

## LITIGATION

Web address: <http://www.nylj.com>

MONDAY, AUGUST 25, 2008

### PERSPECTIVE

# Liable Until Proven Innocent

*The illogic of the current pleading standard for Securities Act §§11 and 12 claims.*

BY JOSHUA S. SOHN

FOR MORE THAN 10 years, both the legislative and judicial branches of the federal government have been trying various measures to control securities litigation. In the past year, the Supreme Court recognized that securities class actions extract a significant toll on defendants, in terms of both time and money, regardless of the outcome. As it noted in *Bell Atlantic v. Twombly*, that cost “will push cost-conscious defendants to settle even anemic cases before reaching those proceedings.”<sup>1</sup>

In a previous round of attempting to limit frivolous securities litigation, Congress passed the Private Securities Litigation Reform Act (PSLRA) in 1995,<sup>2</sup> which was intended to raise pleading standards to assist courts in sorting meritorious claims from bad ones. Consistent with this legislative goal, the Supreme Court’s decisions last year in both *Twombly* and *Tellabs Inc. v. Makor Issues &*

**Joshua S. Sohn** is a litigation partner in the New York office of DLA Piper. **Michael McMahan**, a summer associate with the firm, assisted in the preparation of this article.

*Rights, Ltd.*, have continued making it harder for complaints to survive motions to dismiss.<sup>3</sup> This combination of legislation and case law, however, has not addressed the “strict liability” provisions of §§11 and 12(a)(2) of the Securities Act of 1933, which may still be

non-issuer defendants need to affirmatively prove an absence of scienter to have a complaint dismissed.

As a practical matter, this means that a plaintiff who alleges the existence of a material false statement in a registration statement is almost assured of surviving a motion to dismiss and conducting discovery. The non-issuer defendants in that case cannot reasonably expect to exonerate themselves, even if they can meet their burden and prove the elements of the statutory affirmative defenses, unless and until

---

As a practical matter, a plaintiff who alleges the existence of a material false statement in a registration statement is almost assured of surviving a motion to dismiss and conducting discovery. This result is counter to the intention of Congress when it passed the PSLRA and the reasoning of the Supreme Court in ‘*Twombly*.’

---

exploited by enterprising attorneys.

Under current pleading standards, complaints alleging securities fraud must allege plausible theories through particularized allegations. By contrast, complaints alleging violations of §§11 and 12(a)(2) need not allege any particularized wrongful conduct, unless the claims also sound in fraud. Moreover, the PSLRA’s heightened scienter pleading requirements do not apply to §§11 and 12(a)(2) claims because scienter is not an affirmative element of either cause of action. Therefore, in the absence of fraud allegations, which plaintiffs’ lawyers deliberately now omit,

they complete discovery.

This result is counter to the intention of Congress when it passed the PSLRA and the reasoning of the Supreme Court in *Twombly*. In both instances, the goal was to empower district court judges to protect defendants from frivolous, implausible litigation; litigation, which the prevailing application of §§11 and 12(a)(2) typically allows to proceed past motions to dismiss and into discovery. District courts, however, can demand more from plaintiffs in §§11 and 12(a)(2) cases; they can insist that their complaints set forth a plausible theory, one that makes sense

and alleges that the non-issuer defendants acted wrongfully.

## Background

In the wake of the stock market crash of October 1929 and the onset of the Great Depression, Congress, intending to deter fraud and misrepresentations in connection with the securities markets,<sup>4</sup> enacted §§11<sup>5</sup> and 12(a)(2)<sup>6</sup> of the Securities Act of 1933 and §10(b) of the Securities Exchange Act of 1934.<sup>7</sup> Section 10(b) of the Exchange Act and Rule 10b-5, promulgated thereunder,<sup>8</sup> make securities fraud actionable, and require scienter, a wrongful state of mind.<sup>9</sup> By contrast, §§11 and 12(a)(2) of the Securities Act focus on whether registration statements, prospectuses or other statements made are false.<sup>10</sup>

Under §11, if “any part of the registration statement...contained an untrue statement of a material fact or omitted to state a material fact..., any person acquiring such security” may sue five classes of people:

- 1) every signatory of the registration statement,
- 2) every director or partner of the security issuer,
- 3) every person about to become a director or partner after the issuance,
- 4) every accountant, engineer or appraiser who certified a part of the registration statement, and
- 5) every underwriter of the security.<sup>11</sup>

Section 12(a)(2) makes any security offeror or seller who made material misrepresentations in a “prospectus or oral communication” liable for that misstatement.<sup>12</sup>

Significantly, both §§11 and 12(a)(2) provide statutory affirmative defenses for non-issuer defendants if they can prove they did not act wrongfully.<sup>13</sup> Essentially, instead of plaintiffs having to allege that defendants recklessly or knowingly acted wrongfully, defendants in these cases bear an affirmative burden of establishing they did not.

## Evolution of Pleading Standards

### A. Congress Imposes a Heightened Pleading Standard in Securities Fraud Cases.

Before the passing of the Private Securities

Litigation Reform Act (PSLRA)<sup>14</sup> in 1995, securities litigation, much of it frivolous, was rampant.<sup>15</sup> According to one widely read study from that time, “suits alleging securities violations were filed whenever the stock price declined sufficiently following the IPO to support [a worthwhile] award of attorneys’ fees....”<sup>16</sup>

That study, which included §11 cases,<sup>17</sup> found that these cases typically settled for approximately one-quarter of pleaded, potential damages, regardless of merit, concluding that “a strong case in this group appears to have been worth no more than a weak one.”<sup>18</sup> The study’s author, Jane Alexander, testified before Congress that securities class action litigation “is not doing a good job of telling good suits from bad ones, of resolving suits based on the strength of the evidence that a violation was committed, of eliminating weak and nonmeritorious suits at an early stage....”<sup>19</sup>

Based on the state of securities litigation and this study and testimony, Congress passed the PSLRA.<sup>20</sup> Among other things, the Act raised securities fraud pleading standards (but not in §§11 or 12 cases) by requiring plaintiffs to allege with particularity, not only the factual parameters of the alleged fraud, but also facts “giving rise to a strong inference that the defendant acted with the requisite state of mind.”<sup>21</sup>

### B. Particularized Pleading in Certain §§11 and 12(a)(2) Cases.

In *Rombach v. Chang*,<sup>22</sup> the Second Circuit held that §§11 and 12(a)(2) claims must meet Rule 9(b)’s particularity standard when “the claim sounds in fraud.”<sup>23</sup> In so doing, the Second Circuit explained:

By its terms, Rule 9(b) applies to “all averments of fraud.” This wording is cast in terms of the conduct alleged, and is not limited to allegations...(of fraud) or...fraud cause(s) of action.<sup>24</sup>

Thus, the court decided that, “while a plaintiff need allege no more than negligence to proceed under §§11 and 12(a)(2), claims that do rely upon averments of fraud are subject to the test of Rule 9(b).”<sup>25</sup>

Under this requirement, plaintiffs must allege the specifics surrounding the misstatement. As

a result, plaintiffs now typically include specific disclaimers in §§11 and 12(a)(2) complaints that they are not alleging or averring fraud in relation to those claims.<sup>26</sup> They expressly disavow fraud in the context of their §§11 or 12(a)(2) claims, even though they are often alleging §10(b) fraud claims on the next page against the same defendants arising out of the same conduct.<sup>27</sup>

### C. The Supreme Court Raises the Bar.

**1. *Tellabs Inc. v. Makor Issues & Rights, Ltd.***<sup>28</sup> Since the passage of the PSLRA,<sup>29</sup> academics<sup>30</sup> and courts<sup>31</sup> had debated what Congress meant when it included the requirement that plaintiffs “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”<sup>32</sup> The Supreme Court in *Tellabs Inc. v. Makor Issues & Rights, Ltd.* answered this question, holding that the scienter inference “need not be irrefutable...or even the ‘most plausible of competing inferences.’”<sup>33</sup> Instead, it need only be at least as reasonable as other competing inferences.

**2. *Bell Atlantic v. Twombly.*** In *Twombly*, the Supreme Court recognized that civil litigation has reached the point that cases settle independent of their merit because of the cost of discovery.<sup>34</sup> As a result, a complaint’s ability to withstand a motion to dismiss may determine in large part whether, and for how much, that case will settle.

In an attempt to reclaim some of the advantage previously enjoyed by plaintiffs whose speculative claims were making it to discovery (and to settlement) in large numbers, the Court strengthened the previously anemic threshold for motions to dismiss, holding that: “Factual allegations must be enough to raise a right to relief above the speculative level on the assumption that all the allegations in the complaint are true (even if doubtful in fact).”<sup>35</sup>

Before *Twombly*, the oft-repeated *Conley v. Gibson* motion-to-dismiss standard was used by virtually every federal court around the country; that “a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove *no set of facts* in support of his claim which would entitle him to relief.”<sup>36</sup> The

*Twombly* Court, however, was quick to dismiss Conley's "no set of facts" standard, declaring Conley "questioned, criticized, and explained away long enough," and ultimately having "earned its retirement."<sup>37</sup>

With that said, the Court did not "require heightened fact pleading of specifics, but only enough facts to state a claim to relief that is plausible on its face."<sup>38</sup> Though the Court disclaimed that it created any "heightened" pleading standard,<sup>39</sup> given its use of the new plausibility standard and its colorful language concerning Conley's retirement, *Twombly* has been interpreted to have done precisely this. For example, the Second Circuit has explained: "We have declined to read *Twombly*'s flexible 'plausibility standard' as relating only to antitrust cases."<sup>40</sup>

## The Pleading Gap

Since the Supreme Court decided *Twombly* and *Tellabs* last term, the Northern District of California has decided two cases that illustrate the existence of a pleading gap between §10(b) claims and §§11 or 12 claims.

In both *In re Levi Strauss & Co. Securities Litigation*<sup>41</sup> and *In re Juniper Networks Inc. Securities Litigation*,<sup>42</sup> §10(b) claims were evaluated under *Twombly* and *Tellabs* and, against at least one defendant in each case, dismissed, while the §11 claims were allowed to proceed against those same defendants.

In *Levi Strauss*, investors brought a class action alleging claims under §10(b), §11, and §12 arising out of a single scheme: that a registration statement and prospectus filed in connection with a bond offering contained false financial statements. The court dismissed the §10(b) claim, finding that "plaintiffs have failed to plead facts suggesting improper accounting," and that "the complaint fails to raise a plausible inference that the financial statements were misstated in the manner alleged by plaintiffs."<sup>43</sup>

Despite its fundamental finding that plaintiffs' theory of the case—that the defendants deliberately caused the misstating of the company's financial information—was without merit, the court denied the motion to dismiss the §11 claim because "plaintiffs

have alleged sufficient facts of misstatements in the financial information contained in [the] registration statements in violation of §11."<sup>44</sup> Similarly in *In re Juniper Networks*, the court dismissed the §10(b) claim, but not the §11 claim against one of three defendants.<sup>45</sup>

Although it is possible to imagine a scenario in which a non-issuer defendant may have violated §11 or §12(a)(2), but not §10(b), in most cases, that scenario is unlikely to be particularly plausible. Instead, a significantly more plausible reading of a complaint under those circumstances contemplates not only that the plaintiff failed to allege that the non-issuer defendants acted with scienter, but also that this same failure to act with scienter entitles those defendants to the statutory defenses to liability contained in the 1933 Act.

The current pleading framework, however, rewards plaintiffs, and correspondingly penalizes non-issuer defendants, by allowing them to contort their pleadings to fit in illogical silos.

Certainly, this is an issue that could be addressed by amendment of the relevant statutes or enactment of legislation. But, that is not the only way to address this pleading gap.

Consistent with the letter and spirit of Rule 9(b), the PSLRA and *Twombly*, district courts can, and should, require that plaintiffs plead facts amounting to a plausible theory of how the fraud was perpetrated and correspondingly, how any non-issuer defendant would not be able to satisfy the statutory bases for exoneration. By allowing plaintiffs, despite the singularity of underlying facts, to simply assert that their §11 claim does not sound in fraud, but the §10(b) claim does, will, as recognized by the Supreme Court, continue to "push cost-conscious defendants to settle even anemic cases before reaching those proceedings."<sup>46</sup>



1. *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955, 1967 (2007).

2. 15 U.S.C. §78u-4 (1998).

3. See *Twombly*, 127 S. Ct. 1955; *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

4. See Kevin S. Shmelzer, "The Door Slammed Shut Needs to Be Reopened: Examining the Pleading Requirements Under the Private Securities Litigation Reform Act," 78 TEMP. L. REV. 405, 408 (2005) (citing S. REP. NO. 73-792, at 3 (1934)).

5. 15 U.S.C. §77k (1998).

6. 15 U.S.C. §77l (2000).

7. 15 U.S.C. §78j (2000).

8. 17 C.F.R. § 40.10b-5 (2008).

9. See Shmelzer, *supra* note 4, at 408-09.

10. See 15 U.S.C. §§77k, 77l.

11. 15 U.S.C. §77k.

12. 15 U.S.C. §77l.

13. See *id.*; 15 U.S.C. §77k.

14. 15 U.S.C. §78u-4.

15. See Janet Cooper Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions," 43 STAN. L. REV. 497 (1991).

16. *Id.* at 513.

17. See Adam F. Ingber, "10b-5 or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?," 61 FORDHAM L. REV. S351, S361-62 (1993) (criticizing Alexander for including §11 cases as part of her study).

18. *Id.* at 500.

19. Testimony of Janet Cooper Alexander, Professor of Law, Stanford Law School, on the Subject of Sec. Fraud Litig., Before the H. Subcomm. on Telecomms. & Fin. of the H. Comm. on Energy & Commerce, United States House of Representatives (Aug. 10, 1994).

20. See, e.g., Shmelzer, *supra* note 4, at 405-06.

21. See, e.g., Joseph A. Grundfest, "Statutes With Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation," 54 STAN. L. REV. 627, 633 (2002); Bradley R. Aronstam, "The Private Securities Litigation Reform Act of 1995's Paradigm of Ambiguity: A Circuit Split Ripe for Certiorari," 28 HOFSTRA L. REV. 1061, 1070-80 (2000).

22. See *Rombach v. Chang*, 355 F.3d 164, 167 (2d Cir. 2004).

23. 355 F.3d at 167.

24. *Id.* at 171 (internal citations omitted).

25. *Id.*

26. See, e.g., *Garber v. Legg Mason Inc.*, 537 F.Supp. 2d 597, 612 (S.D.N.Y. 2008); *In re Openwave Sys. Sec. Litig.*, 528 F.Supp. 2d 236, 244 (S.D.N.Y. 2007).

27. See *Openwave*, 528 F. Supp. 2d. at 244; *Legg Mason*, 537 F.Supp. 2d. at 609.

28. *Tellabs*, 127 S. Ct. at 2504-05.

29. 15 U.S.C. §78u-4(b)(2).

30. See, e.g., Aronstam, *supra* note 21, at 1070-80; Shmelzer, *supra* note 4, at 410-21.

31. See *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999); *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542 (6th Cir. 1999); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999); *Bryant v. Avado Brands Inc.*, 187 F.3d 1271 (11th Cir. 1999); *Greebel v. FTP Software Inc.*, 194 F.3d 185 (1st Cir. 1999).

32. 15 U.S.C. §78u-4(b)(2).

33. *Id.* at 2510 (internal citations omitted).

34. *Id.* at 1967.

35. *Id.* at 1964-65.

36. *Conley v. Gibson*, 355 U.S. at 45-46 (emphasis added).

37. *Twombly*, at 1969 (citing *Car Carriers Inc. v. Ford Motor Co.*, 745 F.2d 1101, 1106 (7th Cir. 1984); *Ascon Properties Inc. v. Mobil Oil Co.*, 866 F.2d 1149, 1155 (9th Cir. 1989); *O'Brien v. DiGrazia*, 544 F.2d 543, 546, n.3 (1st Cir. 1976); *McGregor v. Industrial Excess Landfill Inc.*, 856 F.2d 39, 42-43 (6th Cir. 1988)).

38. *Id.* at 1974.

39. *Id.* at 1973 n.14.

40. *ATSI Comm. Inc. v. The Shaar Fund, Ltd.*, 493 F.3d 87, 98 n.2 (2d Cir. 2007).

41. 527 F. Supp. 2d 965 (N.D.Cal. 2007).

42. 542 F. Supp. 2d 1037 (N.D.Cal. 2008).

43. *In re Levi Strauss*, 527 F. Supp. 2d. at 987-88.

44. *Id.* at 980.

45. *In re Juniper Networks*, 542 F. Supp. 2d. at 1054.

46. *Twombly*, 127 S. Ct. at 1967.