounds if misstatements were minor enough that “reasonable minds could not differ on the question of their importance” (*see, e.g.*, *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 197 (2d Cir. 2009)), a number of doctrines and principles still stand in a plaintiff’s way with respect to pleading and establishing materiality. Each is addressed in turn as follows:

“Bespeaks caution” doctrine. Under the “bespeaks caution” doctrine, sufficient cautionary language in a disclosure document can render an alleged omission or misrepresentation immaterial as a matter of law. *See Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 357 (2d Cir. 2002).
Forward-looking statements. SEC Rule 175, 17 C.F.R. § 230.175, creates a safe harbor for forward-looking statements in registration statements, and other specific documents, making misrepresentations in these types of statements not actionable unless the plaintiff can show that the defendant made the statement with actual knowledge of its falsity. See 15 U.S.C. § 77z-2(c). Examples of forward-looking statements include

- a statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
- a statement of management's plans and objectives for future operations; and
- a statement of future economic performance.

Opinions. For Section 10(b) claims, statements of opinion are only actionable if the statement/opinion was not honestly held by the speaker at the time the statement was made. Virginia Bankshares v. Sandberg, 501 U.S. 1083, 1095–96 (1991).

Concerning Section 11 claims, on March 3, 2014, the Supreme Court granted certiorari in Omnicare, Inc. v. Laborers District Council Constuction Industry Pension Fund, No. 13-435. The issue to be decided will be whether, for purposes of a claim under Section 11 of the Securities Act, a plaintiff may plead that a statement of opinion was “untrue” merely by alleging that the opinion itself was objectively wrong, as the Sixth Circuit has concluded, or whether the plaintiff must also allege that the statement was subjectively false—requiring allegations that the speaker’s actual opinion was different from the one expressed—as the Second, Third, and Ninth Circuits have held.

In Indiana State District Council v. Omnicare, Inc., 719 F.3d 498, 505 (6th Cir. 2013), the Sixth Circuit noted that Section 11 is a strict liability statute and held that “once a false statement has been made, a defendant's knowledge is not relevant to a strict liability claim.” Thus, the Sixth Circuit concluded, “if the defendant discloses information that includes a material misstatement, that is sufficient and a complaint may survive a motion to dismiss without pleading knowledge of falsity.” In contrast, in Fait v. Regions Financial Corp., 655 F.3d 105, 110–13 (2d Cir. 2011), the plaintiffs claimed that certain statements concerning goodwill and loan loss reserves in the defendant’s registration statement gave rise to liability under Sections 11 and 12 of the Securities Act. The Second Circuit held that a defendant’s statements were opinions because they were based on subjective estimates by the company’s management. The Ninth and Third Circuits reached similar holdings in Rubke v. Capitol Bancorp, Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009) (holding that statements of opinion “can give rise to a claim under section 11 only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading”) and In re Merck & Co., Inc. Sec. Derivative & ERISA Litig., 543 F.3d 150, 166 (3d Cir. 2008) (“[I]n the context of a claim alleging falsely-held opinions or beliefs, investors must have sufficient information to suspect that the defendants engaged in culpable activity, i.e., that they did not hold those opinions or beliefs in earnest.”).
**Puffery.** Most courts conclude that “vague and general statements of optimism constitute no more than ‘puffery’ and are understood by reasonable investors as such.” See, e.g., *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 538-39 (3d Cir. 1999) (citing cases).

**Factual characterizations.** As long as material facts are disclosed, a failure to characterize facts in a negative manner is not actionable. See, e.g., *Ley v. Visteon Corp.*, 543 F.3d 801, 808 (6th Cir. 2008).

**Firm-specific information.** The Acts “only require” issuers to disclose firm-specific information, and there is no duty to disclose industrywide or nationwide economic information. See *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 515 (7th Cir. 1989) (“Issuers need not 'disclose' Murphy’s Law or the Peter Principle, even though these have substantial effects on business.”).

#7. The SEC's Failure to Adequately Patrol Public Markets
There is no comprehensive enforcement by the SEC of public company disclosures. Rather, plaintiffs’ lawyers end up policing the public company markets. This raises a number of obstacles to recovery. First, parallel government actions will typically lead to higher settlement amounts in private actions. Also, because an SEC complaint gives the allegations in a private action more credibility, facts uncovered in an SEC investigation can assist plaintiffs in developing a robust complaint that can overcome a motion to dismiss. Lastly, because plaintiff’s firms generally work on a contingent fee basis, only the most substantial plaintiffs’ firms are able to pursue certain cases where an SEC complaint is not involved.

#6. Heightened Pleading under Rules 8 and 9 of the Federal Rules of Civil Procedure
Rule 8 applies to claims under Section 11 that are not based on fraud. After the Supreme Court’s rulings in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), however, Rule 8 no longer only requires “a short and plain statement of the claim showing that the pleader is entitled to relief” that “gives the defendant fair notice of what the . . . claim is and the grounds upon which it rests.” *Conley v. Gibson*, 355 U.S. 41, 47 (1957). Now, the plaintiff’s allegations, stripped of legal conclusions, must state a claim that is not merely possible, but “plausible on its face.”

Historically, Section 11 was, in essence, a strict liability statute. See *In re Fleetboston Fin. Corp. Secs. Litig.*, 253 F.R.D. 315, 343 n.29 (D.N.J. 2008) (stating that Section 11 “imposes virtually strict liability on offerors and sellers directly involved in a fraudulent registered transaction”). In order to state a claim, a plaintiff only had to show that the defendant made an untrue statement or omission in a registration statement and that there was a “substantial likelihood that a reasonable investor would consider it important.” See *Greenapple v. Detroit Edison Co.*, 468 F. Supp. 702, 708 (S.D.N.Y. 1979), aff’d 618 F.2d 198 (2d Cir. 1980). This was especially true as to claims against issuers, as others had a “due diligence” defense to Section 11 claims. Recently, however, courts have dismissed Section 11 claims at the pleading stage, on the basis that the plaintiff’s

Under Rule 9(b), complaints alleging fraud must be pled with particularity. See Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 (2007) (“Rule 9(b) applies to ‘all averments of fraud or mistake’; it requires that ‘the circumstances constituting fraud . . . be stated with particularity’ but provides that ‘[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally.’”). Most courts have held that claims brought under the Securities Act that “sound in fraud,” regardless of how a plaintiff labels the claim, must satisfy Rule 9(b)’s heightened-pleading requirement. See, e.g., ACA Fin. Guar. Corp. v. Advest, Inc., 512 F.3d 46, 68 (1st Cir. 2008) (“Where section 12(a)(2) claims are grounded in fraud, Rule 9(b) applies.”); Rombach v. Chang, 355 F.3d 164, 171 (2d Cir. 2004) (Rule 9(b) applies to claims brought under Sections 11 and 12(a)(2) of Securities Act when claims are grounded in fraud and not in negligence); Shapiro v. UJB Fin. Corp., 964 F.2d 272, 288 (3d Cir. 1992) (same).

**To Be Continued**
In Part II, which will appears in the next issue of *Securities Litigation Journal*, we will discuss the Top 5 obstacles, including important subjects such as heightened-pleading requirements, the elimination of group pleading, recklessness, discovery stays, and class certification. We believe our description of these remaining obstacles will aid practitioners in both preparing complaints and defending against them.

**Keywords:** litigation, securities, litigation tips, securities fraud

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Corporate Criminal Liability for Insider Trading
By Howard J. Kaplan

Although insider traders often work for business entities, their employers are rarely held criminally liable for their acts. Two recent cases of indictments of businesses, not just their employees, for insider trading raise the question of when the Department of Justice (DOJ) will criminally pursue corporations for insider trading. This article examines the DOJ's policies and practices in this respect.

Introduction
When will the Department of Justice indict a company on the basis of criminal acts of its employees? This question raises an age-old debate concerning whether a company itself should ever be indicted. As history demonstrates, the collateral consequences of such an indictment can be catastrophic for businesses in the financial services industry. Two notable examples were Drexel Burnham and Arthur Andersen, two major financial services firms that did not survive criminal convictions.

The government’s crackdown on insider trading has generally not targeted business entities. Two recent exceptions are the indictment and guilty plea of SAC Capital Advisors L.P. (SAC) and the plea agreement with Tiger Asia Management LLC. The SAC matter in particular has caused substantial debate because the firm was indicted despite the fact that the government apparently lacked sufficient evidence to indict the firm’s founder and owner, Steven A. Cohen.

This article provides an overview of the guidelines for holding a company criminally responsible for the misconduct of its employees and how such guidelines appear to have been applied in cases of insider trading.

Criminal Liability of Business Entities
According to Blackstone, “[a] corporation cannot commit treason, or felony, or other crime, in its corporate capacity though its members may, in their distinct individual capacities.” This was the early consensus view—that a corporation could not be held criminally liable for the acts of its agents. This view was based on the notion that corporations do not commit crimes, people commit crimes. Blackstone’s view, however, was rejected by the United States Supreme Court in New York Central & H.R.R. Co. v. United States. A railroad company was convicted because two of its managers illegally gave rebates to various sugar companies for shipping on their line. The Supreme Court affirmed the conviction, saying that “there are some crimes which, in their nature, cannot be committed by corporations. But there is a large class of offenses … wherein the crime consists in purposely doing the things prohibited by statute. In that class of crimes we see no good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred upon them.”

Since New York Central, federal courts have generally adopted a broad, respondeat superior approach to business entity criminal liability. “[T]he corporation may be criminally
bound by the acts of subordinate, even menial, employees.” See, e.g., United States v. Basic Construction Co., (affirming conviction for bid-rigging, rejecting the corporation’s argument that the offense was carried out by “minor officials” without the knowledge of management and against established company policy); United States v. Harry L. Young & Sons, Inc., (company was held criminally liable when two drivers left a truck full of explosives unattended, in violation of company policy and dispatcher instructions). “[T]he only thing that keeps deceived corporations from being indicted for the acts of their employee-deceivers is not some fixed rule of law or logic but simply the sound exercise of prosecutorial discretion.”

In 1991, Congress provided guidance in the area of corporate criminal liability with the adoption of the Organizational Sentencing Guidelines of the United States. The Sentencing Guidelines rest on two principles: The business entity should “remedy any harm caused by the offense,” and its punishment “should be based on the seriousness of the offense and the culpability of the organization.” Culpability, in turn, was determined by six factors: (1) the business entity's “involvement in or tolerance of criminal activity”; (2) its “prior history”; (3) any “violation of an order”; (4) “obstruction of justice”; (5) “the existence of an effective compliance and ethics program”; and (6) “self-reporting, cooperation, or acceptance of responsibility.” The Sentencing Guidelines concern post-conviction sentencing, but the standards set forth therein are obviously relevant to charging decisions and the exercise of prosecutorial discretion.

The Department of Justice issued its first formal statement of principles in charging business entities in June 1999. Known as the Holder Memorandum after its drafter, then Deputy Attorney General Eric H. Holder, Jr., it adopted the basic rules of respondeat superior as governing criminal prosecutions: “Under the doctrine of respondeat superior, a corporation may be held criminally liable for the illegal acts of its directors, officers, employees, and agents. To be held liable for these actions, the government must establish that the corporate agent's actions (i) were within the scope of his duties and (ii) were intended, at least in part, to benefit the corporation. In all cases involving wrongdoing by corporate agents, prosecutors should consider the corporation, as well as the responsible individuals, as potential criminal targets.”

The Holder Memorandum went on to set forth a set of guidelines to be followed by the Department of Justice in deciding whether it would exercise its discretion to indict (or refrain from indicting) a business entity. The Holder Memorandum identified eight factors that prosecutors should consider in determining whether to charge a business entity: “the nature and seriousness of the offense,” “the pervasiveness of wrongdoing within the corporation,” “the corporation's history of similar conduct,” “timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of the corporate attorney-client and work product privileges,” “the corporation's compliance program,” “remedial actions,” “collateral consequences,” and “the adequacy of non-criminal remedies.” The Holder Memorandum was revised several times, but all revisions retained the basic respondeat superior premise for corporate prosecutions.
In 2003 the new Deputy Attorney General issued the Thompson Memorandum, which added another factor to be considered in determining whether it seeks an indictment against a business entity—“adequacy of prosecution of individuals.” The Thompson Memorandum also elaborated on the effect of a failure to cooperate with the government. This latter factor, especially insofar as it encouraged business entities to waive privileges or to refuse to pay for the criminal defense of its employees, caused much controversy. The DOJ also began to resort more frequently to deferred prosecution agreements, a less harsh form of criminal sanction than a guilty plea.

The business entity guidelines were revised again in 2008 in the Filip Memorandum, and today are reflected into the U.S. Attorneys’ Manual §§ 9-28.000-28.1300. The Manual incorporates the factors set out in the Holder and Thompson Memoranda:

- The nature and seriousness of the offense (see USAM 9-28.400)
- The pervasiveness of wrongdoing within the corporation (see USAM 9-28.500)
- The corporation's history of similar misconduct (see USAM 9-28.600)
- The corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents (see USAM 9-28.700)
- The existence and effectiveness of the corporation's pre-existing compliance program (see USAM 9-28.800)
- The corporation's remedial actions (see USAM 9-28.900)
- Collateral consequences (see USAM 9-28.1000)
- The adequacy of the prosecution
- The adequacy of remedies such as civil or regulatory enforcement actions (see USAM 9-28.1100)

In the current U.S. Attorneys’ Manual, deferred prosecution agreements (filed with the court) and non-prosecution agreements (between the DOJ and the target) are discussed in the section on “Collateral Consequences.” Recognizing that the prosecution of business entities may affect other employees, investors, and customers who had no knowledge of the offense and would have been unable to prevent it, the DOJ will, under what it considers to be appropriate circumstances, enter into deferred prosecution agreements or non-prosecution agreements with business entities. Between 2004 and 2009, the Justice Department’s Criminal Division entered into more such agreements than it brought cases. David M. Uhlmann, Deferred Prosecution and Non-Prosecution Agreements and the Erosion of Corporate Criminal Liability, 72 Md. L. Rev. 1295, 1317 (2013).

**Prosecution of Business Entities for Insider Trading**

In contrast to the numerous individuals indicted in recent years for insider trading, only a handful of business entities have been charged for the insider trading of their employees. It appears that the government is more likely to be satisfied with a business entity’s disgorgement of improper profits and may even treat the entity as a victim, particularly where the entity has strong controls and cooperates with the government’s investigation.
For example, in *United States v. Gupta*, Rajat K. Gupta, a former director of Goldman Sachs, was convicted of insider trading and received a criminal penalty that included a requirement that he reimburse Goldman Sachs for its fees and costs incurred in connection with the investigation under the Mandatory Victims Restitution Act. Goldman Sachs was not sued by either the DOJ or the SEC. To be sure, it is doubtful that Goldman Sachs would have been liable even on a *respondeat superior* theory. However, it is noteworthy that Goldman Sachs was considered a victim of the crime.

In *United States v. Skowron*, a managing director at Morgan Stanley engaged in insider trading, and pled guilty to conspiracy to commit securities fraud. Morgan Stanley was not criminally prosecuted, although the SEC *sued the hedge funds* that Skowron managed as “relief defendants” and received a $33 million disgorgement payment. In connection with Skowron’s criminal case, the court held that Morgan Stanley was entitled to compensation from Skowron under the Mandatory Victims Restitution Act for its fees and expenses in connection with the government investigation, and for a portion of the employee’s compensation. Then, in a follow-up *civil action*, Morgan Stanley was awarded the entirety of Skowron’s compensation for his period of insider trading under a “faithless servant” theory. Neither the criminal nor civil courts were willing to award Morgan Stanley restitution of its payment to the SEC, on the grounds that the money was the fruit of illegal conduct and Morgan Stanley had not been entitled to it in the first place. Morgan Stanley’s claim for fraud against Skowron, though, was allowed to stand, although Morgan Stanley ultimately *dismissed* its remaining causes of action.

Similarly, in the case of *United States v. Newman*, No. 12-cr-00121, docket # 242, Government’s Sentencing Memorandum (S.D.N.Y. April 26, 2013), the government sought to have the court reimburse Newman’s employer, Diamondback Capital Management, for its legal fees and expenses and a portion of Newman’s compensation. The government asked the court to follow the model of the Skowron case. The government had previously entered into a non-prosecution agreement with Diamond Capital, which also paid $9 million in disgorgement and penalties to the SEC.

The prosecution of SAC stands in contrast to the treatment of Morgan Stanley and Diamond Capital. According to the indictment, SAC hired portfolio managers and research analysts with inside contacts, and then pressed them to develop trading ideas for which they had a “high conviction” of profit. Many of these “high conviction” proposals were allegedly based on inside information. Eight SAC employees were convicted of insider trading.

Before the indictment, SAC had settled with the SEC and had agreed to pay an astounding $616 million in disgorgement and penalties. Nonetheless, the company was indicted on five counts of wire and securities fraud. In addition, the government also brought a civil forfeiture action for the proceeds of the insider trades based on a money-laundering theory. SAC pled guilty to the criminal counts and agreed to pay an additional $284 million in forfeiture. SAC’s plea bargain itself departed from the usual, in that it was reached under Fed. R. Crim. Proc. 11(c)(1)(C),
which obliged the district court to either reject the plea agreement or accept it in toto, which it did.

In the Tiger Asia case, Tiger Asia was charged with short-selling on the basis of confidential information it had obtained on a promise of non-trading. The SEC further charged it with attempting to manipulate the Hong Kong Stock Exchange. The SEC sued and settled with both the company and two of its officials, including its founder and principal Sung Kook "Bill" Hwang. Only the company was criminally prosecuted. It pled guilty to one count of wire fraud, agreed to a $16 million forfeiture, and paid an additional $28 million to the SEC.

Despite criticisms of the SAC indictment, it appears from the publicly available record that the government’s decision to prosecute SAC was well within its own guidelines. For example, with respect to the “nature and seriousness of the offense” and the “pervasiveness of wrongdoing,” the government charged and convicted eight employees, and another two settled with the SEC. Moreover, this insider trading scheme made SAC hundreds of millions of dollars in illicit profits. Similarly, with respect to SAC’s compliance program, according to the indictment the program had identified only one example of suspected insider trading in its history. Additionally, it appears that SAC may have decided not to cooperate during the investigation. SAC sent a memorandum to its clients reporting that, “[w]hile we have in the past told you of our cooperation with the government’s investigation, our cooperation is no longer unconditional, and we do not intend to give updates in this area going forward.”

Similarly, in the Tiger Asia matter, it appears that the firm was engaged in a scheme to manipulate the Hong Kong stock market and that the firm blatantly violated numerous agreements by using confidential information it had received pursuant to a “no trade” restriction to make trading decisions. The company thus blatantly violated a contractual obligation, and the head of the company consented to an SEC judgment. While there is not much publicly available information regarding this matter, it appears that the violations were serious and pervasive.

The fact that the principals of SAC and Tiger Asia were not indicted does not necessarily raise a question about the government’s indictment of their respective companies. As stated by the then-head of the DOJ Criminal Division, Lanny A. Breuer: “There are of course times when, despite a company’s admission of significant misconduct, we lack the evidence to prove that any particular individual committed a crime.” In both of these cases, one factor may have very well been lack of sufficient evidence to indict the principals where there was overwhelming evidence of misconduct by the firm and other employees.

Conclusion
Beginning with the investigation of Raj Rajaratnam and the Galleon group, the government, and particularly the United States Attorney for the Southern District of New York, have embarked on a broad effort to eradicate insider trading. In practice, the government has demonstrated restraint in targeting companies whose employees engaged in insider trading. However, as the
government made clear in the SAC and Tiger Asia indictments, it will pursue a company when the facts warrant it.

Not everyone agrees that the Drexel Burnham and Arthur Andersen experiences prove that criminal prosecution is necessarily fatal. According to one study, “[n]o public company convicted in the years 2001-2010 went out of business because of a federal criminal conviction.” Gabriel Markoff, Arthur Andersen and the Myth of the Corporate Death Penalty: Corporate Criminal Convictions in the Twenty-First Century, 15 U. Pa. J. Bus. L. 797, 827 (2013). The government is, however, sensitive to the collateral consequences of an indictment. For example, in its non-prosecution agreement with Diamondback Capital Management, it explained that one of the reasons it entered into the agreement was because of “the negative effect that the continuing uncertainty regarding the Government’s investigation would have on Diamondback’s financial condition and its remaining employees and investors.”

Given the potentially dire consequences of an indictment on financial services firms, and particularly hedge funds, it is critical that firms exercise diligence in policing its traders, and maintain robust compliance programs. Firms should be able to prove to a prosecutor that it is truly the victim of a rogue employee’s insider trading.

Keywords: litigation, securities, insider trading, hedge funds, criminal investigations, corporate criminal liability

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NEWS & DEVELOPMENTS

Private Equity Firms Beware of Potentially Conflicting Fiduciary Duties

The Delaware Chancery Court recently reaffirmed that minority shareholders may owe fiduciary duties to the corporation and to other shareholders where the members of the control group are connected in a “legally significant way” and exercise control. *Frank v. Elgamal*, 2014 Del. Ch. LEXIS 37, *5 (Del. Ch. Mar. 10, 2014).

It has long been recognized under Delaware law that a minority shareholder may be deemed a controlling shareholder and assume fiduciary duties for purposes of specific transactions even where it does not generally exercise control over the company’s business affairs or over the board of directors. *In re Western Nat’l Corp. Shareholders Litig.*, 2000 Del. Ch. LEXIS82, at *70 (Del. Ch. May 22, 2000). “A number of shareholders, each of whom individually cannot exert control over the corporation (either through majority ownership or significant voting power coupled with formidable managerial power), can collectively form a control group where those shareholders are connected in some legally significant way, e.g., by contract, common ownership, agreement, or other arrangement-to work together toward a shared goal.” *Dubroff v. Wren Hldgs.*, LLC, 2009 Del. Ch. LEXIS 89, *12 (Del. Ch. May 22, 2009). In *Dubroff*, allegations that a group of investors planned and caused a series of transactions in order to enrich themselves at the expense of minority shareholders, supported by detailed allegations of the steps taken by the group, were held sufficient to uphold claims of control.

Application of this principle is also seen in *In Zimmerman v. Crothall*, 2012 Del. Ch. LEXIS 64, at *36–38 (Del. Ch. 2012). There, two venture capital investors who cumulatively held 66 percent of the company’s stock were deemed a control group based on the facts that they were the two largest investors in the company, were early stage investors with similar economic interests, had appointed two of five directors, and were involved in communications regarding capital-raising efforts.

Where the controlling minority shareholder has its own shareholders, the situation becomes more complex because the minority shareholder may also owe fiduciary duties to its own investors. This happens frequently with private equity investors. Often the interests of the corporation conflict with those of the private equity firm’s own investors. But this does not mean that such private equity firms who qualify as controlling shareholders cannot participate in transactions that have the potential to enrich themselves. Rather, where private equity firms are found to be dual fiduciaries, their conduct will be scrutinized under the entire fairness standard. *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 636-640 (Del. Ch. 2013) (directors who were fiduciaries of funds approved deals favoring the funds); *In re Primedia, Inc.*, 2013 Del. Ch. LEXIS 306, at *24 (Del. Ch. Dec. 20, 2013) (“Because KKR was Primedia's controlling stockholder and received a special benefit in the Merger, the operative standard of review would become entire fairness.”); *In re Trados Inc. S’holder Litig.*, 73 A.3d 17 (Del. Ch. 2013) (six of seven directors
were held to be not disinterested and independent and three directors who were fiduciaries of venture capital funds faced a conflict as “dual fiduciaries,” where the merger triggered the preferred stockholders’ liquidation preference such that those directors had “a divergent interest in the Merger that conflicted with the interests of the common stock”).

Private equity and venture capital firms that invest in Delaware corporations need to be aware of the possibility that they have dual (and perhaps competing) fiduciary obligations, particularly where they are significant minority shareholders or may be considered part of a control group.

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Fifth Circuit Fashions Totality of the Circumstances Test For Loss Causation

Corrective disclosures for loss causation can now be established through a "totality of the circumstances" test, at least in the Fifth Circuit. In Public Emples. Ret. Sys. of Miss. v. Amedisys, Inc., No. 13-30580 (5th Cir. Oct. 2, 2014), the Fifth Circuit held that a series of partial disclosures "collectively constitute and culminate" in a corrective disclosure that adequately pleads loss causation for purposes of 12(b)(6) dismissal analysis. The Retirement System (lead plaintiff in the class action) relied on five separate disclosures from August 2008 through July 2010 in support of its claims that Amedisys defrauded investors by concealing fraudulent Medicare billing practices and issued false statements resulting in artificially inflated trading prices throughout the class period, causing a 63.6 percent drop in stock value. The five partial disclosures were (1) an August 2008 research report "raising questions" about Amedisys's accounting and Medicare billing practices; (2) the September 2009 resignation of Amedisys's CEO and CIO; (3) an April 2010 Wall Street Journal article analyzing publicly available Medicare data and showing a statistical correlation between Medicare reimbursement thresholds and the number of home visits performed by Amedisys therapists; (4) the commencement of three government investigations into Amedisys practices (by the Senate Finance Committee, the Securities Exchange Commission, and the Department of Justice) from May 2010 through September 2010; and (5) Amedisys’s disappointing second quarter operations results, released in July 2010.

The district court had examined each of the five disclosures individually, found none of them alone sufficient to establish a corrective disclosure for purposes of pleading loss causation, and granted Amedisys’s motion to dismiss for failure to state a claim. However, the Fifth Circuit focused on "relevance" as used in the Lormand standard for establishing proximate causation, i.e., a plaintiff must allege that the truth that emerged via the disclosures was "related to" or "relevant to" the defendant's fraud or earlier misstatements, finding that the "relevant truth" test "simply means that the truth disclosed must make the existence of the actionable fraud more

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probable than it would be without that alleged fact, taken as true." The court also reiterated that "the truth can be gradually perceived in the marketplace through a series of partial disclosures." The court then combined these approaches, examining each of the Retirement System's five partial disclosures individually against the relevant truth test, but then considering them collectively to determine whether a corrective disclosure had been made to plead loss causation at the motion to dismiss stage.

The Fifth Circuit agreed with the district court that neither the 2008 research report, the executives' resignation, nor the commencement of government investigations alone constituted a corrective disclosure. However, the court held that the district court erred in finding that a government investigation must discover actual fraud to constitute a corrective disclosure and specifically reversed on application of this "overly rigid" rule. For now, the new plausibility standard for loss causation at the dismissal stage in the Fifth Circuit requires: specific allegations of a series of partial corrective disclosures, a subsequent drop in stock value, and the absence of any other contravening negative event.

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