SECURITIES LITIGATION UPDATE:

KEY CASES AND DEVELOPMENTS FROM THE PLAINTIFF'S PERSPECTIVE

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INTRODUCTION

From the plaintiff's perspective, there have been several interesting and significant developments in securities litigation in both the federal and Georgia courts during the past 18 months. For example, last June the U.S. Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), finally issued its first decision on the provision in the Private Securities Litigation Reform Act of 1995 ("PSLRA") that requires a plaintiff to state with particularity facts giving rise to a "strong inference" of scienter or fraudulent intent on the part of each defendant to survive a motion to dismiss. The Georgia Court of Appeals also resolved a long-standing issue when it addressed in *Insight Technology, Inc. v. FreightCheck, LLC*, 280 Ga. App. 19 (2006), whether the state recognizes claims for aiding and abetting a breach of fiduciary duty.

This outline examines these and other recent federal and Georgia opinions. Rather than being a comprehensive overview of the law in this area, it focuses only on those cases and issues that are on the cutting edge of the law. It also offers several practice tips and pointers for plaintiffs' attorneys.

I. Federal Decisions

A. Pleading Standards and Confidential Sources

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), the Supreme Court resolved an existing split among the Circuits on whether inferences favorable to a defendant must be considered in ruling on a motion to dismiss. The issue before the Court was the interpretation of a provision in the PSLRA that sets out what investors must contend in a fraud action to prevent the case from being dismissed. The

PSLRA requires that investors state facts "giving rise to a strong inference that the defendant acted with the requisite state of mind."

The *Tellabs* Court held that a district court must consider all "plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff." To qualify as "strong" under the Private Securities Litigation Reform Act, "an inference of scienter must be more than merely plausible or reasonable -- it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."

The Court adopted a "holistic" approach to evaluating a complaint's scienter allegations, and established three "prescriptions" for courts to follow in making an assessment that there was a strong inference of scienter. First, as has always been the case, a court "must accept all factual allegations as true." *Id.* Second, "courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions." The inquiry is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id.* (emphasis is original). Third, "in determining whether the pleaded facts give rise to an inference of scienter, the court must take into account plausible opposing inferences." *Id.*

The Supreme Court explained that the inference that the defendant acted with scienter "need not be irrefutable, *i.e.*, of the 'smoking-gun' genre or even the 'most plausible of competing inferences.'" *Id.* at 2510. Under this test, however, a complaint will survive "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.*

Significantly, the Court in *Tellabs* expressly avoided deciding whether allegations demonstrating recklessness establish scienter. In a footnote, however, the Court noted that "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly." *Id.* at 2507, n. 3.

Several recent cases have demonstrated that defendants have already begun to derive significant benefits from the *Tellabs* decision. Plaintiffs should be wary of making conclusory allegations and speculations in their complaint and refrain from using confidential informants to bolster their claims. They should also be aware that pleading scienter by pointing to a defendant's stock sales may be subject to greater scrutiny. *Tellabs* clearly makes it more difficult for investors to pursue federal securities fraud actions.

- *Jaffee v. The Home Depot, Inc.*, No. 1:06-CV-1617-ODE, slip op. (N.D. Ga. July 18, 2007). Claims against all defendants were dismissed for failure to plead scienter under *Tellabs*. The complaint did nothing more than "infer that 'someone' in the management [of the company] had to know about the scheme." Since there were no allegations that the misconduct was "communicated up the corporate chain of command" to the individually-named defendants or any other members of senior management who were responsible for preparing the statements that contained the false and misleading information, dismissal was required.
- *Higginbotham v. Baxter International, Inc.*, 2007 WL 2142298 (7th Cir. July 27, 2007). Relying on *Tellabs*, the court took a dim view of the plaintiff's reliance on information received from "confidential informants" purporting to

be former employees of the company. The court must "discount" allegations from such informants and the discount will usually be "steep." It is "hard to see how information from anonymous sources could be deemed 'compelling' or how [a court] could take account of plausible opposing inferences" as required under *Tellabs*.

- *Elam v. Neidorff*, 2007 WL 1880747 (E.D. Mo. June 29, 2007). The court held that plaintiffs failed to plead scienter by relying on stock sales made pursuant to SEC Rule 10b5-1, which allows executives to trade in company stock via a pre-determined plan. Merely pointing to such sales is insufficient to plead scienter, particularly when plaintiffs fail to allege facts that would show these pre-arranged sales were unusual in any respect. Since *Tellabs* directs that any omitted information about overall trading practices must be considered, plaintiffs should consider including information on the defendants' prior sales history or the total number of shares held by each.

B. Scheme Liability and Primary Liability vs. Aiding and Abetting

The Supreme Court's expected decision in *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, 127 S. Ct. 1873 (2007), which is scheduled for oral argument on October 9, should provide some definitive guidelines on the viability of scheme liability. Scheme liability attempts to avoid the impact of *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) -- which held that a private plaintiff may not maintain an aiding and betting action under section 10(b) -- and the PSLRA, both of which limit private plaintiffs to filing cases only against the troubled companies themselves, and their officers and directors, who are regarded as primary violators.

Under *Central Bank* and the PSLRA, outside advisers and other secondary actors are typically viewed as aiders and abettors who almost always are immune from liability in a private action.

In *Stoneridge*, the Supreme Court will consider whether a secondary actor such as a banker, an accountant or a lawyer can be held liable for a primary violation of Section 10(b) of the Securities Exchange Act of 1934 for engaging in a "scheme to defraud" even when the secondary actor did not himself make or otherwise participate in any challenged misstatements or omissions. Although it is difficult to predict how the Court will rule, the justices have been moving away from the populist position of the 1970s and private rights of action in securities cases have been no exception.

The Fifth Circuit in *Regents of University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007) (primary liability under § 10(b) exists only where a party engaged in "deceptive conduct") and the Eighth Circuit in *In re Charter Communications, Inc. Securities Litigation*, 443 F.3d 987 (8th Cir. 2006) (to impose liability on secondary actors "would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings") both rejected scheme liability. The Ninth Circuit, however, held in *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006) that a secondary actor may in certain circumstances be held liable "as a primary violator of § 10(b) for participation in a scheme to defraud."

The Ninth Circuit adopted the following test for scheme liability:

> We hold that to be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had he principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. It is not enough that a *transaction* in which a defendant was involved had a deceptive purpose and effect; the defendant's *own*

> *conduct* contributing to the transaction or overall scheme must have had a deceptive purpose or effect.

Id. at 1048 (emphasis in original).

The Supreme Court granted *certiorari* on the Eighth Circuit case to consider whether *Central Bank* forecloses claims for deceptive conduct under section 10(b) of the Exchange Act and Rule 10b-5(a) and (c). The plaintiffs in *Stoneridge* are shareholders of cable company Charter Communications who alleged that Scientific-Atlanta and Motorola sold Charter cable boxes through sham transactions that Charter used to mislead its investors. Although the plaintiffs did not allege that Scientific-Atlanta or Motorola disseminated false information to analysts or investors, they did claim that the defendants were aware that they were contributing to a fraud upon investors. In other words, defendants engaged in transactions with a public company that had no legitimate business or economic purpose except to artificially inflate the company's financial statements, yet defendants themselves made no public statements concerning those transactions.

The Supreme Court's resolution of this battle over secondary actor liability is likely to have broad implications for litigants in securities cases. Indeed, the Wall Street Journal's editorial page recently described *Stoneridge* as "the biggest securities litigation case in a generation." Merrill Lynch & Co., the U.S. Chamber of Commerce and the Bush administration have all filed amicus briefs supporting the plaintiffs. Union and consumer groups, state retirement systems and several states, including Georgia, have lent their support to the plaintiffs.

A reversal of the Eighth Circuit decision may permit plaintiffs to rely on the concept of scheme liability to reach secondary actors such as banks and other parties

with which an issuer of securities conducts business. This is especially significant when an issuer of securities is in financial trouble at the time a class or other action is filed. Alternatively, if the Supreme Court affirms the Eighth Circuit's rejection of scheme liability, plaintiffs will be less likely to name as defendants secondary actors such as bankers, lawyers and accountants who engage in business transactions with companies accused of securities fraud, but do not make any challenged misstatements.

C. Loss Causation

In light of the loss causation test articulated in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) and its progeny, plaintiffs' attorneys should be aware that whenever a complaint includes any allegation of fraud -- whether the fraud is based on violations of the securities laws or common law fraud -- a motion to dismiss will almost surely follow. The Supreme Court held in *Dura* that, to survive a motion to dismiss, a plaintiff must allege specific facts sufficient to prove a causal connection between a defendant's misrepresentation or fraudulent act and a plaintiff's economic loss.

In opposing a motion to dismiss where the complaint alleges only common law fraud, plaintiffs' attorneys should keep in mind that fraudulent misrepresentations and statements to an investor can be the proximate cause of a plaintiff's losses. An act is a cause of an injury if it is a proximate cause, which means that it was a substantial factor in bringing about the injury. Conduct is a substantial factor in bringing about the injury so long as it is not a slight or trivial factor. A misrepresentation is a proximate cause of an injury resulting from action or inaction in reliance upon it only if the injury might reasonably be expected to result from that reliance. Simply stated, a misrepresentation is a proximate cause of an injury if the injury is a foreseeable result of the misrepresentation.

It is well established in the law of most, if not all states, including Georgia, that there may be more than one cause of an injury. When there is more than one cause, only one of which is unlawful, the unlawful actor's conduct is a proximate cause of the loss and the unlawful actor is responsible for the loss. If an investor can establish that he relied on a broker's false representations to retain stock he had purchased and would have sold the stock had he known the broker's true opinion of the company issuing the stock, and subsequently suffers a loss when the stock declines in value, the investor's loss is a direct and foreseeable result of the broker's fraud.

Even if there are two causes of an investor's losses, for example, the broker's fraud and industry conditions that caused the company's stock price to fall, both causes are obviously substantial factors. If either had not occurred, the investor would not have been injured. When a fraudulent act and a natural cause together produce the harm, the fraudulent actor is responsible.

While proof of proximate cause is always required for a plaintiff to recover damages, the type of proof held to be sufficient to establish proximate cause in securities fraud cases varies, depending on the nature of the claim. In cases where the plaintiff makes no claim that the fraud artificially inflated the price of the stock, but instead claims his loss occurred because his broker or investment advisor misrepresented the risks of the investment and the stock declines due to the risks that were the subject matter of the misrepresentation, the loss is clearly foreseeable. If proved, the loss satisfies proximate cause.

Defendants frequently cite *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161 (2d Cir. 2005) to show that an investor cannot satisfy the loss causation test and thus cannot recover damages. They typically argue that, under *Lentell*, a plaintiff must allege and

prove that the stock price declined when the misrepresentation became known, even if the plaintiff does not claim that the misrepresentation artificially inflated the stock price.

A close reading of *Lentell* reveals that there is nothing in the opinion to support that argument. On the contrary, the touchstone of proximate cause is foreseeability. To allege proximate cause, the plaintiff must allege facts that show his loss was "a foreseeable consequence of any misrepresentation or material omission." *Lentell*, 396 F.3d at 172-173. Once he does so, the causation element is satisfied.

In *Louros v. Kreicas*, 367 F. Supp.2d 572 (S.D.N.Y. 2005), the plaintiff alleged that his investment advisor misrepresented the risk of investments directly to him and he incurred losses when the risk materialized. There was no allegation that the value of the investment declined when the misrepresentation was made known to the market. The court analyzed the allegations both under the fraud provisions of federal law and New York common law. The *Louros* court held that "loss causation, as delineated in *Lentell*" was satisfied, as was the causation requirement under New York fraud law. *Louros*, 367 F. Supp. 2d at 593.[1]

Examples of affidavits successfully used by a claimant in an NASD arbitration to defeat a motion to dismiss arguing that the claimant could not prove loss causation are attached hereto. The affidavits of former Georgia Supreme Court Chief Justice Norman Fletcher (Attachment A) and University of Georgia Law School Professor Thomas Eaton

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[1] To date, it appears that only Judge Cote's decision in *In Re WorldCom, Inc. Securities Litigation (Holmes)*, 456 F. Supp.2d 508 (S.D.N.Y. 2006) -- pending on appeal before the Second Circuit -- requires an allegation that the stock price declined when the misrepresentation was revealed to the market. In *Holmes*, the plaintiff alleged that his loss resulted from a misrepresentation as to the brokerage firm's assessment of the risk of an investment. There was no allegation that the misrepresentation artificially inflated the stock price.

(Attachment B) state that a plaintiff's allegations that his investment losses occurred as the result of a broker's fraudulent misrepresentations would support a claim for common law fraud under Georgia law and would be considered a proximate cause of the plaintiff's foreseeable injuries. These allegations would therefore satisfy the pleading requirements for loss causation.

II. Georgia Decisions

A. Aiding and Abetting a Breach of Fiduciary Duty.

In *Insight Technology, Inc. v. FreightCheck, LLC*, 280 Ga. App. 19 (2006), the Georgia Court of Appeals addressed a long-standing question of whether plaintiffs in Georgia are allowed to pursue claims for aiding and abetting a breach of fiduciary duty. The decision is important because it provides the clearest precedent to date that, in the context of breaches of fiduciary duties by corporate officer and directors, under some circumstances, secondary actors may be held liable for their participation in the fiduciary's wrongdoing.

Although aiding and abetting is one of the well-established means through which a person may become a party to a crime, requiring both wrongful intent and assistance in the criminal activity, there is no statute in Georgia authorizing civil liability for aiding and abetting. Citing *Rome Industries, Inc. v. Jonsson*, 202 Ga. App. 682 (1992), the *Insight Technology* court noted that it had explicitly acknowledged a cause of action for procuring a breach of fiduciary duty based on O.C.G.A. § 51-12-30.[2] The Court advanced

[2] O.C.G.A. § 51-12-30 provides: "In all cases, a person who maliciously procures an injury to be done to another, whether an actionable wrong or a breach of contract, is a joint wrongdoer and may be subject to an action either alone or jointly with he person who actually committed the injury."

the argument for liability a step further and found that secondary actors may be held liable when they "procure" the fiduciary's wrongdoing.

The Court of Appeals stated that whatever the activity was called -- "aiding and abetting a breach of fiduciary duty," "procuring a breach of fiduciary duty," or "tortious interference with a fiduciary relationship" -- Georgia law authorizes a plaintiff to recover damages. To do so, the plaintiff must establish the following: (1) through improper action or wrongful conduct and without privilege, the defendant acted to procure a breach of the primary wrongdoer's fiduciary duty to the plaintiff; (2) with knowledge that the primary wrongdoer owed the plaintiff a fiduciary duty, the defendant acted purposely and with malice and the intent to injure; (3) the defendant's wrongful conduct procured a breach of the primary wrongdoer's fiduciary duty; and (4) the defendant's tortious conduct proximately caused damage to the plaintiff.

Insight Technology appears to be the first case to attempt to reconcile Georgia's existing case law declining to recognize a cause of action for aiding and abetting a breach of fiduciary duty, with other decisions supporting a cause of action for "procuring" certain torts. The decision is clearly important in any litigation challenging the actions of secondary actors in the corporate management context, including attorneys, accountants and other professionals. The impact of the ruling, however, may be lessened somewhat by the high standards of proof required to prevail on a claim for aiding and abetting a breach of fiduciary duty. The defendant's state of mind and the role the defendant played in causing the breach of fiduciary duty to occur are especially difficult to prove.

B. Holder Claims

Holder claims are simply claims of fraudulent misrepresentation and suppression, which base the element of reliance on a plaintiff's fraudulently induced forbearance or inaction. In *Argentum International, LLC v. Woods*, 280 Ga. App. 440 (2006), the Court of Appeals recognized the validity of a plaintiff's holder claim, i.e., a claim by an investor that he was fraudulently induced to retain an investment.[3] The *Argentum* case involved claims for fraud brought by equity investors and debenture holders who purchased securities in a company whose major asset was a patent. The business plan, upon which the plaintiffs made their decision to invest, indicated that the company owned the patent. Unknown to the investors, however, the patent was subsequently transferred to another entity.

The *Argentum* court held that the investors had presented evidence establishing that they "were fraudulently induced into making and keeping their investments." In other words, an investor induced to hold securities because of the defendant's fraudulent misrepresentations may recover the losses caused by that fraud.[4]

The affidavits of former Georgia Supreme Court Chief Justice Norman Fletcher (Attachment A) and University of Georgia Law School Professor Thomas Eaton

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[3] The holding in *Argentum* is directly at odds with Judge Cote's decision in *Holmes*, in which the Court opined that Georgia law would not allow recompense to a defrauded securities holder. In *Holmes*, Judge Cote mistakenly states that under Georgia law a plaintiff who claims his brokerage firm falsely misrepresented its assessment of the risk of an investment to him, and makes no claim that the misrepresentation artificially inflated the stock price, must nonetheless allege that the stock price declined when the misrepresentation was revealed to the market.

[4] The case is also significant because earlier in 2006 the U.S. Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006), determined that class actions asserting holding claims under state law are preempted by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). Individual holding claims or claims not involving publicly-traded securities, however, are not preempted under SLUSA.

(Attachment B) state that Georgia recognizes the validity of holders claims and that a common law fraud claim may be based on intentional misrepresentations that induce a person to refrain from acting (such as refraining from selling securities).

C. Common Law Claims for Securities Law Violations

In *Douglas v. Bigley*, 278 Ga. App. 117 (2006), the Georgia Court of Appeals held that, in the context of a fiduciary relationship, the defendant's failure to register securities under Georgia's securities laws could support the plaintiff's claims for breach of fiduciary duty and fraud.

The Court also found, however, that despite the violations of the securities laws and other laws, the contracts were neither illegal nor unenforceable and, as such, were not subject to rescission. In rejecting the contract argument, the Court relied on the fact that the securities could have been sold legally had they been registered and the failure to register could have been remedied. "The alleged illegalities . . . were incidental to the purpose of the investment contracts; those contracts did not *require* a securities violation." 278 Ga. App. at 124 (emphasis in original).

ATTACHMENT A

ATTACHMENT B