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Securities Litigation & Enforcement Trends

In this issue…

- **Supreme Court Arms Securities Class Action Defendants with Powerful Ammunition to Defeat Class Certifications 2**

  On June 23, 2014, the Supreme Court handed down its long-awaited decision in *Halliburton Co. v. Erica P. John Fund, Inc.* and issued a ruling that could dramatically alter the landscape of class action securities litigation.

- **Second Circuit Vacates Judge Rakoff's Order Refusing to Approve Consent Decree 4**

  In *S.E.C. v. Citigroup Global Markets, Inc.*, Judge Rakoff declined to approve the consent decree entered into between Citigroup Global Markets, Inc. and the U.S. Securities and Exchange Commission. On June 4, 2014, the Second Circuit Court of Appeals vacated Judge Rakoff's order, finding that the district court applied the incorrect legal standard in its review.

- **SEC Brings New Kind of Enforcement Action Aimed at Preventing Retaliation Against Whistleblowers ... 6**

  On June 16, 2014, the U.S. Securities and Exchange Commission instituted an administrative proceeding against Paradigm Capital Management, Inc. and its majority owner, Candace King Weir, in part for retaliation against a whistleblower for informing the agency about alleged improper principal transactions between the firm and an affiliated broker-dealer. The SEC indicated this first-of-its-kind action should serve as a warning to firms not to retaliate against whistleblowers who tip the SEC about possible illegal activity.

- **Second Circuit Upholds Dismissal in UBS Securities Case 7**

  In a case of first impression, the Second Circuit Court of Appeals recently revisited the standard set forth in *Morrison v. National Australia Bank Ltd.* regarding the bar on extraterritorial application of federal securities laws as it applies to claims stemming from foreign-issued securities purchased on foreign exchanges but cross-listed on domestic exchanges.

- **First Circuit Court of Appeals Bar of Expert Testimony Fatal to Class Plaintiffs' Claims 8**

  The lesson is clear—picking the right expert can make or break your case. In *Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse Securities (USA) LLC*, the U.S. First Circuit Court of Appeals held that the district court properly excluded the testimony of class plaintiffs' expert as unreliable. Since the expert's testimony was the sole basis on which the class relied to establish damages, the Court found that plaintiffs failed to establish loss causation, and summary judgment was thus properly granted in favor of defendants.

- **Delaware Supreme Court Finds Fee-Shifting Provisions in Bylaws to Be Facially Valid 9**

  In a unanimous *en banc* opinion and in response to certified questions of law from the U.S. District Court for the District of Delaware, the Delaware Supreme Court held that a fee-shifting provision contained in a non-stock corporation's bylaws requiring unsuccessful plaintiffs to bear the costs of intra-corporate litigation may be valid and enforceable under Delaware law.

- ***In re: BP p.l.c. Securities Litigation* 10**

  In this matter, the U.S. District Court for the Southern District of Texas returned to the issue of class certification. In its prior decision on December 6, 2013, the court denied class certification to investors suing BP for alleged misrepresentations the company made about the safety of its drilling operations and the massive Deepwater Horizon oil spill in 2010. Upon further review, the pre-explosion subclass was denied class certification due to the necessity of "individualized inquiry" and the post-explosion subclass was granted class certification.

Supreme Court Arms Securities Class Action Defendants with Powerful Ammunition to Defeat Class Certification

On June 23, 2014, the Supreme Court handed down its long-awaited decision in *Halliburton Co. v. Erica P. John Fund, Inc.* and issued a ruling that could dramatically alter the landscape of class action securities litigation. The question presented was whether or not to overrule *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), which held that investor plaintiffs could invoke a presumption at class certification that a stock's price reflects all public, material information including material misstatements in order to demonstrate the plaintiffs' reliance on these misrepresentations.[1] The Court also considered whether or not defendants should have the opportunity to rebut the presumption at class certification.[2] While the high court declined to overturn *Basic* altogether, it also ruled that defendants should be able to introduce evidence at class certification demonstrating that the misstatements alleged had no effect on the stock's price, one of the prerequisites necessary to invoke the *Basic* presumption.

Factual Background and Procedural History

The plaintiffs accused Halliburton and one of its executives of misrepresenting the company's potential liability in asbestos litigation, its expected revenue from construction contracts, and the anticipated benefits of a merger in an attempt to inflate the company's stock price in violation of, *inter alia*, Section 10(b) of the Securities Exchange Act.[3] Halliburton made a number of corrective disclosures that plaintiffs argued caused the company's stock to drop at the investors' expense.[4]

Lead plaintiff Erica P. John Fund, Inc. moved to certify a class comprising all investors who purchased stock between the alleged misstatements and the corrective disclosures.[5] After a lengthy legal battle, which included another appeal to the Supreme Court concerning a separate class certification issue, the district court certified the class, ignoring Halliburton's argument that the evidence it had submitted to disprove loss causation also showed "that none of its alleged misrepresentations had actually affected its stock price."[6] The Fifth Circuit affirmed, ruling that such evidence could not be considered at the class certification stage.[7]

The Supreme Court granted *certiorari* "to resolve a conflict among the Circuits over whether securities fraud defendants may attempt to rebut the *Basic* presumption at the class certification stage with evidence of a lack of price impact."[8] The Court also "accepted Halliburton's invitation to reconsider the presumption of reliance for securities fraud claims" adopted in *Basic*.[9]

The Court Declines to Overrule Basic, *Keeping the Presumption Intact*

The Court first considered whether or not to overrule the *Basic* presumption. Specifically, Halliburton argued "that securities fraud plaintiffs should *always* have to prove direct reliance and that the *Basic* Court erred in allowing them to invoke a presumption of reliance instead."[10] After noting the increased burden for overturning a "long-settled precedent," the Court ruled that Halliburton had failed to make the required showing for the following reasons:

- Halliburton's contention that reading a presumption into a Section 10b-5 right of action contravenes Congress's express intent was simply a resubmission of an argument rejected by the *Basic* court lacking any "new reason to endorse it now," and need not be considered.[11]
- In arguing that recent studies had debunked the "efficient capital markets hypothesis" underlying *Basic*'s holding, Halliburton failed "to take *Basic* on its own terms," noting that the modest premise adopted by the *Basic* court "that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices" was still valid.[12]
- Halliburton's argument that *Basic*'s second premise for the presumption was not true (specifically, the notion that investors invest in reliance on the integrity of market price) was also unavailing, as even "value investors" who attempt to beat the market by buying misvalued stocks rely on the fact that the market price "will incorporate public information within a reasonable period."[13]

[1] *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 1 (2014).
[2] *Id.* at 1–2.
[3] *Id.* at 2.
[4] *Id.*
[5] *Id.*
[6] *Id.* at 3.
[7] *Id.* at 4.
[8] *Id.*
[9] *Id.*
[10] *Id.* at 7.
[11] *Id.* at 8.
[12] *Id.* at 10 (internal citations and quotations omitted).
[13] *Id.* at 12.

- Halliburton's contention that *Basic* was inconsistent with more recent decisions in which the Court emphasized the need to limit the reach of Section 10b-5 was unpersuasive, as those cases involved the proposed extension of liability to "new categories of defendants who themselves had not made any material, public misrepresentation."[14]
- The *Basic* presumption did not relieve Section 10b-5 plaintiffs of the burden to prove, rather than simply plead, the predominance prerequisite to class certification under Federal Rule of Civil Procedure 23(b)(3); rather, the presumption "establishes that a plaintiff satisfies that burden by proving the prerequisites for invoking the presumption," and also affords defendants the opportunity to rebut the presumption.[15]

The Court also noted that Halliburton's complaint that the *Basic* presumption had facilitated meritless class actions that imposed "excessive costs on businesses" and consumed "a disproportionately large share of judicial resources" was better addressed to Congress, which had in fact passed legislation addressed to that very issue.[16]

The Court Also Declines to Require Plaintiffs to Prove Price Impact at Class Certification

The Court next considered Halliburton's two proposed alternatives to overruling *Basic*: (1) requiring plaintiffs to prove that a defendant's misrepresentation actually affected the stock price in order to invoke the *Basic* presumption, also called "price impact"; and (2) allowing defendants to rebut the *Basic* presumption with evidence of a lack of price impact to defeat class certification.

With respect to the argument that plaintiffs should have to prove "price impact," the Court noted that "Halliburton's argument for doing so is the same as its primary argument for overruling the *Basic* presumption altogether: Because market efficiency is not a yes-or-no proposition, a public material misrepresentation might not affect a stock's price even in a generally efficient market."[17] Noting that the *Basic* Court "never suggested otherwise," the Court declined to require plaintiffs to prove "price impact" for "the same reasons we declined to completely jettison the *Basic* presumption."[18]

[14] *Id.*
[15] *Id.* at 14–15.
[16] *Id.* at 15.
[17] *Id.* at 18.
[18] *Id.*

The Court Permits Defendants to Introduce Evidence Disproving Price Impact to Defeat Class Certification

The Court did, however, agree with Halliburton that Section 10b-5 defendants should be allowed to defeat the *Basic* presumption at the class certification stage through evidence that the misrepresentation did not, in fact, affect the stock price.[19] The Court was persuaded by the undisputed fact that defendants could already introduce evidence to rebut the presumption at the merit stages of litigation, and could introduce such evidence at class certification to counter a plaintiff's showing of market efficiency.[20]

The Court also found it significant that Section 10b-5 plaintiffs were already introducing evidence at class certification of price impact in connection with "event studies," which are "regression analyses that seek to show that the market price of the defendant's stock tends to respond to pertinent publicly reported events."[21] For example, the plaintiffs in *Halliburton* "submitted an event study of various episodes that might have been expected to affect the price of Halliburton's stock, in order to demonstrate that the market for that stock takes account of material, public information about the company," even examining one of the alleged misrepresentations forming the basis for the suit.[22] The Court reasoned that it made no sense to allow defendants to submit price impact evidence without allowing them to use it to rebut the presumption altogether.

The Court demonstrated the "bizarre" scenarios resulting from the Fifth Circuit's decision with a specific example:

> Suppose a defendant at the certification stage submits an event study looking at the impact on the price of its stock from six discrete events, in an effort to refute the plaintiffs' claim of general market efficiency. All agree the defendant may do this. Suppose one of the six events is the specific misrepresentation asserted by the plaintiffs. All agree that this too is perfectly acceptable. Now suppose the district court determines that, despite the defendant's study, the plaintiff has carried its burden to prove market efficiency, but that the evidence shows no price impact with respect to the specific misrepresentation challenged in the suit. The evidence at the certification stage thus shows an efficient market, on which the alleged misrepresentation had no price impact. And yet

[19] *Id.*
[20] *Id.* at 18–19.
[21] *Id.* at 19.
[22] *Id.*

> under [the lead plaintiff's] view, the plaintiffs' action should be certified and proceed as a class action (with all that entails), even though the fraud-on-the-market theory does not apply and common reliance thus cannot be presumed.[23]

The Court concluded that, while the *Basic* Court's reasoning for allowing plaintiffs an indirect proxy for price impact was sound, that should not preclude the introduction of direct evidence when such evidence is available.[24]

The Court also addressed the Fifth Circuit's reliance on *Amgen*, in which the Supreme Court held that plaintiffs need not prove materiality of the alleged misstatement as a prerequisite to class certification, noting that materiality and price impact differed in a crucial respect, namely, that materiality was an objective issue subject to classwide proof, which would not require examination of each individual defendant's actions, as reliance would.[25] The Court reasoned that "because materiality is a discrete issue that can be resolved in isolation from the other prerequisites, it can be wholly confined to the merits stage."[26]

Holding and Potential Impact of the Halliburton *Decision*

Ultimately, the Court decided to "adhere" to the *Basic* decision in declining "to modify the prerequisites for invoking the presumption of reliance."[27] Even so, the Court held that, in order to "maintain the consistency of the presumption with the class certification requirements of Federal Rule of Civil Procedure 23, defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock."[28] As such, the high court vacated the Fifth Circuit judgment and remanded the case to the district court.

The *Halliburton* decision will certainly have wide-ranging consequences for securities class actions. Section 10b-5 defendants are now armed with a new weapon to defeat class certification. While certification was already a hotly contested issue in Section 10b-5 cases, it is reasonable to expect even heavier litigation surrounding certification now. While eviscerating the *Basic* presumption altogether would have had more dramatic consequences for Section 10b-5 cases, there is no question that the Court's decision in *Halliburton* will benefit defendants in a meaningful way going forward. ■

Second Circuit Vacates Judge Rakoff's Order Refusing to Approve Consent Decree

In *S.E.C. v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011), Judge Rakoff declined to approve the consent decree entered into between Citigroup Global Markets, Inc. (Citigroup) and the United States Securities and Exchange Commission (the SEC). On June 4, 2014, the Second Circuit Court of Appeals vacated Judge Rakoff's order, finding that the district court applied the incorrect legal standard in its review.

In October 2011, the SEC filed a complaint against Citigroup alleging that Citigroup negligently misrepresented its role and economic benefit in structuring and marketing a billion-dollar fund known as the Class V Funding III (the Fund). The complaint alleged, among other things, that Citigroup "exercised significant influence" over the selection of over $500 million worth of the Fund's assets. According to the SEC, Citigroup told Fund investors that the Fund's investment portfolio was chosen by an independent investment advisor but, in fact, Citigroup itself selected a substantial amount of assets in which Citigroup had taken a short position. The SEC alleged that, by doing so, Citigroup realized a profit of approximately $160 million while Fund investors suffered millions in losses.

Shortly after the complaint was filed, the SEC proposed a consent judgment in which Citigroup agreed to: (i) a permanent injunction barring it from violating Sections 17(a)(2) and (3) of the Securities Exchange Act; (ii) disgorgement of $160 million; (iii) prejudgment interest of $30 million; and (iv) a civil penalty of $95 million. Pursuant to the consent judgment, Citigroup also agreed not to seek an offset of any compensatory damages awarded in any related investor action. The consent decree did not contain any admission of guilt or liability.

After hearing in the matter, the district court declined to approve the consent judgment. Specifically, the district court found that:

> Before a court may employ its injunctive and contempt powers in support of an administrative settlement, it is required, even after giving substantial deference to the views of the administrative agency, to be satisfied that it is not being used as a tool to enforce an agreement that

[23] *Id.* at 19–20.
[24] *Id.* at 20.
[25] *Id.* at 21.
[26] *Id.* at 22.
[27] *Id.* at 23.
[28] *Id.*

is unfair, unreasonable, inadequate, or in contravention of the public interest.[1]

The district court further found that the proposed consent decree was "neither fair, nor reasonable, nor adequate, nor in the public interest . . . because it [did] not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards."[2]

Both the SEC and Citigroup filed immediate notices of appeal and moved in the district court for an emergency stay pending the outcome of the appeal. In addition, the SEC sought an emergency stay in the Second Circuit. In the alternative, the SEC filed a petition for a writ of mandamus to set the district court's order aside. Prior to the Second Circuit's ruling on the motion to stay, the district court issued an order denying the SEC's motion to stay, reasoning that the Second Circuit lacked jurisdiction to hear an interlocutory appeal from the denial of approval of a consent judgment.[3]

The Second Circuit disagreed, concluding that the SEC demonstrated a strong likelihood of success on the merits because the district court did not accord the SEC's judgment adequate deference.[4] Because both Citigroup and the SEC sought approval of the consent order, the Second Circuit appointed counsel to advocate on behalf of the district court's order.[5]

As an initial matter, the Second Circuit determined that it had jurisdiction to hear the interlocutory appeal pursuant to 28 U.S.C. § 1292(a)(1).[6] The Court then turned to the "far thornier question of what deference the district court owes an agency seeking a consent decree."[7] The district court found that it was "required, even after giving substantial deference to the views of [the SEC], to be satisfied that it is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest."[8] Other district courts, however, "view the role of the Court in reviewing and approving proposed consent judgments in S.E.C. enforcement actions [as] restricted to assessing whether the settlement is fair, reasonable and adequate within the limitations Congress has imposed on the S.E.C. to recover investor losses."[9]

The Second Circuit noted that the "fair, reasonable, adequate and in the public interest" standard applied by the district court "finds its origins in a variety of cases."[10] The Second Circuit then clarified that the proper standard for reviewing a proposed consent decree "involving an enforcement agency requires that the district court determine whether the proposed consent decree is fair and reasonable, with the additional requirement that the public interest would not be disserved in the event that the consent decree includes injunctive relief."[11] Moreover, "[a]bsent a substantial basis in the record for concluding that the proposed consent decree does not meet these requirements, the district court is required to enter the order."[12]

The "adequacy" requirement is omitted from the standard because, although reviewing a proposed settlement for adequacy makes "perfect sense" in the class action context, in which the settlement typically contains a waiver of all future claims, a consent decree proposed by the SEC does not pose the same concerns since potential plaintiffs with a private right of action are free to sue on their own behalf.[13]

Thus, at a minimum, a court reviewing a proposed consent decree for fairness and reasonableness should assess "(1) the basic legality of the decree . . .; (2) whether the terms of the decree, including its enforcement mechanism, are clear. . .; (3) whether the consent decree reflects a resolution of the actual claims in the complaint; and; (4) whether the consent decree is tainted by improper collusion of some kind."[14] The "primary focus of the inquiry, however, should be on ensuring the consent decree is procedurally proper, using objective measures similar to the factors set out above, taking care not to infringe on the S.E.C.'s discretionary authority to settle on a particular set of terms."[15]

Against that framework, the Second Circuit held that it was an abuse of discretion for the district court to require that the SEC establish the "truth" of the allegations as a condition for approval of the decree.[16]

In addition, when a proposed consent decree contains injunctive relief, a district court must also consider the public interest.[17] Here, the district court "correctly recognized that it was required to consider the public interest in deciding whether to grant the injunctive relief in the proposed injunction. However, the district court made no findings that the injunctive relief proposed in

1 827 F. Supp. 2d at 332.
2 *Id.*
3 *S.E.C. v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 336, 338–39 (S.D.N.Y. 2011) ("*Citigroup I*").
4 *S.E.C. v. Citigroup Global Markets, Inc.*, 673 F.3d 158, 163–65 (2d Cir. 2012).
5 *Id.* at 169.
6 *S.E.C. v. Citigroup Global Markets, Inc.*, Nos. 11-5227-cv (L); 11-5375-cv(con); 11-5242-cv(xap) at 12–16 (2d Cir. June 4, 2014) ("*Citigroup IV*").
7 *Id.* at 17.
8 *Citigroup I*, 827 F. Supp. 2d at 332.
9 *Citigroup IV*, at 18 (internal citations omitted).
10 *Id.* (citing cases).
11 *Id.* at 19 (internal citations omitted).
12 *Id.*
13 *Id.* at 19–20.
14 *Id.* at 20.
15 *Id.* at 21.
16 *Id.*
17 *Id.* at 23.

the consent decree would disserve the public interest . . . . [and] the district court's failure to make the proper inquiry constitutes legal error."[18] On remand, the Second Circuit instructed the district court to consider whether the public interest would be disserved by the entry of the consent decree.[19]

Further, the Second Circuit found that, to the extent the district court failed to approve the consent decree because it believed the SEC failed to bring the proper charges against Citigroup (negligence as opposed to fraud), it further abused its discretion.[20]

Accordingly, the Second Circuit vacated the district court's order and remanded the case for further proceedings in accordance with its opinion.[21] ■

Update:

On Tuesday, August 5, 2014, Judge Rakoff filed an Opinion and Order approving the consent decree entered into between Citigroup and the SEC, following the mandate by the Second Circuit Court of Appeals, leaving him with "nothing but sour grapes."[22] Judge Rakoff began by acknowledging that "[t]hey who must be obeyed have spoken" and that it was the District Court's duty to "faithfully fulfill their mandate."[23] Judge Rakoff then indicated that he "cannot say that the proposed Consent Judgment is procedurally improper or in any material respect fails to comport with the very modest standard imposed by the Court of Appeals."[24] Nonetheless, Judge Rakoff expressed his fear that, "as a result of the Court of Appeal's decision, the settlements reached by governmental regulatory bodies and enforced by the judiciary's contempt powers will in practice be subject to no meaningful oversight whatsoever."[25]

18 *Id.* at 25.
19 *Id.* at 25–26.
20 *Id.* at 26.
21 *Id.* at 28.
22 *See* Document No. 59, *SEC v. Citigroup Global Markets, Inc.*, No. 11-cv-7387, (Aug. 5, 2014), at 3.
23 *Id.* at 1.
24 *Id.* at 2.
25 *Id.* at 3.

SEC Brings New Kind of Enforcement Action Aimed at Preventing Retaliation Against Whistleblowers

On June 16, 2014, the U.S. Securities and Exchange Commission (SEC) instituted an administrative proceeding against Paradigm Capital Management, Inc. (Paradigm) and its majority owner, Candace King Weir (Weir), in part for retaliation against a whistleblower for informing the agency about alleged improper principal transactions between the firm and an affiliated broker-dealer.[1] The SEC alleged that Paradigm and Weir punished the whistleblower, who was formerly the head trader at the firm, for tipping the SEC about the allegedly improper trades by stripping him of his title and authority until he eventually resigned. Paradigm agreed to settle the charges related to the alleged retaliation and trading violations for $2.2 million in sanctions.

The SEC alleged that Weir caused dozens of improper principal transactions to occur between Paradigm and Weir's affiliated broker-dealer, C.L. King & Associates, Inc. The affiliated nature of the transactions was not disclosed to the hedge fund client on whose behalf the trades were entered. The SEC alleged that such transactions constitute a conflict of interest and should have been executed only with the client's informed consent. Although Paradigm established a review committee to approve the pricing of the trades at issue, the SEC alleged the committee was conflicted based on Weir's supervisory authority over its members. After learning that the whistleblower had contacted the SEC regarding the transactions, the SEC alleged that Paradigm immediately retaliated by removing the whistleblower from his position, stripping him of his supervisory responsibilities and otherwise marginalizing his role at the firm.

The SEC indicated this first-of-its-kind action should serve as a warning to firms not to retaliate against whistleblowers who tip the SEC about possible illegal activity. Andrew Ceresney, director of the SEC's Enforcement Division, emphasized that "those who might consider punishing whistleblowers should realize that such retaliation, in any form, is unacceptable." Sean McKessy, chief of the SEC's Office of the Whistleblower, echoed this sentiment, noting that the SEC "will continue to exercise [its] anti-retaliation authority in these and other types of situations where a whistleblower is wrongfully targeted for doing the right thing and reporting a possible securities law violation." The Paradigm whistleblower may be eligible for a whistleblower award under the Dodd-Frank anti-retaliation provisions, which can range between 10 percent and 30 percent of the SEC's recovery when the tip leads to sanctions of $1 million or more. ■

1 *In the Matter of Paradigm Capital Management, Inc. and Candace King Weir,* Adm. Proc. No. 3-15930.

Second Circuit Upholds Dismissal in UBS Securities Case

City of Pontiac Policemen's & Firemen's Retirement System v. UBS AG

In a case of first impression, the Second Circuit Court of Appeals recently revisited the standard set forth in *Morrison v. National Australia Bank Ltd*.[1] regarding the bar on extraterritorial application of United States securities laws as it applies to claims stemming from foreign-issued securities purchased on foreign exchanges but cross-listed on domestic exchanges. In *City of Pontiac Policemen's & Firemen's Retirement System v. UBS AG*,[2] a putative class action, plaintiffs, domestic and foreign institutional investors, brought claims under Sections 10(b) and 20(a) of the Securities Exchange Act against defendants, UBS AG and several UBS directors and officers.[3] Between 2003 and 2009, plaintiffs had purchased "ordinary shares" of UBS listed on the New York Stock Exchange as well as several foreign exchanges.[4] In addition, plaintiff Alaska Laborers-Employers Retirement Fund (Alaska Laborers) brought claims under Sections 11, 12(a)(2), and 15 of the Securities Act.[5]

Plaintiffs' contentions involved allegedly fraudulent statements made by UBS regarding (1) its mortgage-related assets portfolio and (2) its compliance with U.S. tax and securities law.[6] Regarding the former, plaintiffs alleged that UBS accumulated $100 million in residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDO), overvalued them, and failed to disclose this accumulation to shareholders.[7] Additionally, UBS concealed the scope of the investment bank portfolio that these assets were a part of and, as the subprime market collapsed in 2007, UBS failed to revalue the mortgage-related assets, effectively concealing the portfolio losses.[8] Regarding the latter, plaintiffs alleged that UBS had made materially misleading statements in connection with a scheme where UBS Swiss bankers traveled in and out of the United States and illegally advised Americans on investment purchasing.[9]

The district court had granted the UBS defendants' 12(b)(6) motion to dismiss all claims; after a *de novo* review, the appellate court affirmed the district court's decision.[10] Perhaps most importantly, upon application of the extraterritorial bar in *Morrison*, the court found that the purchases at issue in this case were not within the purview of U.S. securities laws.

In reaching this conclusion, the court dissected the rule proclaimed in *Morrison* that "10(b) only provide[s] a private cause of action arising out of '[1] transactions in securities listed on domestic exchanges, and [2] domestic transactions in other securities.'"[11] The court ultimately determined that *Morrison*'s focus on domestic *purchases and sales* meant that the key to proper 10(b) application was location of *transaction*—not location of *exchange*.[12] Thus, the court determined that a transaction involving a foreign purchaser of foreign-issued shares on a foreign exchange does not come within the purview of 10(b) and *Morrison* regardless of its additional presence on a domestic exchange.[13]

In addition, the court was called to decide whether or not a purchase of foreign-issued shares made on a foreign exchange is considered "domestic" within the meaning of *Morrison* simply because the buy order was initiated in the United States by a domestic entity (here, plaintiff Oregon Public Employees Board).[14] In determining that such a transaction was not "domestic," the court utilized the principle that "[a] securities transaction is domestic [for purposes of *Morrison*'s second prong] when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States" to conclude that neither the fact that the buy order was executed domestically, nor the fact that the purchaser is a U.S. entity, are enough to classify the transaction as "domestic."[15]

After deciding the novel issues above, the court affirmed the district court's dismissal of Alaska Laborers' claims under Sections 11 and 12(a)(2) of the Securities Act for failure to plead any misstatements by UBS that gave rise to a cause of action.[16] In addition, the court dismissed all remaining claims under Section 10(b) of the Securities Exchange Act.[17] In doing so, the court determined that plaintiffs had not properly alleged (1) that UBS was consciously reckless or materially misleading regarding its asset concentration and corresponding risk diversification representations; (2) that UBS' valuation and disclosures of the mortgage-

[1] 561 U.S. 247 (2010).
[2] 752 F.3d 173 (2d Cir. 2014).
[3] *Id.* at 176–77.
[4] *Id.* at 177.
[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id.* at 178.
[9] *Id.*
[10] *Id.* at 178–79.
[11] *Id.* at 179 (quoting *Morrison*, 561 U.S. at 267).
[12] *Id.* at 180.
[13] *Id.* at 181.
[14] *Id.*
[15] *Id.* at 181–82 (quoting *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 68 (2d Cir. 2012)).
[16] *Id.* at 184.
[17] *Id.* at 186–88.

related assets were reckless; and (3) that UBS offered material misstatements related to tax fraud.[18] ■

[18] *Id.*

First Circuit Court of Appeals Bar of Expert Testimony Fatal to Class Plaintiffs' Claims

In *Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse Securities (USA) LLC (Bricklayers)*, the United States Circuit Court of Appeals for the First Circuit held that the district court properly excluded the testimony of class plaintiffs' expert as unreliable. Since the expert's testimony was the sole basis on which the class relied to establish damages, the court found that they failed to establish loss causation, and summary judgment was thus properly granted in favor of defendants.

The *Credit Suisse* case arose out of the January 2001 merger between Time Warner Inc. and AOL. A pension fund and other AOL shareholders brought a class action against Credit Suisse First Boston (Credit Suisse) and several of its former analysts, alleging violation of Sections 10(b) and 20(a) of the Securities Exchange Act as well as violations of Rule 10b-5. Specifically, the class plaintiffs alleged that Credit Suisse fraudulently withheld material information in its reporting on the merger and that, as a result of Credit Suisse's intentional omissions and misrepresentations, the class plaintiffs purchased stock in the new company at artificially inflated prices.

Credit Suisse was one of many financial firms reporting on AOL's business at the time of the merger and providing outlook forecasts. The two former analysts named as defendants were in charge of Credit Suisse's coverage of the merger, beginning the day after the merger and continuing through approximately January 2002 (the Coverage Period). During the Coverage Period, Credit Suisse issued 35 reports containing observations about AOL, buy/sell recommendations and price targets. In all 35 reports, Credit Suisse recommended purchasing AOL stock. Credit Suisse initially projected AOL's future stock price at $80, but by September 2001 Credit Suisse revised its projection downward to $45. Nine months later, AOL's stock price was $11 per share. The class plaintiffs alleged that the analysts misrepresented their true opinions about the company in order to maintain a good relationship with AOL and with the hope of winning future business from AOL.

Both the class plaintiffs and the defendants retained experts to show the effect, or lack thereof, of Credit Suisse's omissions on AOL stock prices. The class plaintiffs retained Dr. Scott D. Hakala. Each side subsequently moved to bar the other's expert under *Daubert*, and the trial court held a *Daubert* hearing to determine the admissibility of the proffered expert testimony on loss causation. Ultimately, the trial court found Dr. Hakala's testimony unreliable and therefore inadmissible.

In reviewing the district court's decision, the First Circuit discussed event studies and expert testimony, generally noting that, in cases such as this, a plaintiff must show that the stock market reacted to the specific misrepresentation or omission at issue and not to a "tangle of [other] factors."[1] In addition, the court noted that the "preferred" method of proving loss causation in securities fraud cases is through an event study. An event study is where an expert determines the extent to which the changes in stock price result from events such as disclosure of negative information about the particular company, and the extent to which those changes result from other factors. In conducting an event study, the expert first "selects the period in which the event could have affected the market price. The expert then attempts to determine the effect on the share price of general market conditions, as opposed to company-specific events, using a multiple regression analysis, a statistical means for explaining the relationship between two or more variables."[2] The defendants in *Credit Suisse* challenged four elements of Dr. Hakala's event study: (i) the selection of event dates; (ii) overuse of dummy variables; (iii) previously disclosed information; and (iv) failure to control for confounding factors.

The district court, in analyzing the four elements set out by the defendants, ultimately concluded that Dr. Hakala's testimony lacked sufficient reliability to be presented to a jury. Specifically, the district court noted that "[h]ad Dr. Hakala's event study suffered from only one of the four methodological defects identified by this Court, or suffered from those flaws jointly but to a lesser degree, today's ruling might have been different."[3] Given the extent of Dr. Hakala's errors, however, the district court found that preclusion was necessary.[4]

The First Circuit engaged in an in-depth analysis of each element of Dr. Hakala's event study and ultimately held that the district court did not abuse its discretion in excluding Dr. Hakala's testimony. In particular, the First Circuit was critical of Dr. Hakala's selection of event dates, many of which bore no relationship to the allegations in the complaint and, in some instances, the

[1] *Bricklayers,* No. 12-1750 at 7 (1st Cir. May 14, 2014).
[2] *Id.* at 8.
[3] *Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse First Boston,* 853 F. Supp. 2d 181, 191 (D. Mass. 2012).
[4] *Id.*

court noted that Dr. Hakala "turned the complaint on its head, treating certain events as corrective when the complaint labeled them inflationary."[1] The court found that "this complete disconnect between the event study and the complaint nullified the usefulness of Dr. Hakala's work."[2]

Further, the court affirmed summary judgment in favor of the defendants because, without Dr. Hakala's testimony, the class plaintiffs could not show a genuine dispute as to loss causation. ■

Delaware Supreme Court Finds Fee-Shifting Provisions in Bylaws to Be Facially Valid

In a unanimous *en banc* opinion and in response to certified questions of law from the U.S. District Court for the District of Delaware, the Delaware Supreme Court held that a fee-shifting provision contained in a non-stock corporation's bylaws requiring unsuccessful plaintiffs to bear the costs of intra-corporate litigation may be valid and enforceable under Delaware law. Furthermore, the Delaware Supreme Court in *ATP Tour, Inc. v. Deutscher Tennis Bund* determined that such a bylaw will "normally apply to all members of a non-stock corporation regardless of whether the bylaw was adopted before or after the member in question became a member."[3]

ATP Tour, Inc. (ATP) is a non-stock Delaware membership corporation that operates a professional men's tennis tour. In the early 1990s, Deutscher Tennis Bund (DTB) and Qatar Tennis Federation (QTF), two entities that own and operate professional men's tennis tournaments, joined ATP. In joining ATP, DTB and QTF agreed to be bound by ATP's bylaws, as amended from time to time. In 2006, ATP's seven-member board of directors amended ATP's bylaws and adopted a fee-shifting provision that required plaintiffs to bear all fees, costs and expenses incurred in intra-corporate litigation if said plaintiffs do "not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought."[4]

When ATP's board voted to change the tennis tour schedule and format in 2007, DTB and QTF subsequently filed suit against ATP and six of ATP's board members in the U.S. District Court for the District of Delaware, alleging federal antitrust claims and fiduciary duty claims under Delaware law. After DTB and QTF failed to prevail on any of their claims, ATP moved to recover its fees, costs and expenses, pursuant to the fee-shifting provision in its bylaws and Rule 54 of the Federal Rules of Civil Procedure. At first, the District Court of Delaware denied ATP's Rule 54 motion, finding that ATP's fee-shifting bylaw was contrary to the policy underlying the federal antitrust laws. However, after ATP appealed, the U.S. Court of Appeals for the Third Circuit vacated the district court's order, holding that the district court should have first decided whether ATP's fee-shifting bylaw was enforceable as a matter of Delaware law. As a result, on remand, the District of Delaware found that the enforceability of ATP's fee-shifting provision presented a novel question of Delaware law that warranted the submission of certified questions of law to the Delaware Supreme Court.

In holding that directors of a Delaware non-stock corporation can lawfully adopt a bylaw provision that shifts all litigation fees, costs and expenses to a plaintiff in intra-corporate litigation, the Delaware Supreme Court noted that a corporation's bylaws are presumed to be valid under Delaware law. The Delaware Supreme Court further noted that, in order to be facially valid, a bylaw "must be authorized by the Delaware General Corporation Law (DGCL), consistent with the corporation's certificate of incorporation, and its enactment must not be otherwise prohibited."[5] As the Delaware Supreme Court went on to explain, a fee-shifting bylaw is facially valid and is not prohibited under the DGCL, any other Delaware statute, or Delaware common law.

Although the Delaware Supreme Court concluded that a fee-shifting bylaw is facially valid, it likewise emphasized that even a facially valid bylaw will not be enforced "if adopted or used for an inequitable purpose."[6] However, because the certified questions before the court addressed only questions of law, the Delaware Supreme Court's decision did not address the enforceability of the bylaw at issue, which turned on the application of specific factual circumstances not before the court. While the Delaware Supreme Court did not examine whether the bylaw at issue was adopted or used for an improper purpose, it did note that the "intent to deter litigation, however, is not invariably an improper purpose."[7]

Notably, in answering the certified questions before it, the Delaware Supreme Court also concluded that a fee-shifting provision can be enforceable against members who joined the non-stock corporation before the provision's enactment, assuming that the provision is otherwise valid and enforceable.

1 *Bricklayers*, No. 12-1750, at 20.
2 *Id.*
3 91 A.3d 554, 2014 WL 1847446, at *1 (Del. May 8, 2014).
4 *Id.*
5 *Id.* at *3.
6 *Id.*
7 *Id.* at *4.

While the *ATP Tour* decision addressed a fee-shifting provision in the context of a non-stock corporation's bylaws, the decision's potential application to stock corporations prompted the Delaware legislature to consider potential amendments to the DGCL that would prohibit the adoption of fee-shifting provisions in Delaware stock corporations' charters or bylaws. A recent vote before the Delaware State Senate on a bill that would amend the DGCL to prohibit fee-shifting provisions in stock corporations' bylaws was recently delayed until early 2015 in order to allow for further consideration of the bill. ■

In re: BP p.l.c. Securities Litigation

In this matter, the U.S. District Court for the Southern District of Texas returned to the issue of class certification. In its prior decision on December 6, 2013, the court denied class certification to investors suing BP for alleged misrepresentations the company made about the safety of its drilling operations and the massive Deepwater Horizon oil spill in 2010. The court agreed that most prerequisites for class certification under Federal Rule of Civil Procedure 23, including numerosity, commonality, typicality and adequate representation, were met, with the exception of the predominance of classwide damages. The court allowed plaintiffs to supplement their motion and address the deficiencies noted in its prior order.

As a result, the plaintiffs renewed their motion for class certification. Plaintiffs modified their proposed subclasses and articulated differing damages methodologies for each. The subclasses were defined as: (1) the pre-explosion subclass consisting of persons or entities who purchased or otherwise acquired BP American Depositary Shares (BP AD shares) between November 8, 2007 and April 20, 2010, and were injured thereby; and (2) the post-explosion subclass consisting of persons or entities who purchased or otherwise acquired BP AD shares between either April 26 or April 29, 2010 and May 28, 2010 and were injured thereby.

The court presented a two-pronged issue to determine whether the plaintiffs' proposed damages methodologies (1) quantify the injury caused by defendants' alleged wrongful conduct and (2) can be deployed on a classwide basis such that common issues will predominate over those that are individualized. Defendants set forth a number of arguments against class certification, addressing various deficiencies in plaintiffs' proposed damages methodologies, most of which accused plaintiffs of continuing to seek recovery for theories of liability no longer part of the case, or proposing damages methodologies inconsistent with their liabilities.

After reviewing the briefs and supporting experts presented by the parties, the court denied class certification as to the pre-explosion subclass and granted class certification to the post-explosion subclass. For the pre-explosion subclass, the plaintiffs alleged that the defendants "repeatedly and falsely assured the market that process safety improvements . . . were being rolled out throughout the organization, across the globe." The plaintiffs' contention was that these misrepresentations lured the market into believing that BP was safer than it really was. The loss methodology calculation involved computing total investment losses caused by fraudulent statements by measuring the decline in stock price on days when "corrective events" entered the marketplace. The plaintiffs set forth eight different "corrective events" in their analysis, and defined these events as stock price declines associated with the market realization that BP could not contain the oil spill. These mistakes were proximate causes of the post-explosion investment losses because plaintiffs were deprived of the opportunity to divest prior to the explosion.

The court stated that this proposed measurement of damages could not be deployed without an "individualized inquiry" into each investor's subject motivations, into what is supposed to be a classwide model of recovery. Plaintiffs' theory suggests that investors determine their own risk thresholds specific to the company at issue. These types of individualized questions would be patently inappropriate for classwide treatment. The court relied on *Comcast Corp. v. Behrend*, which noted that "a methodology that identifies damages that are not the result of the wrong can provide no assurance that damages resulting from the wrong are capable of measurement and will not require labyrinthine individual calculations."[1] As such, the plaintiffs were unable to show that the damages of pre-explosion purchasers could be calculated on a classwide basis consistent with their theory of liability; thus, the predominance requirement of Rule 23 was not met as to the pre-explosion subclass.

The court did find that the damages methodology for calculating the "post-explosion" subclass met the requirements for Rule 23. The court found that none of the defendants' criticisms of the proposed damages methodology were sufficient to deny class certification for the post-explosion subclass. The defendants' first criticism concerned the calculation method and addressed the court's prior rejection of the "constant dollar" approach to damages. Here, the court noted that

[1] *Comcast Corp. v. Behrend,* 133 S. Ct. 1246 (2013).

its concern over using the "constant dollar" approach to calculating damages was relevant to the pre-explosion time frame only and that, having reviewed that methodology in the isolated context of the spill severity misstatements, "the Court perceives no legal or logical impediment to its use."

Despite the other criticisms, the court acknowledged that the damages methodology proposed for the "post-explosion" subclass met the requirements for Rule 23(b)(3) because it attempted to quantify the injury caused by the defendants' alleged wrongful acts and it can be deployed on a classwide basis. Thus, the court certified the post-explosion subclass for class action treatment.

Lastly, the court granted leave to amend pursuant to Rule 15(a)(2), finding that the proposed amendment by plaintiffs to add a fourth spill severity misstatement on April 24, 2010, was clearly not futile. The importance of the amendment could not be overstated, as without it, investors who purchased on three days in the post-explosion time frame would be excluded from the class action. Additionally, $5.26 of the stock price decline that plaintiffs allege was related to the spill severity fraud would be unrecoverable. The court found that neither plaintiffs' delay in asking for the amendment nor the prejudice that would be visited upon defendants was substantial enough to refuse leave to amend. ■

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