

**SECURITIES LITIGATION UPDATE:
RECENT DEVELOPMENTS
UNDER THE PSLRA AND THE UNIFORM STANDARDS ACT**

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I. INTRODUCTION

This past year has witnessed several seismic shifts in the world of corporate governance and securities regulation that will have profound and lasting impact on securities class action litigation. The sudden and catastrophic collapses of Enron, Worldcom, Global Crossing, Tyco, Adelphia, and other major public companies, together with the wave of Securities and Exchange Commission enforcement actions and criminal indictments that followed, fundamentally altered the politics of securities regulation. Investor outrage prompted swift and sometimes overwrought political reactions:

- Vast new legislative initiatives were launched in the Congress, culminating in the passage of the Sarbanes-Oxley Act of 2002, about which much ink already has been spilled.
- State regulators, most famously New York State Attorney General Elliot Spitzer, launched their own initiatives, including the precedent-setting settlement with Merrill Lynch over its analyst research practices.
- The two principal self-regulatory organizations, the NYSE and NASD, have announced a number of proposed changes to their listing standards, designed to address some of the perceived corporate governance failures of public companies, particularly those involving the duties, responsibilities, and conflicts of board and audit committee members.
- The sheer breadth and scope of recent accounting scandals has led to a complete rethinking of regulation of the accounting profession, and the creation of the new Public Company Accounting Oversight Board.

In sum, there has never been a more challenging time for public companies and their directors and officers than now.

The broad reform agenda that has unfolded in Congress and among federal and state regulators undoubtedly will have consequences for private securities litigation for years to come. Most immediately, the judicial environment for the defense of pending class action cases has become utterly toxic, as defendants across the country face the prospect of litigating their cases against a backdrop of widespread public revulsion and mistrust. Longer term, the Sarbanes-Oxley Act and related SEC rulemaking may result in new standards of conduct that will be transformed by creative plaintiffs' counsel into new civil liability standards; in the future, any material business failure may lead to allegations that directors and officers recklessly failed to institute all of the controls and procedures contemplated by Sarbanes-Oxley, or recklessly ignored compliance problems, or otherwise failed to carry out the vast new duties and responsibilities that Sarbanes-Oxley seeks to impose. A new era of "gotcha" litigation is sure to come.

In the meantime, securities litigation under the PSLRA continues apace. This article reviews only some of the recent developments under the PSLRA and the Uniform Standards Act. In each of the areas we feature, the caselaw either is rapidly evolving, or is continuing to exhibit deep and abiding conflicts among the circuits. In any event, the caselaw under the PSLRA and SLUSA surely cannot be said to provide certainty or predictability, and in that respect the ultimate congressional goal of eliminating meritless litigation continues to be elusive.

II. PLEADING CHALLENGES UNDER THE PSLRA: CONFLICTING STANDARDS ON MOTIONS TO DISMISS

The issue of how the PSLRA “scienter” standard should be applied continues to be debated by the appellate courts, and the U.S. Supreme Court so far has chosen not to resolve the clear conflict among the circuits as to whether the PSLRA did or did not eliminate the so-called “motive and opportunity” test from the Second Circuit.¹ That continuing debate will not be addressed here. In the meantime, the Ninth Circuit initially demonstrated a strong propensity to interpret the PSLRA conservatively.² In 2002, the Ninth Circuit issued one of the most significant rulings in several years, arguably setting a different standard for what inferences the courts must draw at the pleading stage. In 2003, a different panel of the Ninth Circuit appeared to pull back from that standard.

The VISX Decision. In *Gompper v. VISX, Inc.*, 298 F.3d 893 (9th Cir. 2002), the Ninth Circuit significantly strengthened the PSLRA pleading requirements, particularly with regard to the pleading of scienter in cases brought under Section 10(b) of the Securities Exchange Act of 1934. *VISX* instructs courts to disregard the traditional motion to dismiss standard – which requires that all alleged facts be considered true and that all reasonable inferences be drawn in favor of the non-moving party – and instead holds that, “when determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs.” *VISX*, 298 F.3d at 897.

In *VISX*, the defendant corporation developed and sold laser vision-correction devices, charging a \$250 fee for each use of its patented laser system. *See VISX*, 298 F.3d at 894. In early 1999, a rival company entered the market with a similar product that did not have a per procedure charge. *Id.* In response to the competitive threat, *VISX* filed suit against the competitor for patent infringement in both federal district court and before the International Trade Commission (the “ITC”). *Id.* The ITC judge ruled against *VISX* and found one of *VISX*’s core patents invalid; two months later, *VISX* publicly announced that it was reducing its per procedure fee to \$100. *Id.* at 894-95. *VISX*’s stock plummeted in the wake of this announcement, and plaintiffs filed suit. *Id.* at 895.

The gravamen of plaintiffs’ complaint was that defendants knew prior to the administrative ruling that there was no basis for their core patent claims and, without a valid patent, knew that *VISX* could neither maintain its high per procedure fee nor substantiate its rosy revenue projections. *See VISX*, 283 F.3d at 895. To support their claim that defendants actually knew *VISX*’s patents were invalid, plaintiffs asserted that *VISX*’s tendency to aggressively sue

¹ *See Novak v. Kasaks*, 216 F.3d 300 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000); *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63 (2d Cir.), *cert. denied*, 122 S. Ct. 678 (2001).

² *See, e.g., In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079 (9th Cir. 2002); *Lipton v. Pathogenesis Corp. Sec. Litig.*, 284 F.3d 1027 (9th Cir. 2002); *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir. 2002); *Brody v. Transitional Hosps. Corp.*, 280 F.3d 997 (9th Cir. 2002); *Ronconi v. Larkin*, 253 F.3d 423 (9th Cir. 2001).

its competitors for patent infringement revealed a strategy of intimidation of competitors through litigation despite its knowledge that its patents were invalid. *Id.* at 896-97.

The court disagreed with the inference plaintiffs drew from these allegations, finding that “it is equally if not more plausible that VISX consistently initiated litigation in defense of its patents because it and its officers believed the patents were valid, and recognized that the very survival of VISX’s business model was contingent on the technology protected by these patents. Consideration of this inference quite clearly impedes the plaintiffs’ progress toward building the requisite strong inference of scienter.” *Id.* at 897.

The court reasoned: “we believe Congress made it crystal clear . . . that only complaints with particularized facts giving rise to a strong inference of wrongdoing survive a motion to dismiss, [and] we agree with the district court that when determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs. District courts should consider all the allegations in their entirety, together with any reasonable inferences that can be drawn therefrom, in concluding whether, on balance, the plaintiffs’ complaint gives rise to the requisite inference of scienter.” *VISX*, 298 F.3d at 897.

America West Holding – Inroads on the VISX Standard. Earlier this year, in *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003), the Ninth Circuit reversed a dismissal of a securities class action complaint. In this case, plaintiffs alleged that America West and its officers and directors had deliberately misrepresented the extent of the company’s aircraft maintenance problems in order to artificially bolster the value of America West’s stock so their controlling shareholders could realize \$67 million in insider trading profits. *Id.* at 934. The district court dismissed the complaint, finding that plaintiffs had “failed to sufficiently support their allegations of false and misleading statements with great detail and all relevant circumstances; and . . . failed to state with particularity all facts that gave rise to a strong inference of deliberate recklessness or actual intent.” *Id.* at 930.

The Ninth Circuit, in its review of plaintiffs’ allegations of scienter, acknowledged the “tension [noted by the Ninth Circuit in *VISX*] between Rule 12(b)(6) and the heightened pleading standard set forth under the Reform Act,” and quoted the *VISX* rule requiring that the court “must consider ‘all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs.’” *America West*, 320 F.3d at 938. However, after discussing plaintiffs’ allegations for many pages, the court seemed expressly to ignore the *VISX* rule when articulating its holding: “In this era of corporate scandal, when insiders manipulate the market with the complicity of lawyers and accountants, we are cautious not to raise the bar of the PSLRA any higher than that which is required under its mandates. The District Court’s *failure to accept Plaintiffs’ allegations as true and construe them in the light most favorable to Plaintiffs* does just that.” *Id.* at 946 (emphasis added).

District Court Cases Interpreting VISX. A recent decision from the Northern District of California, before the same district court judge who dismissed the *VISX* case in the district court, cites *VISX* approvingly and applies the new balancing of inferences standard from *VISX* in its scienter analysis. See *Coble v. Broadvision, Inc.*, No. C01-01969 CRB, 2002 U.S. Dist. LEXIS 17495, at *8-9, *18, *33 (N.D. Cal. Sept. 11, 2002).

In *Coble*, defendant Broadvision restated its financial statements to include \$4 million in previously omitted expenses, causing the stock to drop and precipitating the litigation. *Coble*, 2002 U.S. Dist. LEXIS 17495, at *9. Plaintiffs alleged that defendants knew of the expenses when they issued Broadvision's original financial statements, and asserted that the fact that defendants had attempted to hire a new CFO during the class period who declined the job "strongly suggests that defendants knew, or were consciously reckless in not knowing, that the Company's internal financial controls, in fact, were unreliable and its financial results . . . were false." *Id.* at *17. The court rejected the inference that plaintiffs had drawn that the prospective CFO had declined the job because of his alleged knowledge of financial improprieties. *Id.* at *17-18. "Such an inference is unreasonable, or at least, there are many other far more reasonable inferences to be drawn from that fact." *Id.*; *see also id.* at *32-33 (finding, with regard to an alleged misstatement concerning product compliance, that "[g]iven the lack of any other misstatements, it is equally – if not more – likely that the misstatement was inadvertent, as it is that it was intentional"). While the *Coble* court acknowledged that it "must accept . . . plaintiffs' allegations as true and construe them in the light most favorable to the plaintiffs" on a motion to dismiss, in "determining whether plaintiffs have pled a strong inference of scienter, 'the court must [in light of *VISX*] consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs.'" *Id.* at *8-9 (quoting *VISX*, 298 F.3d at 897).

On May 1, 2003, in a decision from the Southern District of California on a motion by defendants for reconsideration of a denial of their motion to dismiss, the court warned that it did not consider *VISX* an "intervening change in controlling law." *In re Amylin Pharmaceuticals, Inc. Sec. Litig.*, 2003 U.S. Dist. LEXIS 7667, at *9 (S.D. Cal. May 1, 2003). In *Amylin*, plaintiffs alleged that defendants made false and misleading representations concerning clinical studies on a new drug, Symlin, in order to relist its stock on the NASDAQ and raise in excess of \$129 million from two private placements, without excessively diluting the defendants' current holdings. *See id.* at *4. The court found these allegations sufficient to state a claim under Section 10(b). Defendants, on reconsideration, maintained that their investment of millions of dollars in the clinical trials and continued cooperation and communication with the Food & Drug Administration (the "FDA"), led unavoidably to the inference that defendants reasonably believed the trials were sufficient, rendering plaintiffs' allegations insufficient to satisfy the *VISX* standard. *See id.* at *11-12. The court disagreed, and found that in its view, the *VISX* scienter requirement was not inconsistent with the pre-*VISX* treatment of inferences on Rule 12(b)(6) motions to dismiss, and observed that the "concepts are not contradictory." *Id.* at *10. The court noted, however, that "even assuming [*VISX*] qualifies as 'an intervening change in controlling law,'" the denial of defendants' motion was not inconsistent with *VISX*. *Id.* at *11. While the inferences asserted by defendants were consistent with a sincere hope by defendants that the clinical trials were sufficient to garner FDA approval, the court held that they did not "negate the reasonable inference that [defendants] knew that the FDA had serious concerns about its study designs which could prevent the approval of Symlin." *Id.* at *12.

Eminence Capital – "Three Bites at the Apple" For Leave to Amend at the Pleading Stage. In *Eminence Capital, LLC v. Aspeon, Inc.*, 316 F.3d 1048, 1052-53 (9th Cir. 2003), the Ninth Circuit examined whether a securities class action plaintiff who had already had "three bites at the apple" should be permitted, under the PSLRA, another "bite" and be allowed to replead another time. The court noted that "[w]e need to bear in mind that we are not operating in the world of notice pleadings. In this technical and demanding corner of the law, the drafting of a cognizable complaint can be a matter of trial and error." *Id.* at 1052. In light of this reality,

the Ninth Circuit reversed the district court's dismissal with prejudice of plaintiff's complaint, finding that "plaintiffs had not filed three substantially similar complaints alleging substantially similar theories [I]t is not accurate to imply that plaintiffs had filed multiple pleadings in an attempt to cure pre-existing deficiencies." *Id.* at 1053. Rather, the court held, "[t]he existing record demonstrates that plaintiffs' allegations were not frivolous and that they were endeavoring in good faith to meet the heightened pleading requirements of the PSLRA . . . and . . . it appears that plaintiffs had a reasonable chance of successfully stating a claim if given another opportunity." *Id.*

III. PSLRA CASES INVOLVING PLEADING OF SCIENTER WHERE THE COMPANY HAS RESTATED ITS FINANCIAL RESULTS OR OTHERWISE ADMITTED TO GAAP VIOLATIONS

There is an emerging consensus among the courts that the mere allegation that an issuer violated generally accepted accounting principles ("GAAP"), standing alone, is insufficient to meet the PSLRA's scienter requirement. Similarly, many courts agree that merely alleging that a company restated its financial reports, without more, does not satisfy the scienter requirement. Recent cases provide insight about circumstances under which allegations of financial restatements and/or GAAP or Generally Accepted Auditing Standards ("GAAS") violations, under the totality of circumstances, may constitute important factors in evaluating whether scienter has been adequately pleaded.

Some of the factors recent courts have frequently addressed include: (a) the nature, size, and scope of GAAP violations; (b) the magnitude and frequency of restatements; and (c) whether the allegations of GAAP violations and/or restatements are accompanied by allegations of insider trading.³ In addition, in cases where the auditor is the defendant, courts look for "red flags" that should have put the auditor on notice of the company's financial improprieties.

Courts consistently have found certain types of allegations insufficient to survive a motion to dismiss. Insufficient allegations include those claiming that individual defendants "should have known" of violations based on their positions within the company, allegations that

³ *See, e.g., In re SCB Computer Tech., Inc., Sec. Litig.*, 149 F. Supp. 2d 334, 350 (W.D. Tenn. 2001) (acknowledging that "[i]n certain situations, courts have allowed circumstances surrounding GAAP violations to contribute to a strong inference of scienter"). The court proceeded to give several examples of such cases, but then distinguished the case at bar, noting that the previously discussed cases contained "significant factors" not present in this case. For example, the court observed that this complaint "includes no allegations of insider sales." *Id.* at 351. It also noted that the magnitude of the improperly recognized revenue in this case did not come close to that in the others. Plaintiffs alleged that, in fiscal years 1998 and 1999, SCB improperly recognized revenue in violation of GAAP. The court calculated that SCB could only have "misstat[ed] its revenue for fiscal year 1998 by 2.9 percent," or in 1999 by 1.65 percent. *Id.* at 351. The court held that the improper revenue recognition was insufficient to warrant a finding of scienter, and observed that "the magnitude of the financial restatement, without more, fails to indicate that the earlier financial statements were made with an intentional or reckless state of mind at the time they were made." *Id.* at 353.

the GAAP provisions violated were “simple,” and allegations that the magnitude of the violation or of the restatement ought to be determinative. To survive a motion to dismiss, it appears plaintiffs must be able to plead specific factual circumstances which demonstrate not only knowledge of accounting or auditing impropriety, but an actual intent to defraud. When the defendant is an auditor, allegations that the audit was conducted negligently and allegations that the defendant lacked adequate internal controls are also routinely found insufficient.

Alternatively, courts appear willing to allow a complaint alleging GAAP violations and/or a financial restatement to survive at the pleading stage where the magnitude of the GAAP violation is exceptionally large in proportion to previously reported numbers, where the allegations are accompanied by detailed allegations of insider trading, or where there are myriad other detailed allegations of wrongdoing.

A. Defendants Have Scored A Number Of Important Recent Victories

The trend is becoming clear in most circuits that mere allegations of company financial restatements or GAAP/GAAS violations are insufficient to state a fraud claim under the PSLRA. Several recent decisions underscore this trend, and hold that conclusory allegations about what management “must have known” will not suffice.

First Circuit. In *In re Tyco International, Ltd., Securities Litigation*, 185 F. Supp. 2d 102 (D.N.H. 2002), the court dismissed a complaint at the pleading stage despite significant earnings restatements. Plaintiffs alleged that reserves were overstated to show artificial growth in later quarters, and pointed to the restatements as evidence that defendants’ earlier financial statements were false and misleading. *Id.* at 111-12. The court found that the plaintiffs failed to provide “a coherent explanation linking the restatements to the fraud alleged.” *Id.* at 112. In fact, one restatement, the court noted, “actually reduced charges taken in that quarter and thereby increased earnings per share at a time when, if the [plaintiffs’] allegations are to be believed, earnings per share were originally reported as being too high.” *Id.*

In *In re Stone & Webster, Inc. Securities Litigation*, 2003 WL 1697724, at *29 (D. Mass. Mar. 28, 2003), the court dismissed a complaint alleging that PriceWaterhouseCoopers (“PwC”) violated GAAP and GAAS in its audit of Stone & Webster’s (“S &W”) financial statements. Plaintiffs alleged that PwC had “actual knowledge,” in the form of several “red flags,” that S & W was violating GAAP by booking revenue in its financial statements that that should have been, but was not, disclosed to investors. *Id.* at *27. Plaintiffs also alleged that PwC had ignored S & W’s GAAP violations and “had performed audits that violated GAAS in so many respects that PwC ‘utterly failed in its role as an auditor.’” *Id.* at *28. The court found, however, that plaintiffs’ allegations concerning S & W’s violations of GAAP were so conflicting as to be insufficient to support a claim of fraud against S & W, let alone PwC, and that “each of plaintiffs’ claims of a GAAS violation [was] stated in completely conclusory terms.” *Id.* The court also rejected plaintiffs’ allegations of PwC’s reckless disregard of “red flags,” noting that “such ‘red flags’ must be ‘something more than the accounting violation itself,’” especially where plaintiffs fail to allege, “in other than conclusory terms, that PwC was even aware of some of the alleged red flags.” *Id.*

Second Circuit. In *AIG Global Sec. Lending Corp. v. Banc of America Sec. LLC*, ---F. Supp. 2d ---, 2003 WL 1738484, at *11 (S.D.N.Y. Mar. 31, 2003), the court dismissed a complaint alleging that defendants had used “unorthodox and non-standard” accounting practices

which materially misrepresented the loss and delinquency rates for certain contracts. Plaintiffs alleged that other retailers used different accounting treatment, rendering defendants' reported figures misleading and artificially inflated. *Id.* The court found that while "the plaintiffs allege that the numbers were misleading because other retailers may have used different calculations or accounting practices," plaintiffs fail to allege that defendants' practices "were not acceptable accounting standards." *Id.* The court held that "even if the plaintiffs had alleged that the measures used by [defendants] failed to comply with . . . [GAAP], such a statement would be insufficient to comply with Rule 9(b), since there would be no basis to conclude that the practices actually used were fraudulent." *Id.*

Fourth Circuit. In *Svezzese v. Duratek, Inc.*, No. MJG-01-1830, 2002 U.S. Dist. LEXIS 20967, at *4 (D. Md. Apr. 30, 2002), the court granted defendant's motion to dismiss and held that allegations of GAAP violations "can only raise a strong inference of scienter if plaintiff's other allegations evince fraudulent intent."⁴

Fifth Circuit. The Fifth Circuit held in *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 435 (5th Cir. 2002), that the plaintiffs failed to allege that defendants had the knowledge requisite to establish scienter, despite alleging that the defendants violated GAAP, requiring a restatement of previously issued reports. The court found that scienter cannot adequately be pled based on defendants' alleged knowledge of the misstatements stemming from defendants' positions in the company. *Id.* at 432. The court also noted that "company officials should not be held responsible for failure to foresee future events." *Id.* at 433. Rather, to be held liable for misstatements, such officials must have had actual knowledge that they were making misstatements at the time those statements were made. *Id.*

In *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 2003 WL 1089307, at *44-45 (S.D. Tex. Mar. 12, 2003), Judge Harmon dismissed claims of financial fraud under Sections 10(b) and 20(a) against Enron's outside directors. Plaintiffs had alleged that the outside directors "knew or recklessly disregarded fraudulent acts taking place and approved them to further the alleged Ponzi scheme" at Enron, and that they were motivated to do this so that they could profit from illegal insider selling. *Id.* at *34. The court was unimpressed with plaintiffs'

⁴ See also *In re E.Spire Communications, Inc. Sec. Litig.*, 127 F. Supp. 2d 734, 749 (D. Md. 2001) (granting defendant issuer's motion to dismiss, holding that the plaintiff failed to sufficiently allege scienter where plaintiff relied on both the defendant's violations of GAAP and its subsequent restatement of its financials and the plaintiff pointed to three factors: (1) the simplicity of the rule violated, (2) defendant's knowledge of the rule and the possibility that it was being violated, and (3) a statement by the defendant's new CEO, after the class period had ended, that, "there is absolutely zero tolerance for any lying, cheating, or stealing, in any way, shape or form here. And that includes any public statement, or any public information that I or anybody else gives out to you or to any other investor."). The court held that the fact that "a restatement of financials occurred is not sufficient to raise a strong inference of scienter. It is settled that 'scienter requires more than a misapplication of accounting principles,' and that 'mere allegations that statements made in one report should have been made in earlier reports do not make out a claim of securities fraud.'" *Id.* at 745 (quoting *MicroStrategy Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 634-35 (E.D. Va. 2000)).

allegations, finding that despite “allusions” to board minutes containing “lists” of agenda items, the complaint was devoid of “particular facts or details about the presentation or discussion . . . that would indicate that the Outside Directors knew or recklessly disregarded that there was a Ponzi scheme afoot or that would suggest that their resolutions as members of the board or committees were intended to further fraud.” *Id.* The court also held that plaintiffs had “failed to plead facts showing that any of the Outside Directors personally benefited from any nonpublic information to which he or she was given access by engaging in timely, highly unusual and suspicious insider trading of their Enron securities.” *Id.* Under these circumstances, Judge Harmon found that plaintiffs’ allegations “fail to raise a strong inference of scienter with respect to any of the Outside Directors,” and therefore failed to state a claim under Sections 10(b) or 20(a).⁵ *Id.* at *44-45.

In *Umstead v. Andersen LLP*, 2003 WL 222621, at *2 (N.D. Tex. Jan. 28, 2003), plaintiffs alleged that defendant Andersen violated GAAP and GAAS when it audited issuer Intellect’s financial statements because of “the potential for significant fees, a chance to do lucrative consulting work for Intellect, and the opportunity to grow its presence in the Dallas auditing market motivated Andersen to take the Intellect account and ultimately to commit securities fraud.” Plaintiffs’ alleged that Andersen failed to consider the impact of the weakening foreign economy on Intellect, ignored red flags which would have placed Andersen on notice that Intellect’s receivables were uncertain, and generally failed to take action or modify its audit procedures in light of “a great deal” of information reflecting the “financial difficulties” at Intellect that made it a “high risk audit.” *Id.* at *2-3. The court found that plaintiffs’ allegations regarding Andersen’s actions and inactions were “merely conclusory,” and that, because the only alleged motive for the conduct was “no more than a desire to make money, and not an extraordinary amount of money for an auditing engagement,” the allegations did not demonstrate the requisite scienter. *Id.* at *4; *see also In re Capstead Mortgage Corp. Sec. Litig.*, 2003 WL 1813837, at *12 (N.D. Tex. Mar. 31, 2003) (“Plaintiffs’ allegations of accounting fraud based on Defendants’ non-compliance with or violation of GAAP do not sufficiently demonstrate conscious misbehavior or severe recklessness.”).

Seventh Circuit. In *Riggs Partners, LLC v. Hub Group*, No. 02 C 1188, 2002 U.S. Dist. LEXIS 20649, at *17 (N.D. Ill. Oct. 25, 2002), the court dismissed claims against the issuer despite acknowledging that “the magnitude and nature of accounting errors may belie a defendant’s claim that it was unaware of any improprieties.”

Eighth Circuit. The Eighth Circuit reiterated the rule that allegations of GAAP violations, standing alone, are insufficient to plead scienter. *See In re K-tel Int’l, Inc. Sec. Litig.*, 300 F.3d 881, 890 (8th Cir. 2002). Such allegations are only sufficient where they are accompanied by evidence of fraudulent intent. *Id.* In *K-tel* the plaintiffs alleged that the

⁵ *See also In re Enron Corp. Sec., Derivative & ERISA Litigation*, 2003 WL 230688, at *15-17 (S.D. Tex. Jan. 28, 2003) (allegations that individual partners of Arthur Andersen, Enron’s independent auditor, were “deeply involved” in fraudulent audit were insufficient to state a Section 10(b) claim against them, but sufficient Section 10(b) earlier stated against Arthur Andersen itself was proper claim on which to base Section 20(a) “control person” claim against same individuals).

defendant's "knowing overstatement of assets in violation of GAAP evinces fraudulent intent." *Id.* at 895.⁶ The court held that plaintiffs' allegations failed for lack of particularity because the plaintiffs failed to allege any reason why the losses should have been written off as they were pursuant to certain accounting rules, as opposed to at a later date pursuant to other equally applicable accounting rules, *id.* at 892, and that other allegations failed for lack of particularity because the plaintiffs "fail[ed] to specify any contracts or circumstances that K-tel knew at the time of the March 10-Q or June 10-K would result in the specified losses." *Id.* at 893. The court also found that conclusory allegations of insider trading or a generalized desire to increase stock price could not suffice. *Id.* at 895; *see also In re Navarre Corp. Sec. Litig.*, 299 F.3d 735 (8th Cir. 2002) (dismissing allegations of accounting fraud at the pleading stage); *Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 827 (8th Cir. 2003) ("Without allegations of particular facts demonstrating . . . that [defendants] knew the financial statements over represented the company's true earnings, or that they were aware of a GAAP violation and disregarded it, a showing in hindsight that the statements were false does not demonstrate fraudulent intent.").

Ninth Circuit. A defendant's admitted failure to follow GAAP is insufficient to establish scienter. *See DSAM Global Value Fund v. Altris Software*, 288 F.3d 385 (9th Cir. 2002). In *Altris*, the plaintiff argued that the auditor's failure to follow GAAP was sufficient evidence to establish scienter. The Ninth Circuit affirmed the district court's dismissal, acknowledging first that the audit conducted by the defendant was "seriously botched," and second that the defendant conceded that the audit failed to comply with GAAP. *Id.* at 390. Nevertheless, the court held that "the complaint sets out a compelling case of negligence – perhaps even gross negligence – but does not give rise to a strong inference that the auditor acted with an intent to defraud, conscious misconduct, or deliberate recklessness, as is required in a securities fraud case." *Id.* at 387.⁷ The court in *Altris* noted that "[t]he plaintiff must prove that the accounting practices were

⁶ The accounting violations asserted by the plaintiffs in this case were as follows. First, the plaintiffs alleged that "K-tel knew in March 1998 of a \$1.498 million loss due to the poor performance of a subsidiary and K-tel was required by GAAP to write off the assets of the subsidiary in its March 10-Q filing, filed May 8, 1998. K-tel wrote down assets in that amount by March 1999. Additionally, the Class alleged K-tel failed to disclose future losses of \$1.8 million related to the subsidiary, also in violation of GAAP. The Class alleged such overstating of assets in the March 10-Q and the later June 10-K is a violation of GAAP and is evidence of fraud and scienter because K-tel's inclusion of the overstated assets concealed its inability to comply with the minimum necessary tangible net asset requirement for continued listing on the NMS." *K-Tel*, 300 F.3d at 888.

⁷ *See also In re McKesson HBOC, Inc. Sec. Litig.*, No. C-99-20743-RMW, Order Granting in Part and Denying in Part Motion by McKesson HBOC, Inc. to Dismiss or, in the Alternative, to Strike Portions of the Third Amended Complaint, slip op. at 3-4 (N.D. Cal. Jan. 6, 2003) (allegations that McKesson's officers and directors "were aware of and discussed" accounting issues at HBOC with outside auditors "do not reasonably support the conclusion that they acted with the intent to deceive or recklessly by accepting their professional advisors' opinions or by not concluding that the accounting issues raised 'red flags' or potentially material errors"; "the court concludes that it cannot draw a strong inference that McKesson acted with scienter").

so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.” *DSAM Global Value Fund*, 288 F.3d at 390 (citation omitted).⁸

The Ninth Circuit decision in *In re Vantive Corp. Securities Litigation*, 283 F.3d 1079 (9th Cir. 2002), also is instructive. In *Vantive*, the court affirmed dismissal of a class action alleging widespread accounting fraud and revenue recognition manipulations. Despite the presence of allegations of “secret agreements” and “secret” changes to the company’s revenue recognition policies, the court refused to find that plaintiffs had sufficiently alleged scienter. *Id.* at 1090-91.

Eleventh Circuit. When plaintiffs assert claims against an auditor based on allegations of GAAP and GAAS violations, courts have required the presence of additional related “red flags” in order to state a claim for violation of the securities laws. *See Ziemba v. Cascade Int’l, Inc.*, 256 F.3d 1194 (11th Cir. 2001). In *Ziemba*, the plaintiffs brought claims against Cascade International (“Cascade”), as well as Coopers and Lybrand (“Coopers”), Cascade’s accounting firm. Coopers had audited two of Cascade’s subsidiaries, and issued opinions stating that both audits had been conducted in accordance with GAAS. *Id.* In their case against Coopers, the plaintiffs pointed to certain “red flags” that it claimed the defendant auditor ignored in issuing its opinions. *Id.* at 1209.⁹ After enumerating the plaintiffs’ list of red flags, the court acknowledged that, “[i]n certain circumstances, courts have held that allegations of violations of GAAP or GAAS, coupled with allegations of ignoring ‘red flags,’ can be sufficient to state a claim for securities fraud.” *Id.* at 1209-10. But in affirming the dismissal of the complaint, the court noted that here, “[p]laintiffs have not alleged any facts suggesting actual awareness by [Coopers] of any fraud. Plaintiffs have pointed to no ‘tips,’ letters, or conversations raising inferences that [Coopers] knew of any fraud. Furthermore, Plaintiffs have pointed to no facts suggesting that [Coopers] was severely reckless in not knowing about any fraud.” *Id.* at 1210. The court held that, “at most, these allegations raise an inference of gross negligence, but not fraud.” *Id.*¹⁰

⁸ *See also In re Williams v. FVC.com Sec. Litig.*, No. 00-15555, 2002 WL 465161 (9th Cir. Mar. 15, 2002); *Colin v Onyx Acceptance Corp.*, No. 01-55499, 2002 WL 4608030 (9th Cir. Feb 14, 2002).

⁹ Many of these red flags concerned alleged improprieties by Cascade’s independent auditor Bernard H. Levy. For example, among Coopers’ work papers for the relevant time period was a newspaper article that depicted Levy as part of Cascade’s “management team, which called into question Levy’s independence.” *Id.* at 1209. Another alleged red flag was the fact that “Levy was a sole practitioner rather than a large Big Six accounting firm.” *Id.* Furthermore, a Coopers employee “sent Levy a checklist on procedures to follow in preparing a 10-Q, indicating that Levy needed assistance in preparing such a filing.” *Id.*

¹⁰ *See also Nappier v. Pricewaterhouse Coopers LLP*, No. 01-4717(JEI), 2002 U.S. Dist. LEXIS 18781, at *32 (D.N.J. Oct. 4, 2002), in which the court dismissed plaintiffs’ claims against auditor despite the fact that plaintiffs alleged both that the auditor violated GAAP, and that it failed to heed certain “red flags” in conducting its audit of a company that engaged

B. Cases Surviving Motions to Dismiss Have Involved More Detailed Allegations of Defendants' Knowledge of Accounting Failures

Claims based on defendants' restatements or GAAP violations survive motions to dismiss when those allegations are coupled with related detail concerning the claimed financial wrongdoing.

First Circuit. In *In re Cabletron Systems, Inc.*, the First Circuit recognized that “[s]ignificant GAAP violations . . . ‘could provide evidence of scienter.’” 311 F.3d 11, 39 (1st Cir. 2002) (citation omitted). The plaintiff in *Cabletron* made “particularized allegations of large-scale fraudulent practices over time” which the court held made it “difficult to escape a strong inference of the type of recklessness concerning wrongdoing that amounts to scienter.” *Id.* The court did not, however, rely solely on the GAAP allegations in its scienter analysis. *See id.* at 39-40. Other allegations implicating defendants' knowing falsity, such as insider trading allegations, contributed to the court's conclusion. *See id.* at 40. The court also observed that “[e]ach individual fact about scienter may provide only a brushstroke, but the resulting portrait satisfies the requirement for a strong inference of scienter under the PSLRA.” *Id.* at 40.¹¹

In *Aldridge v. A.T. Cross, Corp.*, 284 F.3d 72 (1st Cir. 2002), the First Circuit reversed the district court's dismissal where the plaintiff alleged that the defendant violated GAAP by failing to disclose its price protection practices to shareholders or to reserve for them in financial statements. In *Aldridge*, the defendant had a successful and profitable business year. *Id.* at 79. Upon a dramatic drop in sales, in an effort to reassure investors, directors of the defendant company explained to investors and analysts that sales had decreased in the first quarter of the following year due to price protections that were part of the company's initial sales strategy. *Id.* The district court held that it would be unreasonable to infer from these allegations that the defendant had engaged in price protection in the first year of operation. *Id.* The First Circuit reversed, noting first that Federal Rule of Civil Procedure 12(b)(6) requires drawing all reasonable inferences in a plaintiff's favor. It subsequently held that “it is an extremely reasonable inference, from the defendants' statements in 1999, that the company had offered its customers price protection guarantees in 1998 . . . [and that] it may easily be inferred that the statements were misleading and that the defendants knew they were misleading.” *Id.*

Second Circuit. In *Burstyn v. Worldwide Xceed Group, Inc.*, the court denied defendants' motion to dismiss, noting that the “magnitude” of the violations “raises questions about defendants' credibility, makes the [optimistic] press statements increasingly suspect, and

[Footnote continued from previous page]

in unlawful business practices. The court noted that “so-called ‘red flags’ . . . must be ‘closer to ‘smoking guns’ than mere warning signs.’” *Id.*

¹¹ In *In re Lernout & Hauspie Securities Litigation*, 236 F. Supp. 2d 161, 174-76 (D. Mass. 2003), the court, following the First Circuit's holding in *Cabletron*, permitted financial fraud allegations to proceed against two secondary actor defendants involved in related-party transactions with defendant Lernout & Hauspie (“L & H”), on the basis that plaintiffs' complaint alleged that such related parties were aware of and “substantially assisted” in L & H's alleged scheme to artificially inflate revenues by entering into “sham” partnerships.

by doing such, further supports a strong inference of scienter.” No. 01 Civ. 1125, 2002 U.S. Dist. LEXIS 18555, at *18 (S.D.N.Y. Sept. 30, 2002) (citation omitted).

In *In re Nortel Networks Corp. Sec. Lit.*, 238 F. Supp. 2d 613, 626 (S.D.N.Y. 2003), plaintiffs’ complaint cited a number accounting practices that they alleged had improperly inflated the defendants’ reported revenues, including: (1) improper recognition of revenue from sales based upon letters of intent rather than formal purchase orders; (2) failure to properly reflect the risk of “noncollectibility” of unsecured loans extended to uncreditworthy customers; and (3) failure to recognize billions of dollars in impairment losses on long-term assets obtained through defendants’ acquisitions. The complaint alleged that defendants improperly reported revenue on sales where “Nortel extended 100 percent vendor-financing to customers, with the knowledge that those customers could not pay for the products.” *Id.* Plaintiffs also alleged that revenue from these sales was “known to be materially uncollectible” and that recording the revenue violated Nortel’s “internal revenue recognition policies, which required collection to be ‘reasonably assured’ prior to recognition,” and that this practice led Nortel improperly to record “hundreds of millions, if not billions, of dollars” in revenue. *Id.* The court found that “[t]hese allegations, if true, are more than a mere ‘contention that Nortel extended unwise loans,’” and determined that they were a sufficiently detailed account of fraud to survive a motion to dismiss. *Id.*; see also *Teachers’ Retirement System of Louisiana v. A.C.L.N., Ltd.*, 2003 WL 21058090, at *11 (S.D.N.Y. May 12, 2003) (denying defendants’ motion to dismiss based on plaintiffs’ allegations that defendants committed “multiple violations of the GAAS general standards, standards of fieldwork, and standards of reporting,” including 20 enumerated “red flags”).

Third Circuit. Claims against auditor defendants survived when accompanied by detailed allegations of related “red flags” that should have put defendants on notice of improprieties. In *In re Rent-Way Securities Litigation*, 209 F. Supp. 2d 493, 506 (W.D. Pa. 2002), the plaintiff not only alleged GAAP violations, but bolstered its claims of recklessness by looking to: (1) the magnitude and duration of the fraud; (2) the serial nature of the GAAP violations; (3) the auditor’s knowledge that the issuer’s internal accounting structure was inadequate; and (4) the auditor’s disregard for a number of “red flags.” The court noted that none of the first three allegations, standing alone, would be sufficient to satisfy the scienter requirement, however, when combined with “red flags,” the allegations here satisfied the pleading standard of the PSLRA. *Id.* at 508-09. Because the plaintiffs “alleged specific facts explaining how [the defendant] recklessly or consciously disregarded GAAS,” and enumerated significant red flags that the defendant should have heeded, the court held that the allegations supported a strong inference of scienter. *Id.* at 507, 509, 511.

Fifth Circuit. In *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002), Judge Harmon found that claims against several secondary actor defendants, such as Enron’s outside auditor Arthur Andersen, several investment banks that allegedly participated with Enron in fraudulent transactions and accounting schemes, and Enron’s attorneys, could proceed under Section 10(b).

With regard to defendant Arthur Andersen, plaintiffs alleged that the auditor violated GAAS, GAAP, accounting rules, and the rules of professional accounting conduct. Plaintiffs contended that: (1) despite these violations, Arthur Andersen certified that Enron’s financial statements for the years 1997-2000 were in compliance with GAAP and that its audits of the financial statements were consistent with GAAS; (2) Andersen knew the reports it prepared would be relied upon by investors in Enron securities; (3) Andersen permitted the audited

financial statements to be included in registration statements, prospectuses, and annual shareholders' reports that were filed by Enron; and (4) Andersen destroyed documents to conceal its fraudulent accounting. *In re Enron*, 235 F. Supp. 2d at 706. The court concluded that "[a]ll of these [actions] constitute primary violations under § 10(b)" and thus stated a claim for securities fraud. *Id.*

With regard to certain bank and investment bank defendants, plaintiffs contended that the banks had knowledge of Enron's allegedly "precarious" financial condition, and alleged that the banks: (1) engaged in fraudulent transactions, at quarter-end or other suspicious times, in which they made large loans to Enron which were "disguised" as commodities trades in order to falsify Enron's financial condition and "perpetuate" Enron's Ponzi scheme; (2) engaged in a bogus IPO transaction, in conjunction with falsely hedging another transaction, that were together designed to be a guarantee from Enron against any loss to the banks; (3) advised Enron with respect to asset sales at inflated prices in non-arms-length transactions, and other bogus transactions, designed to "create sham profits and conceal massive debt for Enron"; (4) "cooperated with Enron's misuse of mark-to-marketing accounting to improperly accelerate and record" profits. *In re Enron*, 235 F. Supp. 2d at 695-704. The court found these allegations sufficient to state a Section 10(b) claim for intentional financial fraud against these defendants. *Id.*

With regard to Enron's attorneys at Vinson & Elkins ("V & E"), plaintiffs alleged that the attorneys were "privy to its client's confidences and intimately involved in and familiar with the creation and structure of its numerous businesses, and thus . . . had to know of the alleged ongoing illicit and fraudulent conduct." *In re Enron*, 235 F. Supp. 2d at 704. Plaintiffs contended that in light of Enron's unlawful activities of which V & E was aware, it nonetheless did not resign as Enron's attorneys, as the rules of conduct directed. *Id.* at 705. Rather, in the pursuit of lucrative fees, V & E made public statements about Enron's business and financial condition, and was alleged to have "voluntary, essential, material, and deep involvement as a primary violator in the ongoing Ponzi scheme . . . [as] essentially a co-author of the documents it created for public consumption concealing its own and other participants' actions." *Id.* The court found that V & E's actions – directing statements to the public designed to "keep the Ponzi scheme afloat" – were sufficient to state a claim against them under Section 10(b). *Id.*

Eighth Circuit. In *In re Chronimed Inc. Securities Litigation*, No. 01-1092 (DWF/AJB), 2002 U.S. Dist. LEXIS 8962 (D. Minn. May 16, 2002), the court denied a motion to dismiss where the defendant was a parent corporation that restated its revenues due to problems in its subsidiary's accounting software. Plaintiffs alleged that the defendant was made aware of the inaccuracies in the financial reports generated by the subsidiary in monthly meetings between representatives of both the parent and subsidiary during which they discussed the financial reports. *Id.* at *18-19.

Ninth Circuit. In *In re Ramp Networks, Inc. Securities Litigation*, 201 F.Supp. 2d 1051, 1081 (N.D. Cal. 2002), the district court permitted plaintiffs to amend accounting fraud claims as to some, but not all, defendants. The court found that the company's restatement of financial

results, together with other allegations as to why senior management knew or should have known of the accounting problems, could potentially be amended to state a claim. *Id.* at 1073-74.¹²

IV. RECENT DEVELOPMENTS CONCERNING THE PSLRA “SAFE HARBOR” FOR FORWARD-LOOKING STATEMENTS

The past year has seen the continued application by a number of courts of the “safe harbor” for forward-looking statements at the pleading stage. The following discussion underscores the problem that despite Congress’s best intentions, clarity is lacking regarding the types of statements that are immune from shareholder attack.

A. The Statutory Framework For The “Safe Harbor” Defense

The PSLRA provides defendants a safe harbor from liability for forward-looking statements.¹³ Specifically, forward-looking statements cannot serve as the basis for a securities

¹² See also *In re Homestore.com, Inc. Sec. Litig.*, --- F. Supp. 2d ---, 2003 WL 1227643, at *25-28 (C.D. Cal. Mar. 7, 2003) (denying motion to dismiss financial fraud claim against: (i) CEO, where plaintiff alleged that CEO had “personal involvement in deals that were later restated, as well as specific, detailed allegations regarding personal behind-the-scenes conversations” implicating him in the fraud; and (ii) outside auditor, where plaintiffs had alleged sufficient “red flags” to demonstrate that auditor’s certification of financial statements was an action taken with “deliberate recklessness”); *In re Commtouch Software Ltd. Sec. Litig.*, No. C 01-00719 WHA, 2002 U.S. Dist. LEXIS 13742, at *27 (N.D. Cal. July 24, 2002) (denying motion to dismiss where the court held that the plaintiffs’ allegation that the restatement was based on facts available at the time revenue was recorded was “well-supported.”); *In re Adaptive Broadband Sec. Litig.*, No. C 01-1092 SC, 2002 U.S. Dist. LEXIS 5887, at *38 (N.D. Cal. Apr. 2, 2002) (holding that “[w]hile it is true that conclusory allegations of GAAP violations standing alone cannot be used to prove intentional or reckless misconduct, if pled in detail and read in context, GAAP violations may support an inference of scienter” (citation omitted)).

¹³ A forward-looking statement is defined as:

- (A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;
- (B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
- (C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;
- (D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C);
- (E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or
- (F) a statement containing a projection or estimate of such other items as maybe specified by rule or regulation of the Commission.

fraud claim where they are: (1) identified as such and accompanied by “meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement,” 15 U.S.C. § 78u-5(c)(1)(A); (2) are “immaterial,” *id.*; or (3) where the plaintiff fails to prove that the statements were made with actual knowledge that they were false or misleading, 15 U.S.C. § 78u-5(c)(1)(B); *see also In re Amylin Pharms., Inc.*, No. 01CV1455BTM(NLS), 2002 U.S. Dist. LEXIS 19481, at *23 (S.D. Cal. Oct. 9, 2002) (paraphrasing statute and finding statements relating to possible future FDA approval identified as forward-looking but accompanied by insufficient cautionary warning).

The two prongs of the PSLRA “safe harbor” work independently from one another. *See, e.g., In re ATI Techs., Inc.*, 216 F. Supp. 2d 418, 429 (E.D. Pa. 2002) (“A careful reading of this provision, and its disjunctive syntax, reveals that a defendant will be immune from liability if any one of its criteria is met.”); *In re U.S. Interactive, Inc. Sec. Litig.*, 2002 U.S. Dist. LEXIS 16009, at *32-33 (E.D. Pa. Aug. 23, 2002) (noting that there is protection for a forward-looking statement if it is “accompanied by a sufficient cautionary statement or if it is otherwise immaterial”). The defendant can claim the safe harbor if either: (1) the statement is forward-looking and accompanied by meaningful cautionary language or is immaterial; or (2) plaintiff has not proven that the statements were made with actual knowledge that they were false or misleading. *Id.*¹⁴ Thus, even if a plaintiff can allege and prove that the statements were made

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15 U.S.C. § 78u-5(i)(1); *see also In re Splash Tech. Holdings, Inc.*, 160 F. Supp. 2d 1059, 1067 (N.D. Cal. 2001) (defining forward-looking statement as “a statement containing a projection of revenues, income, or earnings per share, management’s plans or objectives for future operations, and a prediction of future economic performance”). “[C]ertain categories of statements are ineligible for protection under the safe-harbor provision, including: (1) statements made in connection with a roll-up transaction; (2) statements contained in a registration statement or otherwise issued by an investment company; (3) statements made in connection with an initial public offering; and (4) financial statements prepared in accordance with generally accepted accounting principles.” *In re Unicapital Corp. Sec. Litig.*, 149 F. Supp. 2d 1353, 1373 (S.D. Fla. 2001) (citing 15 U.S.C. §§ 78u-5(b)(1)(D), 78u-5(b)(2)(A),(B),(D)). However, the judicially created “bespeaks caution” doctrine, outlined below, may still apply to those categories of statements. *In re Ins. Mgmt. Solutions Group, Inc.*, No. 00-CV-2013-T-26MAP, 2001 U.S. Dist. LEXIS 9962, at *30 (M.D. Fla. July 11, 2001) (applying the “bespeaks caution” doctrine to initial public offerings).

¹⁴ In one recent case a court rejected a defendant’s argument that its challenged statements were projections and thus entitled to safe harbor protection because, the court found, “knowingly false predictive statements are not protected,” and to find that defendants’ statements were protected and dismiss a complaint where “[t]he very crux of Plaintiff’s allegations are that Defendants made misleading statements knowing they were misleading” would be “premature.” *In re Applied Micro Circuits Corp. Sec. Litig.*, 2002 U.S. Dist. LEXIS 22403, at *26-27 (N.D. Cal. Oct. 4, 2002).

with the requisite scienter,¹⁵ the defendant has the protection of the safe harbor if the requirements of the first prong are satisfied. *Id.*

B. Disagreement Continues Regarding Which Statements Are Truly “Forward-Looking”

Courts agree that “the safe harbor provision does not protect statements that misrepresent historical/hard or current facts,” *Holmes v. Baker*, 166 F. Supp. 2d 1362, 1381 (S.D. Fla. 2001) (internal citations omitted); *see also In re Secure Computing Corp.*, 184 F. Supp. 2d 980, 990 (N.D. Cal. 2001) (holding that statements of current business conditions do not fall under the safe harbor); *Manavazian v. Atec Group, Inc.*, 160 F. Supp. 2d 468, 481 (E.D.N.Y. 2001) (noting that the safe harbor does not apply to misrepresentations of existing facts); *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Co.*, 320 F.3d 920, 937 (9th Cir. 2003) (statements for which defendants sought safe harbor protection were not forward-looking because they concerned a fine imposed for *past* violations of FAA regulations and the *present* effect of those fines on the company; noting, “[i]f we allow America West to shield itself from liability based on these statements, any corporation could shield itself from future exposure for past misconduct by making present-tense statements regarding the misconduct and its effects on the corporation. Such blanket protection would eviscerate the 1934 Act altogether”).

Not all courts agree, however, on what statements are protected by the statute.¹⁶ Some courts have precluded defendants from invoking the safe harbor where “the statements depict, in

¹⁵ In *In re Sun Healthcare Group, Inc. Sec. Litig.*, the court defined “actual knowledge” as “a higher level of scienter than the ‘recklessness’ required by the pleading standards of the PSLRA.” 181 F. Supp. 2d 1283, 1289 (D.N.M. 2002); *see also Lipton v. Pathogenesis Corp. Sec. Litig.*, 284 F.3d 1027, 1039 n.18 (9th Cir. 2002) (noting in dicta the stricter standard of “actual knowledge of falsity” required to avoid safe harbor); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 409 (5th Cir. 2001) (noting plaintiff must demonstrate that statements were made with actual knowledge that the statements were false or misleading at the time they were made). Plaintiffs must plead “in great detail, all the facts forming the basis for their belief that defendants made the forward-looking statements with actual knowledge that they were false.” *In re Splash Tech. Holdings, Inc.*, 160 F. Supp. 2d 1059, 1069 (N.D. Cal. 2001) (internal quotations omitted).

¹⁶ It should be noted that many recent cases find that a “present-tense statement can qualify as a forward-looking statement as long as the truth or falsity of the statement cannot be discerned until some point in time after the statement is made.” *Amylin Pharms.*, 2002 U.S. Dist. LEXIS, at *23 (citing *Harris v. Ivax Corp.*, 182 F.3d 799, 805 (11th Cir. 1999)); *see also In re Noven Pharmaceuticals, Inc., Sec. Litig.*, 238 F. Supp. 2d 1315, 1320 (S.D. Fla. 2002) (statements contained in SEC filings were covered by safe harbor provisions “because they relate to Defendants’ plans, expectations, and optimism concerning the implementation and success” of a signed agreement with a licensor); *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371, 440-41 (S.D.N.Y. 2001); *In re Federal-Mogul Corp. Sec. Litig.*, 166 F. Supp. 2d 559, 565 (E.D. Mich. 2001) (finding unpersuasive the grammatical argument that a present-tense statement cannot predict the future); *compare In re Harmonic, Inc. Sec. Litig.*,

part, the [c]ompany's past and current performance." *In re Lucent Tech., Inc. Sec. Litig.*, 217 F. Supp. 2d 529, 557 (D.N.J. 2002). Others have noted that "in assessing whether statements are subject to the forward-looking safe harbor provision, a line or paragraph referenced in a complaint must be viewed in the context in which it was made, rather than standing alone," and that "if a review of the entire statement, as opposed to an isolated line or two, reveals that it is a mixed statement (*i.e.*, it contains historical observations and prognostications based upon those observations), the entire statement qualifies as forward-looking for the purposes of the PSLRA's safe harbor provision." *In re Smith-Gardner Sec. Litig.*, 214 F. Supp. 2d 1291, 1305-06 (S.D. Fla. 2002) (citations omitted); *In re The Clorox Co. Sec. Litig.*, 238 F. Supp. 2d 1139, 1145 (N.D. Cal. 2002) ("Although her statement was based on existing knowledge, it was quite clearly a prediction of future events."); *but see In re Penn Treaty Am. Corp.*, 202 F. Supp. 2d 383, 393 (E.D. Pa. 2002) (finding first sentence of paragraph severable from other sentences in paragraph that were forward-looking).

In contrast, the court in *In re Independent Energy Holdings PLC*, 154 F. Supp. 2d 741 (S.D.N.Y. 2001), stated that "[i]t is well recognized that even when an allegedly false statement has both a forward-looking aspect and an aspect that encompasses a representation of present fact, the safe harbor does not apply." *Id.* at 557 (citations omitted); *see also In re Scientific-Atlanta, Inc. Sec. Litig.*, 239 F. Supp. 2d 1351, 1362 (N.D. Ga. 2003) (rejecting safe harbor defense where "the Complaint refers to misrepresentations of or omissions of historical fact as well as forward-looking statements . . . [and] avers that Defendants had actual knowledge of the falsity of these statements at the time they were made"); *Argent Classic Convertible Arbitrage Fund, L.P. v. Amazon.com, Inc.*, No. C01-0640L, slip. op. at 4 (W.D. Wash. Jan. 6, 2003) ("statements and omissions regarding the nature of the revenues its strategic partners were contractually obligated to pay in the future are not 'forward-looking statements' subject to the 'safe harbor' provided in" the PSLRA). Similarly, the court in *In re U.S. Interactive Securities Litigation*, NO. 01-CV-522, 2002 U.S. Dist. LEXIS, at *55 n.11 (E.D. Pa. Aug. 23, 2002), noted that the defendants could not "convert a larger statement containing a series of misstatements about current factual conditions into one forward-looking statement simply by including one statement that is clearly forward-looking. A larger statement can be divided into component parts and analyzed." *Id.*¹⁷ The court then noted which statements the safe harbor protected within the larger statement. *Id.*

Even fairly similar reports may be treated differently based on their context and presentation. For example, the court in *In re Campbell Soup Co. Securities Litigation*, 145 F. Supp. 2d 574, 590 (D. N.J. 2001), held that defendants' earnings statements were represented as historical facts, not projections of revenue. Although noting that earnings reports are "relevant in predicting what future earnings might be," that did not make earnings reports forward-looking. *Id.* (citations omitted). By contrast, the court in *In re SI Corp. Securities Litigation*, 173 F.

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163 F. Supp. 2d 1079, 1087 n.6 (N.D. Cal. 2001) ("Statements concerning . . . present facts are not forward-looking.").

¹⁷ *See also In re Viropharma, Inc. Sec. Litig.*, 2003 WL 1824914, at *7 (E.D. Pa., Apr. 7, 2003) ("Simply because material misrepresentations appear in the same document as a forward-looking statement does not make the statements of fact eligible for the safe harbor.").

Supp. 2d 1334 (N.D. Ga. 2001), found that statements regarding recurring revenue were forward-looking when analyzed in context, because the preceding sentence discussed “executing the company’s vision through four primary objectives.” *Id.* at 1357.

C. The Requirements For Establishing “Meaningful Cautionary Statements” Are Not Uniform

The extent to which cautionary statements must predict the actual harm that occurs is also unclear from the cases. Some courts have noted that to be a “meaningful” cautionary statement, the “statement did not have to mention explicitly the factor which proved the projection inaccurate,” *In re Nike, Inc. Sec. Litig.*, 181 F. Supp. 2d 1160, 1172 (D. Or. 2002) (citing *Harris*, 182 F.3d at 807), but was sufficient as long as “the stated and actual risks have similar significance.” *Id.* While noting that “[p]redictions of future performance are inevitably inaccurate because things almost never go as planned,” the court in *Lindelow v. Hill* held that “[t]o be effective, cautionary language must be substantive and tailored to the specific future projections, estimates or opinions . . . which the plaintiffs challenge.” No. 00 C 3727, 2001 U.S. Dist. LEXIS 10301, at *13-14 (N.D. Ill. 2001) (citations omitted). In *Unicapital*, the court held that “there needs to be some correlation between the disclaimer and the subsequent events.” 149 F. Supp. 2d at 1374. “[T]he warning need not explicitly describe the particular happenings that ultimately come to pass, but it must be sufficient to put a reasonable investor on notice of the potential that something similar to those happenings could occur.”¹⁸ *Id.* at 1375.

Courts also disagree about the status of boilerplate language. The *Lindelow* court noted that “[v]ague or boilerplate disclaimers advising that a particular investment has risks generally will not suffice.” 2001 U.S. Dist. LEXIS 10301, at *16 (citations omitted). However, in *Smith-Gardner*, 214 F. Supp. 2d at 1306-07, the court found that although the warnings issued were “little more than generic, boilerplate language,” they nevertheless met the requirement of “meaningful cautionary language.” *Id.* Other courts have found that boilerplate language is inadequate both because it is not “sufficiently meaningful,” in that it fails to warn investors of specific potential problems, and because “individuals commonly ignore boilerplate warnings.” *Amylin Pharms.*, 2002 U.S. Dist. LEXIS 19481, at *26-27.

A few courts have been relatively strong in finding that “meaningful cautionary language” was communicated to investors. In *In re Pacific Gateway Exchange, Inc., Securities Litigation.*, No. C-00-211 PJH, 2002 WL 851066 (N.D. Cal. Apr. 30, 2002), the court found the company’s disclosures not only sufficient, but powerful: “a reasonable investor who read the

¹⁸ At least one court has held that to be effective, cautionary statements must appear in the same document or occur on the same occasion as the forward-looking statements. See *Apple Computer, Inc. Sec. Litig.*, 243 F. Supp. 2d 1012, 1025 (N.D. Cal. 2002). In *Apple*, the court held that defendants could not rely on cautionary statements made in its 10-K and 10-Q to trigger safe harbor protection for statements not appearing in those filings. The court held that “[t]he making of a cautionary statement on one occasion does not provide a shield to liability for all statements subsequently made.” *Id.* The cautionary language must accompany or be contained in the forward-looking statement that is the basis of the plaintiff’s claim. See *id.*

1998 10-K . . . could well have considered it a toss-up whether to invest the money in PGEX or invest it at the racetrack.” *Id.* at *11.

Finally, although most courts seem to agree that a defendant may qualify for the protection of the safe harbor defense under only one prong, one court noted in dicta that “[w]arnings of detriment are insufficient if they are simply a smoke screen to cover a company’s internal reasonably informed certainty of detriment.” *Rombach v. Chang*, No. 00 CV 0958 (SJ), 2002 U.S. Dist. LEXIS 15754, at *39 (E.D.N.Y. June 7, 2002) (citations omitted). This statement implies that a defendant is precluded from relying on the first prong of the safe harbor defense if there is evidence that the forward-looking statements were made with scienter.

D. Not All Courts Agree On The Required Connection Between Oral Statements And Their Accompanying Cautionary Statements

The safe harbor also applies to oral forward-looking statements if they are accompanied by a cautionary statement warning that the particular oral statement is forward-looking and that the actual results might differ materially from those projected, and that the information about the risks is contained in a readily available written document. 15 U.S.C. § 78u-5(c)(2).

Courts differ over whether the cautionary language must be paired with the particular oral forward-looking statement. The literal language of the safe harbor provision supports the argument that cautionary language must be paired with the “particular” oral statement. 15 U.S.C. § 78u-5(c)(2). Some courts have so held. *See, e.g., In re Honeywell Int’l, Inc. Sec. Litig.*, 182 F. Supp. 2d 414, 427 (D.N.J. 2002) (each particular oral statement must be identified as forward-looking); *ATI Techs.*, 216 F. Supp. 2d at 443 n.18. Others, however, have held that the legislative history and “absurdity of requiring a company to identify every forward-looking statement as such every time one is made” support the rule that a “cautionary warning at the beginning of a conference call is sufficient.” *Coble*, 2002 U.S. Dist. LEXIS 17495, at *28 (citing *Wenger v. Lumisys*, 2 F. Supp. 2d 1231, 1242 (N.D. Cal. 1998)).

With regard to oral forward-looking statements, corporate officials may refer listeners to written documents containing meaningful cautionary language, as long as they specifically identify the document. *See ATI Techs.*, 216 F. Supp. 2d at 443 (citing 15 U.S.C. § 78u-5(c)); *see also In re Sprint Corp. Sec. Litig.*, No. 01-4080-CM, 2002 U.S. Dist. LEXIS 19275, at *39 (D. Kan. Sept. 30, 2002) (admitting press release as cautionary statement incorporated by reference to oral statement). However, in *In re Humphrey Hospitality Trust, Inc.*, 219 F. Supp. 2d 675, 684 (D. Md. 2002), where a press release’s warning incorporated its “filings with the SEC,” the court held that “SEC filings incorporated by reference are adequate to invoke the Safe Harbor provision for forward-looking statements,” even though the specific filing was not identified.

E. The “Bespeaks Caution” Doctrine Has Continued Vitality

Along with the safe harbor, courts often consider the judicially created “bespeaks caution” doctrine which states that liability may not be imposed based on statements that, considered in their entirety, clearly “bespeak caution,” rather than encourage optimism. *See In re Towne Servs., Inc.*, 184 F. Supp. 2d 1308, 1321 (N.D. Ga. 2001); *Amylin Pharms.*, 2002 U.S. Dist. LEXIS 19481, at *27-28; *see also In re Nortel Networks Corp. Sec. Lit.*, 238 F. Supp. 2d 613, 629 (S.D.N.Y. 2003) (examining “bespeaks caution” doctrine in conjunction with safe harbor provision); *In re Scientific-Atlanta, Inc. Sec. Lit.* 239 F. Supp. 2d 1351, 1361 (N.D. Ga.

2002) (“bespeaks caution” doctrine is the safe harbor’s counterpart”); *In re Enron Corp. Sec. Derivative & ERISA Lit.*, 235 F. Supp. 2d 549, 576 (S.D. Tex. 2002) (describing “bespeaks caution” doctrine as “judicially created equivalent to the PLSRA’s ‘safe harbor’ provision”); *In re Xerox Corp. Sec. Litig.*, 165 F. Supp. 2d 208, 219 (D. Conn. 2001) (comparing the “bespeaks caution” doctrine to PSLRA’s safe harbor). Courts also find that there is no liability for statements that are too optimistic. Statements that are classified as “corporate optimism” or “mere puffing” are often forward-looking, but these vague, “generalized statements of optimism that are not capable of objective verification” are not actionable because “reasonable investors do not rely on them in making investment decisions,” and they are, therefore, not material. *In re SI Corp.*, 173 F. Supp. 2d at 1350-51 (defining “corporate optimism” and “mere puffing”); *see also In re MCI Worldcom, Inc. Sec. Litig.*, 191 F. Supp. 2d 778, 787 (S.D. Miss. 2002) (noting that there is no liability where statements constitute vague sales “puffery”).

V. RECENT DEVELOPMENTS IN PLEADING SCIENTER BASED UPON “INFORMATION AND BELIEF” AND THE ROLE OF “CONFIDENTIAL WITNESSES”

Under the PSLRA, a securities fraud complaint containing allegations based on information and belief “shall state with particularity all facts on which that belief is formed.” 15 U.S.C. § 78u-4(b)(1). Because the majority of securities fraud complaints contain allegations purportedly based on information provided to plaintiffs by unnamed “confidential witnesses,” courts since the enactment of the PSLRA have been faced with the question of how much detail identifying the sources of such allegations is required in the complaint to satisfy the PSLRA’s “all facts” requirement. Early in the post-PSLRA period, it appeared that two distinct judicial views would develop: the first requiring that plaintiffs identify their sources by name in the complaint, and the second requiring only that the complaint contain adequate identifying detail about the confidential source to allow the court to assess the reliability of the allegations learned from that source. Recent cases, however, reveal a trend toward the second view, and most courts today will not dismiss a complaint for failure to name plaintiffs’ confidential sources.¹⁹

¹⁹ Another issue arises when a complaint includes allegations referencing one or more confidential witnesses who may be current or former company officers or directors. In that instance, it is important to consider the “insured vs. insured” coverage limitation in the company’s director and officer (“D&O”) liability insurance policy. D&O policies typically contain a coverage exclusion for damages arising from lawsuits brought by or with the assistance or solicitation of current or former directors or officers of the insured. The purpose of insured vs. insured exclusions is to prevent collusive suits. *See Fidelity and Deposit Co. of Md. v. Zandstra*, 756 F. Supp. 429, 431 (N.D. Cal. Feb. 8, 1990). Courts construing this exclusion generally perform an analysis of the plain-meaning of the language of the insurance policy to determine whether the exclusion applies. *See, e.g., Level 3 Communications, Inc. v. Fed. Ins. Co.*, 168 F.3d 956 (7th Cir. 1999); *In re County Seat Stores, Inc. v. Nat’l Union Fire Ins. Co.*, 280 B.R. 319 (S.D.N.Y. 2002). Courts require exclusionary clauses to be phrased in clear and unmistakable language; such clauses are then construed strictly against the insurer. *See In re County Seat Stores*, 280 B.R. at 324; *Zandstra*, 756 F. Supp. at 431. Nevertheless, where a current or former director or officer

First Circuit. In *In re Cabletron Systems, Inc.*, 311 F.3d 11, 22-23 (1st Cir. 2002), securities fraud plaintiffs alleged that “unnamed former Cabletron employees . . . said to have personal knowledge” of fraud at the company, provided plaintiffs with “detail[ed],” “self-verifying” and “consistent accounts” of such fraud. Reviewing the district court’s dismissal of these allegations on the grounds that plaintiffs’ descriptions of confidential sources were inadequate to satisfy the PSLRA’s “all facts” requirement, the court of appeals reversed, rejecting the “per se” test requiring the naming of confidential sources expressed in *In re Silicon Graphics, Inc., Securities Litigation*, 183 F.3d 970, 985 (9th Cir. 1999), and adopting the “more moderate view” expressed in *Novak v. Kasaks*, 216 F.3d 300, 313-24 (2d Cir. 2000). *Id.* at 22, 28-31. According to the court, the *Novak* view, which requires “an evaluation, *inter alia*, of the level of detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia, . . . better strikes the balance Congress intended in the PSLRA.” *Id.* at 30. Evaluated by this standard, the court of appeals found that plaintiffs’ allegations “satisfy the test.” *Id.*

Second Circuit. In 2000, the Second Circuit unambiguously and directly answered with a resounding “no” the question of whether plaintiffs were required to name their sources in their complaint. In *Novak*, 216 F.3d at 313-24, the Second Circuit held that “where plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants’ statements were false. Moreover, even if personal sources must be identified, there is no requirement that they be named, provided they are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.” *See also In re Xerox Corp. Sec. Litig.*, 165 F. Supp. 2d 208, 223 (D. Conn. 2001) (upholding allegations based on unnamed confidential sources and quoting *Novak* for proposition that there is no requirement for complaints in securities fraud cases to name confidential sources); *In re Initial Public Offering Sec. Litig.*, 241 F. Supp. 2d 281, 358-59 (S.D.N.Y. 2003) (when there are “many confidential sources who all say the same thing” and such sources are corroborated by media reports, admissions by insiders, and intensive investigations by both state and federal agencies, the cumulative effect of the evidence is important; in such a case, “the sheer volume of the corroboration obviates the need for absolute particularity”).

Third Circuit. The Third Circuit “has never addressed [the] question of whether the PSLRA’s specific pleading requirements now require disclosure of the names of any personal sources of fact.” *ATI Techs.*, 216 F. Supp. 2d at 432. Relying on the *Novak* rule from the Second Circuit, the district court in *ATI Technologies* recently upheld plaintiffs’ “reliance on unnamed former employees of ATI [identified by job title and geographical location] as sources of information,” finding that a “complaint to be particularized need not necessarily reveal the names of anonymous sources of fact” and rejecting a “literal reading” of the PSLRA’s “all facts”

[Footnote continued from previous page]

sues an insured, a court may find that the exclusion is triggered. *See Amer. Med. Int’l, Inc. v. Nat’l Union Fire Ins. Co. of Pittsburgh*, 244 F.3d 715, 722-23 (9th Cir. 2001) (insured vs. insured exclusion triggered where a former director sued the insured company for losses sustained in his capacity as an unsuccessful bidder for the corporation).

requirement as “rigidly produc[tive of] ‘illogical results.’” *Id.* at 432-33 (quoting *Novak*, 216 F.3d at 314 n.1).

In *Tracinda Corp. v. DaimlerChrysler AG*, 197 F. Supp. 2d 42, 78 (D. Del. 2002), the district court rejected allegations of fraud based on “statements from former Chrysler Corporation and former DaimlerChrysler executives, employees, suppliers and dealers” Citing *Silicon Graphics*, 183 F.3d at 985, the court found that this pleading of sources – which had gone so far as to identify one such source as “a large Northeastern dealer” – was insufficient in light of the absence of a name or other pleaded facts “identifying the source from which such allegations originate.” *Id.* In other words, in the Court’s view, “Class Plaintiffs have not adequately and consistently linked their sources of information to their allegations or identified the information from their sources that supports their allegations.” *Id.* at 78-79.

Fifth Circuit. In *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 354 (5th Cir. 2002), the Fifth Circuit recently rejected the “strict *per se* rule” from *Silicon Graphics* “requiring the pleading of the names of confidential sources” as “too onerous.” In adopting the *Novak* approach, the court of appeal considered sufficiently pled an allegation that “a high ranking Alcatel SEL official” who was “a top executive of Alcatel SEL” had a conversation with a named Alcatel executive: “[t]his executive, and his conversation with Dunoge, is described with sufficient particularity to support the probability that a person in such a position would possess the information pleaded and that, to the extent that it is necessary, construing the allegations in the light most favorable to Plaintiffs, this executive was himself Plaintiffs’ source for this information.” *Id.* at 357.

Seventh Circuit. The Seventh Circuit has not addressed the question whether the PSLRA requires the pleading of the names of confidential sources. However, in a recent district court decision, *Riggs Partners, LLC v. Hub Group, Inc.*, No. 02-C-1188, 2002 WL 31415721, at *7 (N.D. Ill. Oct. 25, 2002), the court dismissed “vague allegations regarding management’s knowledge of improprieties” and conclusory allegations that management was “specifically aware” of accounting problems, the source of which was described in the complaint only as “a former Hub Group employee.” In concluding that plaintiffs had failed adequately to allege scienter under the PSLRA based on these allegations, the court noted that “[a]lthough plaintiffs are entitled to plead upon information and belief, the court is troubled by plaintiffs’ failure to identify the source of this allegation, as well as others, with greater particularity.” *Id.* at *7 and n.10 (citing *Novak*, 216 F.3d at 314).

Ninth Circuit. In *In re Silicon Graphics, Inc., Securities Litigation*, 183 F.3d 970, 985 (9th Cir. 1999), the Ninth Circuit suggested that, when pleading on information and belief, plaintiffs are required to name their confidential witness sources in the complaint. Recently, however, several district courts in the Ninth Circuit have hesitated to require plaintiffs to “name names” in the complaint. One case interpreting the *Silicon Graphics* rule in light of the Second Circuit’s decision in *Novak* was *In re McKesson HBOC, Inc. Securities Litigation*, 126 F. Supp. 2d 1248 (N.D. Cal. 2000). In *McKesson*, the court concluded that the two cases were not inconsistent, noting that *Silicon Graphics* did not address squarely the question whether sources must be identified by name, and found the reasoning in *Novak* directly on point. *Id.* at 1271. Following *Novak*, the court declined to require plaintiffs to name their sources of information

and belief allegations, finding that plaintiffs' pleading, which identified their sources by job title and linked each identified source to the allegations derived therefrom, was sufficient to satisfy the PSLRA.²⁰ *Id.* at 1254-56, 1271-72.

More recently, in *In re Northpoint Communications Group, Inc. Securities Litigation*, 221 F. Supp. 2d 1090, 1097 (N.D. Cal. 2002), the court paraphrased the *Novak* rule without citing the case to hold that “[t]o contribute meaningfully toward a ‘strong inference’ of scienter, . . . allegations attributed to unnamed sources must be accompanied by enough particularized detail to support a reasonable conviction in the informant’s basis of knowledge.” Based on this rule, the court rejected as insufficiently particular descriptions of unidentified former employee witnesses that were (i) limited to job title, (ii) failed to offer “adequate indications as to their duties while in Northpoint’s employ,” (iii) “fail[ed] to identify how the witness came to learn of the information attributed to him or her,” and (iv) failed to identify “whether the witness learned of the underlying facts firsthand or secondhand.” *Id.* at 1097-98; *see also In re Adaptive Broadband Sec. Litig.*, No. C-01-1092SC, 2002 WL 989478, at *11 (N.D. Cal. Apr. 2, 2002) (“The failure to name sources may reduce the weight to be allocated to their testimony when evaluating the complaint’s ability to meet the strict requirements for pleading scienter, . . . [b]ut the failure to name sources will not doom an otherwise well-pled securities complaint. . . . Plaintiffs’ Complaint would be more credible if their sources were named, . . . [b]ut their refusal to provide this detail is not fatal. . . . [T]he Court finds that the failure to name [sources] is more than compensated for by the fact that the witnesses are long-term employees whose positions are described in detail.”) (citations omitted).

A recent unpublished district court opinion cites to both *Northpoint* and *Adaptive Broadband* and follows the *Novak* trend. *See In re Versata, Inc. Sec. Litig.*, No. C 01-1439, slip op. at 16 (N.D. Cal. May 20, 2002) (order granting in part motion to dismiss and granting leave to amend). The *Versata* court implicitly rejected the “name names” requirement by instead holding that the plaintiffs “must reveal all facts about that witness that were material to the formation of their belief that the witness’ statement is accurate.” *Id.* Noting that “only the witness’ job title was provided,” the court rejected confidential witness statements referring to allegedly fraudulent accounting practices. *Id.* “At the least, plaintiffs must describe the witnesses’ period of employment, what the witnesses’ duties were, their accounting expertise, and how they had access to the information being provided.” *Id.*; *see also Apple Computer, Inc. Sec. Litig.*, 243 F. Supp. 2d 1012, 1027 (N.D. Cal. 2002) (“a job title by itself will seldom provide an adequate description of the [confidential witness’] basis for his or her knowledge”); *In re Harmonic Inc. Sec. Litig.*, 2002 WL 31974384, at *16 & n.14 (N.D. Cal. Nov. 13, 2002) (rejecting allegations based on “confidential witnesses” where plaintiffs “do not provide

²⁰ At least one court has rejected a defendant’s attempt, in a Rule 12(b)(6) motion to dismiss, to rebut a plaintiff’s citation to confidential witnesses by offering declarations of its employees which challenge or deny the information supposedly learned from such witnesses. *See In re Applied Micro Circuits Corp. Sec. Litig.*, 2002 U.S. Dist. LEXIS 22403, at *9-11 (S.D. Cal. Oct. 4, 2002) (declarations of employees which were not referenced in nor relied upon in the complaint, and which were not in existence at the time the complaint was filed, are not incorporated by reference in the complaint and cannot form basis of motion to dismiss).

sufficient details about CW#1 to enable the court to determine whether the information from this unidentified former employee should be considered reliable”).

Tenth Circuit. Like the Third and Seventh Circuits, the Tenth Circuit has not addressed the question of whether the PSLRA requires that confidential sources be named. In a recent district court opinion, however, the court noted that in the absence of guidance from the Tenth Circuit, which “has not found that confidential sources need to be named in a securities fraud case,” it would adopt the *Novak* approach. See *Anderson v. First Sec. Corp.*, 157 F. Supp. 2d 1230, 1240 (D. Utah 2001).

Eleventh Circuit. The Eleventh Circuit has not explicitly ruled on this issue. However, district courts within the Eleventh Circuit have followed the *Novak* approach. See, e.g., *In re PSS World Med., Inc., Sec. Litig.*, 2002 WL 31261292, at *9, *11 (M.D. Fla. July 2, 2002) (pursuant to *Novak* rule, confidential sources described as “formerly holding a variety of positions within the [defendant] company, including [a list of specific job titles],” all of whom told plaintiffs that defendants “‘cooked the books,’” was sufficient to plead fraud under the PSLRA); cf. *In re Smith-Gardner*, 214 F. Supp. 2d at 1300-01 (even under *Novak* standard, plaintiffs’ reliance on “unidentified former employees,” particularly a “bare bones claim that this former employee” was involved in the installation of the software product in issue without further supporting details, did not “support the probability that a person in that position would possess the information alleged”).

VI. RECENT DEVELOPMENTS UNDER THE UNIFORM STANDARDS ACT OF 1998

A. Background Of SLUSA

After Congress passed the PSLRA, the plaintiffs’ bar attempted to avoid its pleading requirements by filing “‘frivolous and speculative lawsuits in State court where essentially none of the [PSLRA’s] procedural or substantive protections against abusive suits are available.’” *Bertram v. Terayon Communications Sys.*, No. CV00-12653, 2001 U.S. Dist. LEXIS 6215, at *3 (C.D. Cal. Mar. 27, 2001) (quoting H.R. Conf. Rep. No. 105-803, at 14-15 (1998)); see also *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1340 (11th Cir.), cert. denied, 123 S. Ct. 395 (2002). Congress passed the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”), 15 U.S.C. § 77p, in an attempt to restrict plaintiffs’ use of state courts to frustrate the objectives of the PSLRA. SLUSA establishes, through the federal courts, national standards for securities cases involving nationally-traded securities. See *Patenaude v. Equitable Life Assurance Soc’y of the United States*, 290 F.3d 1020, 1025, 1029 (9th Cir. 2002) (“SLUSA mandate[s] that federal court be ‘the exclusive venue for class actions alleging fraud in the sale of certain covered securities,’ and that ‘such class actions be governed exclusively by federal law’”) (citations omitted). In addition, SLUSA provides for the removal to federal court of certain class actions brought in state court, and requires immediate dismissal of “covered lawsuits.” See *Riley*, 292 F.3d at 1341.²¹

²¹ SLUSA provides, in pertinent part:

(b) Class action limitations.

B. Requirements For Removal Pursuant To SLUSA

A party seeking to remove an action to federal court pursuant to SLUSA bears the burden of showing that: (1) the suit is a “covered class action”; (2) the plaintiff’s claims are based on state law; (3) a “covered security” has been purchased or sold; (4) the defendant misrepresented or omitted a material fact or employed a manipulative or deceptive device or contrivance; and (5) which misrepresentation or omission was “in connection with” the purchase or sale of the covered security. *See Riley*, 292 F.3d at 1342. In addition, SLUSA has been held to apply retroactively to cover pre-enactment conduct. *See W.R. Huff Asset Mgmt. Co., Inc. v. Kohlberg Kravis Roberts & Co., L.P.*, 234 F. Supp. 2d 1218, 1224 (N.D. Ala. 2002) (retroactive application of SLUSA “does not impair [plaintiff’s] substantive rights to pursue its causes of action against Defendants” in the federal, rather than state, forum); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, H-02-1150, MDL-1446, Slip. Op. at 19 (S.D. Tex. Aug. 16, 2002) (“Because the court fails to find unambiguous intent of Congress that this statute may be applied to a post-enactment lawsuit challenging pre-enactment conduct, the Court . . . inquires whether SLUSA ‘would impair rights a party possessed when he acted, increase a party’s liability for past conduct, or impose new duties with respect to transactions already completed.’ . . . After considering the issue, this Court concludes that application of SLUSA to this suit is not impermissibly retroactive.”).

The following discussion summarizes recent case law that has developed around each of the requirements for removal under SLUSA.²²

[Footnote continued from previous page]

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging-- (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

(c) Removal of covered class actions.

Any covered class action brought in any State court involving a covered security, as set forth in subsection (b), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to subsection (b).

15 U.S.C. § 77p; *see also id.* § 78bb(f)(1)-(2).

²² The second element – that the plaintiff’s claim be based upon state law – is not addressed separately in this article, as it engenders little substantive discussion in the caselaw. Plaintiffs, having brought their action in state court, have alleged a violation of a state securities law or other statute; defendants, in removing cases to federal court, routinely argue that these state claims are really federal securities fraud claims dressed or disguised as state law claims.

1. Covered Class Action

In a number of cases, the question of proper removal under SLUSA centers on whether or not plaintiff's action is a "covered class action." Generally speaking, a "covered class action" under SLUSA is one "in which one or more named parties seek to recover damages on a representative basis." *See Bertram*, 2001 U.S. Dist. LEXIS 6215, at *5; 15 U.S.C. § 77p(f)(2); 15 U.S.C. § 78bb(f)(5)(B)(i).

Plaintiffs frequently have argued that when a complaint seeks only restitution, disgorgement, or injunctive relief under state law, no "damages" are being sought, as required by SLUSA, therefore the case should be remanded to state court. *See, e.g., Feitelberg v. Merrill Lynch & Co.*, 234 F. Supp. 2d 1043, 1048-49 (N.D. Cal. 2002) (appeal pending). SLUSA does not define the word "damages," but courts have looked to case law and the legislative history of the statute to determine that the term should be interpreted broadly. Many courts have expressly rejected the theory that restitution and disgorgement are not "damages" for the purposes of removal under SLUSA. *See id.* at 1048; *see also Bertram*, 2001 WL 514358, at *2 (complaint seeking only equitable relief could be considered a covered class action); *Gibson v. PS Group Holdings Inc.*, No. 00-CV-0372, 2000 WL 777818, at *3-4 (S.D. Cal. June 14, 2000) (granting remand on other grounds but rejecting argument that seeking only equitable relief removes complaint from scope of SLUSA); *Patenaude v. Equitable Life Assurance Soc'y of the United States.*, No. 00CV-1437, 2000 U.S. Dist. LEXIS 22251, at *14 (S.D. Cal. Oct. 11, 2000) ("Plaintiff provides no authority for his argument that disgorgement of profits is not 'damages' under 15 U.S.C. § 77(p)(f)(2); such a narrow reading defies common sense."), *aff'd*, 290 F.3d 1020 (9th Cir. 2002).

Where a complaint seeks only declaratory and injunctive relief, however, not disgorgement or restitution, the underlying state action is not a "covered class action" under SLUSA. *See Wald v. CM Life Ins. Co.* No. 00-CV-2520-H, 2001 WL 256179, at *6 (N.D. Tex. Mar. 8, 2001).

2. Covered Securities

SLUSA incorporates the definition of "covered security" found in the National Securities Markets Improvement Act of 1996. *See Falkowski v. Imation Corp.*, 309 F.3d 1123, 1128-29 (9th Cir. 2002). Essentially, "covered securities" are those that are listed or authorized for listing on a national securities exchange, or are issued by investment companies registered under the Investment Company Act of 1940. *Id.*; *see also Gray v. Seaboard Sec., Inc.*, 241 F. Supp. 2d 213, 219 (N.D.N.Y. 2003) (securities traded on major exchanges are "covered"; upholding SLUSA preemption). Only actions pertaining to the purchase or sale of securities defined as "covered securities" are preempted by SLUSA.²³

²³ Courts have determined that a variety of investment products beyond traditional equities are "covered securities" under SLUSA. *See, e.g., Falkowski*, 2002 WL 31415487, at *3 (options to purchase securities are not "covered securities" but corporation's securities are, therefore SLUSA applies and removal was proper); *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 109 (2d Cir. 2001) (variable insurance products); *Herndon v. Equitable Variable*

3. Misrepresentation, Omission, Or Use Of A Deceptive Device

A greater number of cases have addressed whether or not a complaint sufficiently alleged a misrepresentation or omission of material fact or the use of a deceptive device to permit removal under SLUSA. There are two lines of cases regarding this element for removal; certain courts follow the scienter analysis articulated by the court in *Burns v. Prudential Securities*, 116 F. Supp. 2d 917, 921 (N.D. Ohio 2000), while other courts analyze the nature of the allegations in the complaint without reference to a scienter requirement.

In *Burns*, the court observed the similarity between the language of Section 10(b) of the 1934 Act and SLUSA, and noted that a complaint for a violation of Section 10(b) must allege that the defendant acted with scienter. *Id.* at 923. Therefore, the court concluded that SLUSA only preempts complaints that allege specific facts giving rise to a strong inference that the defendant acted with scienter. *Id.* Because the plaintiff in *Burns* only alleged a single instance of unauthorized trading, and did not allege facts that suggested an “element of deception” his complaint could not support a securities fraud claim, and therefore removal was improper. *Id.* at 926.²⁴

In *Burekovitch v. Hertz*, No. 01-CV-1277, 2001 WL 984942, at *5-*6 (E.D.N.Y. July 24, 2001), the court did not cite the *Burns* rationale, but simply held that a breach of fiduciary duty claim brought against a controlling shareholder was properly removed pursuant to SLUSA because the complaint alleged sufficient facts that defendant’s misleading statements regarding margin trading induced plaintiffs to buy stock at inflated prices. *Id.* at *6. Similarly, in *Korsinsky v. Salomon Smith Barney, Inc.*, No. 01 CIV 6085, 2002 WL 27775, at *4-5 (S.D.N.Y. Jan. 10, 2002), the court did not require that the complaint allege facts giving rise to an inference of scienter in order to satisfy this element of SLUSA. Instead, the court held that the element was satisfied where the complaint alleges a misrepresentation “concerning the value of securities . . . sold or the consideration received in return.” *Id.* at *4 (citations omitted).²⁵

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Life Ins. Co., 325 F.3d 1252 (11th Cir. 2003) (same); *Patenaude*, 290 F.3d at 1022 (tax-deferred variable annuities); *Kenneth Rothschild Trust v. Morgan Stanley Dean Witter*, 199 F. Supp. 2d 993, 1000 (C.D. Cal. 2002) (money market mutual fund shares purchased with funds deposited for later purchase of CDs).

²⁴ The following cases apply the *Burns* analysis and find that the complaints sufficiently alleged scienter to support removal under SLUSA: *Denton v. H&R Block Fin. Advisors, Inc.*, No. 01-C-4185, 2001 U.S. Dist. LEXIS 15831 (N.D. Ill. Oct. 4, 2001) (repeated allegations in complaint that defendants “intentionally, willfully, and wantonly” misrepresented riskiness of stock and commission structure over period of nine years); *Prager v. Knight/Trimark Group, Inc.*, 124 F. Supp. 2d 229, 234-35 (D.N.J. 2000) (complaint contained sufficient facts regarding a four-year period of false and misleading statements to give rise to a strong inference that defendant acted with intent to defraud).

²⁵ In the following cases, the court did not explicitly state whether a complaint must allege facts giving rise to an inference of scienter for removal under SLUSA to be proper, focusing instead on the facts alleged in the complaint itself. In *Feitelberg*, 234 F. Supp. 2d at 1051, the court observed that “[p]laintiff, in fact, makes allegations that smack of scienter

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4. “In Connection With” The Purchase Or Sale Of A Covered Security

Most reported decisions involving removal under SLUSA concern the final element – whether the alleged misrepresentations or omissions are “in connection with” the purchase or sale of a covered security. Though SLUSA does not define the phrase “in connection with” the purchase or sale of a covered security, but because its language tracks Section 10(b) of the 1934 Act, courts have referred to cases construing Section 10(b) to determine the meaning of “in connection with” in the context of SLUSA. *See Green v. Ameritrade, Inc.*, 279 F.3d 590, 597 (8th Cir. 2002). Last year, the U.S. Supreme Court issued its decision in *SEC v. Zandford*, 535 U.S. 813 (2002), in which the Court interpreted Section 10(b)’s “in connection with” requirement expansively. Although the case did not involve application of SLUSA, as will be discussed below, the Supreme Court’s liberal interpretation of the “in connection with” requirement is likely to have a significant impact on the interpretation of SLUSA, and, ironically, allow for more liberal use of SLUSA to remove cases to federal court.

Pre-Zandford Caselaw. Plaintiffs frequently argue that the alleged misconduct is not “in connection with” the purchase or sale of a security, but rather “incidental” to such purchase or sale. *See Behlen v. Merrill Lynch*, No. 01-16424, 2002 U.S. App. LEXIS 23253, at *5-6 (11th Cir. Nov. 8, 2002); *Dudek v. Prudential Sec., Inc.*, 295 F.3d 875, 879 (8th Cir. 2002) (gravamen of plaintiff’s complaint, despite lack of specific pleading, concerned “an untrue statement or substantive omission of a material fact in connection with the purchase or sale of a covered security”); *Rothschild*, 199 F.Supp 2d at 1003 (denying motion to remand where plaintiff alleged misrepresentations concerning the amount of return on an investment, a factor in evaluating the investment that “falls squarely within the definition of ‘in connection with’ the purchase or sale of securities”).

Until recently, courts differed on this element of removal under SLUSA. Certain courts found that a misrepresentation or omission of material fact was “in connection with” the purchase or sale of a security only if the misrepresented or omitted fact concerned the value of securities bought or sold, or the consideration received in return. *See, e.g., Araujo v. John Hancock Life Ins. Co.*, 206 F. Supp. 2d 377, 382 (E.D.N.Y. 2002); *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 01 CIV 3013, 2001 U.S. Dist. LEXIS 15943 (S.D.N.Y. Oct. 9, 2001) (removal was not proper under SLUSA where allegations were not sufficiently connected to the value of or consideration for covered securities). Other courts found the “in connection

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Consequently, plaintiff’s complaint contains sufficient inferences of behavior to fall within the realm of a ‘misrepresentation or omission of material fact’ . . . under SLUSA.” Similarly, in *Zoren v. Genesis Energy, L.P.*, 195 F. Supp. 2d 598, 603-04 (D. Del. 2002), the court observed that “[b]y voluntarily spelling out that [defendant’s conduct] included misrepresentation, fraud and deception in the sale of a covered security, [plaintiff] has placed himself squarely within the Act’s parameters.” In *MDCM Holdings, Inc. v. Credit Suisse First Boston Corp.*, 216 F. Supp. 2d 251, 257 (S.D.N.Y. 2002), the court did not address whether or not a plaintiff must allege facts giving rise to an inference of scienter, noting that removal of this case was not proper under SLUSA because plaintiffs had not made any allegations regarding misrepresentations or omissions at all, but rather had pled a straight state law breach of contract claim.

with” requirement met if the alleged statements affected the public’s interest in a corporation’s stock. *See, e.g., McCullagh v. Merrill Lynch & Co.*, No. 01 CIV 7322, 2002 WL 362774 (S.D. N.Y. Mar. 6, 2002) (denying motion to remand and dismissing complaint where allegedly fraudulent statements related to “buy” recommendations).

The Zandford Decision. The recent *Zandford* decision, which construed the “in connection with” requirement in the context of a Section 10(b) claim, has effectively settled this question in the context of SLUSA. In *SEC v. Zandford*, a unanimous Supreme Court reaffirmed the protections of the federal securities laws, holding that a stockbroker commits fraud “in connection with” the sale of securities under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 when he sells a customer’s securities for his own benefit and misappropriates the proceeds. At issue in *Zandford* was whether a stockbroker’s sale of securities from a joint investment account constituted fraud under the securities laws. The broker, who had been given discretion to manage the account and a general power of attorney to engage in securities transactions without prior investor approval, secretly sold securities from the client account and made personal use of the proceeds. *Id.* at 815-16.

The SEC filed a complaint against Zandford, alleging that he had violated Section 10(b) and Rule 10b-5 by engaging in a scheme to defraud the client by selling the client’s securities for his own benefit and by misappropriating the proceeds. *Zandford*, 535 U.S. at 816. Reversing the district court’s partial grant of summary judgment for the SEC, the Fourth Circuit ordered that the suit be dismissed – in favor of Zandford – on the ground that the SEC’s complaint did not allege fraud “in connection with” the sale of any security. *Id.* at 816-17. The Fourth Circuit reasoned that Zandford had not misled the client about the value of particular securities and that his fraud lay merely in “absconding with the proceeds” of the sale of their securities. The Fourth Circuit considered that such conduct did not amount to a federal securities violation. *Id.*

The Supreme Court reversed, rejecting the Fourth Circuit’s reasoning that to constitute a violation of Section 10(b), the misrepresentation must be related to the value of the security. *Zandford*, 535 U.S. at 819 (“[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act.”). The Court concluded that Zandford’s fraud occurred “in connection with” the sale of securities because the “securities sales and [Zandford’s] fraudulent practices were not independent events.” *Id.* at 820. According to the Court, to meet the “in connection with” element of a Section 10(b) violation, “[i]t is enough that the scheme to defraud and the sale of securities coincide.” *Id.* at 822.

Cases Following Zandford. Several courts have had the opportunity to apply the *Zandford* rationale in the context of actions removed to federal court pursuant to SLUSA.²⁶ In

²⁶ *See, e.g., Shaw v. Charles Schwab & Company*, 128 F. Supp. 2d 1270, 1274 (C.D. Cal. 2001) (pre-*Zandford*, granting remand and holding that the “in connection with” language of SLUSA should not necessarily be interpreted as broadly as the similar provision of Section 10(b) given the divergent purposes behind the two statutes), *dismissed after remand, Shaw v. Charles Schwab & Co.*, 2003 WL 1463842, at *4 (Cal. Ct. App. Mar. 7, 2003) (dismissing

Falkowski v. Imation Corp., 309 F.3d 1123, 1126-27 (9th Cir. 2002), former employees brought a class action in state court against defendant, their former employer, alleging breach of contract and fraud in connection with their employee stock options, and claiming that defendant misrepresented the value of its stock and options. Defendant removed the action to federal court on the basis that it was wholly preempted by SLUSA. *Id.* at 1127. The district court dismissed plaintiffs' claims and plaintiffs subsequently appealed. *Id.*

On appeal, plaintiffs argued that SLUSA did not bar their claims because the alleged misrepresentations were not "in connection with" the sale of securities. Applying *Zandford*, the court held that "the fraud is in connection with the securities transaction if it 'coincides' with the transaction" or is "more than tangentially related" to the securities in issue. *Falkowski*, 309 F.3d at 1130 (quoting *Zandford*, 535 U.S. at 825). Though certain of the alleged misrepresentations in *Falkowski* did relate to the value of the stock options, such a misrepresentation is sufficient but not necessary after *Zandford*. Accordingly, the Ninth Circuit affirmed. *Id.* at 1131.

Similarly, in *Feitelberg v. Merrill Lynch & Co.*, 234 F. Supp. 2d 1043, 1045 (N.D. Cal. 2002) (appeal pending), plaintiff brought suit in state court alleging that defendants issued deceptive purchase-and-sale advice in the form of stock ratings and analyst research reports for a group of publicly traded internet stocks. Defendants removed the action to federal court based on federal preemption under SLUSA, arguing that plaintiff's claims of fraud were "in connection with" the purchase or sale of securities, and plaintiff subsequently filed a motion to remand. *Id.* at 1044. Plaintiff argued that the focus of his complaint was on the company's internal operations rather than the purchase or sale of stock by shareholders, and thus the alleged wrongdoing was not "in connection with" the purchase or sale of securities as required by SLUSA. *Id.* at 1051. However, the court found that plaintiff's allegations attempted to establish that defendants "misrepresented the value of stock in order to further the interests of their investment banking division and that such misrepresentation affected the value of stock." *Id.* at 1052. Relying on *Zandford*, the court held that "[t]o satisfy the 'in connection with' element, a party must show that a security buyer or seller suffered an injury as a result of 'deceptive practices touching' its purchase or sale of securities, (citations omitted)" and that "'[i]t's enough that the scheme to defraud and the sale of securities coincide.'" *Id.* (quoting *Zandford*, 535 U.S. at 822). Accordingly, the court found that defendants' "scheme to defraud and the sale of securities coincide" and that "the alleged misfeasance clearly is 'in connection with' the sale of securities." *Id.* The court denied plaintiff's motion to remand and dismissed the complaint with leave to amend the complaint under federal securities law. *Id.* at 1053.

In *Araujo v. John Hancock Life Ins. Co.*, 206 F. Supp. 2d 377, 378-79 (E.D.N.Y. 2002), the Court cited *Zandford*, yet seemed to minimize the strong statement in *Zandford* that a misrepresentation as to the value of the security is not required to show a violation of Section 10(b) or, by extension, to support removal pursuant to SLUSA. In *Araujo*, plaintiff commenced a class action alleging that defendant engaged in a scheme to charge life insurance premiums for a period of time when no coverage existed (the "risk-free" period). Defendant removed the case to federal court pursuant to SLUSA and sought to dismiss the case, arguing that insurance

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with prejudice common law fraud claim against broker, in reliance on *Zandford*, where "the alleged fraud and securities transactions were not independent events").

products were covered securities and that plaintiffs' claims were a covered class action. *Id.* at 379.

Quoting *Zandford*, the *Araujo* court stated that to satisfy the "in connection with" element of Section 10(b), "[i]t is enough that the scheme to defraud and the sale of securities coincide." *Araujo*, 206 S. Supp. 2d at 383 (quoting *Zandford*, 535 U.S. at 822). Nevertheless, the court cited cases where courts have found the "in connection with" requirement was not met when the plaintiff had not alleged misrepresentation regarding the value of a security or consideration received for it. *See id.* In granting defendants' motion to dismiss, the court found that "the alleged scheme to charge policyholders premiums during 'risk-free' periods goes to the value of the variable life insurance policy," and held that "the alleged charging practice was 'in connection with' the sale of the policy." *Id.* Though *Araujo* reached the correct result, the discussion of the presence or absence of a misrepresentation as to the value of a security is puzzling in light of *Zandford's* strong statement that such a connection to value is not required.

In *Behlen v. Merrill Lynch*, 311 F.3d 1087, 1089 (11th Cir. 2002), plaintiff filed a class action complaint in state court alleging claims including breach of contract, breach of fiduciary duties, misrepresentation and negligence. Plaintiffs claimed that defendants sold them inferior Class B shares in defendants' growth fund when they were in fact eligible to purchase Class A shares, which were subject to lower fees and commissions. Defendants removed the lawsuit under SLUSA, arguing that the alleged conduct about which plaintiffs complained occurred "in connection with" the purchase or sale of securities, and filed a motion to dismiss. *Id.* at 1089-90.

On appeal, the court determined that "the very reason [plaintiffs] were sold the Class B shares was because those shares were subject to the excess fees and commissions" and that "the fees and commissions were not incidental to the sale of the securities, but were an integral part of the transactions." *Behlen*, 311 F.3d at 1094. Citing *Zandford*, the court held that "[t]o the extent that the defendants misrepresented which shares would be sold to the class, those misrepresentations were made 'in connection with' the sale of the shares" and thus removal pursuant to SLUSA was proper and the claims had properly been dismissed. *Id.* at 1094-95.

Post-Zandford Cases Remanding Suits to State Court. Even after *Zandford*, however, a few courts have remanded cases to state court or dismissed complaints entirely where the alleged misrepresentations or omissions of material fact did not have a sufficient connection to the purchase or sale of a covered security. *See, e.g., French v. First Union Sec., Inc.*, 209 F. Supp. 2d 818, 828 (M.D. Tenn. 2002) (omissions of information by broker and his employer relating to broker's inherent qualifications and previous fraudulent conduct are not "in connection with" the purchase or sale of securities, as there is not a sufficient nexus between the alleged fraud and a securities transaction, therefore removal under SLUSA was improper); *Burns v. Prudential Sec., Inc.*, 218 F. Supp. 2d 911, 912 (N.D. Ohio 2002) (holding that action against stockbroker and his employer for breach of fiduciary duty and violation of other state laws where stockbroker improperly sold plaintiff's holdings was not preempted by SLUSA, even under broader *Zandford* rule, because here, unlike *Zandford*, there were distinct events of unauthorized sales and later misrepresentations, rather than a common scheme or "continuous series" of events, so misrepresentations were not "in connection with" the purchase or sale of covered securities).

C. Claims Involving “Holders,” Not Purchasers Or Sellers, Of Securities

In several cases, courts have remanded actions to state court where the plaintiffs alleged that defendants’ conduct solely affected plaintiff’s holding of securities, rather than the purchase or sale of securities. *See, e.g., Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 593 (W.D. Tex. 2001) (SLUSA does not cover claims based purely upon misrepresentations that caused plaintiffs to retain securities); *Gordon v. Buntrock*, No. 00 CV 303, 2000 WL 556763, at *3 (N.D. Ill. Apr. 28, 2000) (removal improper where “plaintiff has gone to great lengths to stress that his complaint alleges misrepresentations only in the holding of securities, and expressly disavows any injury resulting from the purchase or sale of securities”). In both of these cases, the court found it significant that plaintiffs did not allege that the class included purchasers of securities.

In contrast, where a plaintiff alleged that defendant’s misrepresentations induced him both to purchase and hold securities, SLUSA does apply. *See Riley*, 292 F.3d at 1334 (approving of *Gordon* and *Gutierrez* but finding that plaintiffs’ allegations were not limited solely to holding claims). Most recently, the Ninth Circuit held in *Falkowski* that state class action claims related to employee stock option grants were pre-empted under SLUSA, even though the options had not been exercised and the stock sold. The court held that the option grant itself constituted a “sale” under SLUSA.

These cases suggest that carefully-crafted “holding claims” – those made by non-transacting shareholders claiming damages because misrepresentations or omissions induced them to hold stock – could offer plaintiffs’ attorneys an opportunity effectively to avoid removal under SLUSA and frustrate the goals of the PSLRA.²⁷

VII. RECENT DEVELOPMENTS UNDER THE DISCOVERY STAY PROVISIONS OF THE PSLRA

Two recent decisions in high-profile financial fraud cases have given rise to a new challenge facing securities fraud class action defendants where the securities suit coincides with or follows a government investigation: namely, the prospect that when a parallel government investigation is underway, any effort by the company to cooperate with the government investigation by producing documents and other discovery materials will be rewarded with an

²⁷ Indeed, in April 2003, the California Supreme Court in *Small v. Fritz Companies, Inc.*, 30 Cal. 4th 167, 174-75 (2003), recognized a cause of action for fraud and/or negligent misrepresentation in favor of a shareholder who neither purchased nor sold shares in reliance upon alleged misrepresentations by the defendant – a so-called “holder action.” In *Small*, plaintiff claimed that he had been induced to forbear from selling shares in reliance on alleged misrepresentations by defendants. *See id.* at 170-71. Defendants moved to dismiss the action, arguing, *inter alia*, that SLUSA preempted plaintiff’s fraud and misrepresentation claims because they arose in connection with the purchase or sale of a covered security. *See id.* at 177-78. However, the court expressly rejected this argument, noting that “the Uniform Standards Act by its terms applies only to suits involving the *purchase or sale* of stock,” and thus could not apply to preempt *Small*’s “holder” claim. *Id.* at 178.

order to produce those discovery materials immediately to the civil class action plaintiffs' lawyers, notwithstanding the PSLRA's automatic stay of discovery. These two decisions have set a very dangerous precedent for future cases involving parallel SEC enforcement investigations, or other regulatory or congressional inquiries.

A. Discovery Of Documents Produced To Government Agencies

The Enron Case: The First Shoe Dropping. In the wake of the collapse of the Enron Corporation, Judge Melinda Harmon of the United States District Court for the Southern District of Texas initially ordered Enron to produce to securities plaintiffs all documents and materials produced pursuant to subpoenas by any committee of the legislative branch of the federal government, or by the executive branch of the federal government in connection with investigations into its handling of its ERISA-governed pension plans. *Newby v. Enron Corp.*, No. H-01-3624 (S.D. Tex., Feb. 27, 2002) (Scheduling Order). The order also directed Enron to produce to plaintiffs copies of all transcripts of witness interviews or depositions given or taken in connection with such investigations. *Id.* In ordering this production, the judge relied on the following characterization of the preventative and practical purposes of the discovery stay under the PSLRA: "The automatic stay of discovery mandated by the PSLRA was designed to prevent fishing expeditions in frivolous securities lawsuits. It was not designed to keep secret from counsel in securities cases documents that have become available for review by means other than discovery in the securities case." *Id.* at 3-4.

Several months later, the lead plaintiff in the securities action moved to expand Judge Harmon's earlier ruling beyond ERISA-related documents to the production of all materials previously produced in response to government investigations. *See Newby v. Enron Corp.*, 2002 WL 31845114, at *1 (S.D. Tex. Aug. 15, 2002) (Order). Enron and various individual officer defendants opposed the motion, arguing that the unambiguous language of the Reform Act permits only two exceptions to the ban on discovery during the pendency of motions to dismiss, and prohibits discovery requests, "whether a 'fishing expedition' or 'surgical strike.'" *Id.* The court cited with approval plaintiff's argument that their request did not pose the threat of abusive litigation contemplated by the PSLRA, presumably because the pending government investigations counter any suggestion that this was merely a strike suit, and would impose only a slight burden on the corporation since the documents had already been produced. *Id.* at *2. The court agreed with plaintiffs, noting that "discovery has already been made" and it should not be withheld from a party because of a statute designed to prevent discovery abuse. *Id.* The court ordered Enron to produce "copies of all documents and materials produced by the Debtor related to any inquiry or investigation" by any committee of the legislative branch or the executive branch, and any witness interviews or depositions relating to those inquiries or investigations. *Id.* at *1.

Worldcom: The Next Shoe Dropping. Judge Denise Cotes also recently ordered WorldCom, Inc., a non-defendant but related party to the WorldCom consolidated securities cases, to produce to securities plaintiffs documents and other materials which had already been produced to other entities pursuant to various government investigations. *See In re Worldcom, Inc. Sec. Litig.*, 234 F. Supp. 2d 310, 302 (S.D.N.Y. 2002). In addition, the Court ordered WorldCom to produce documents and materials previously produced to counsel representing the Special Investigative Committee of the Board of Directors, after counsel for the Special Committee produced its final report. *See id.* In contrast to the order in *Enron*, and pursuant to

requests to the Court by the SEC and the U.S. Attorney, WorldCom was not ordered to produce any witness interview notes. *See id.*

In considering whether to grant plaintiff's motion, the Court noted that the PSLRA allows courts to order particularized discovery when the court finds it is necessary to prevent undue prejudice to a party. *See In re WorldCom*, 234 F. Supp. 2d at 305 (citing 15 U.S.C. § 78u-4(b)(3)(B)). The court considered the following "circumstances" in deciding that the stay must be lifted to avoid such prejudice to the securities plaintiffs, and noted that none of these circumstances, standing alone, would justify lifting the stay. First, like the court in *Enron*, the *WorldCom* court concluded that neither rationale underlying the PSLRA discovery stay was contravened by the plaintiff's motion. The lead plaintiff had not filed the motion to initiate a "fishing expedition" and was not attempting to force defendants to settle a frivolous class action. *See id.* The court also noted that lifting the stay would not place an undue burden on the corporation since the requested documents had already been compiled and produced. *See id.* at 306.

Unlike the *Enron* court, the *WorldCom* court explicitly considered "the unique circumstances of this case" to conclude that the stay must be lifted to avoid undue prejudice to the plaintiff investor class. *In re WorldCom*, 234 F. Supp. 2d at 305. The court noted that "[a]ll of the investigations and proceedings concerning WorldCom are moving apace," and that without access to the requested documents, lead plaintiff "would be prejudiced by its inability to make informed decisions about its litigation strategy in a rapidly shifting landscape" including upcoming settlement negotiations. *Id.* The court was not only concerned that the securities plaintiffs would be at an informational disadvantage in formulating their litigation strategy, but also that their lack of knowledge would place them at the end of the line for any recovery: "If [lead plaintiff] must wait until the resolution of a motion to dismiss to obtain discovery and formulate its settlement or litigation strategy, it faces the very real risk that it will be left to pursue its action against defendants who no longer have anything or at least as much to offer." *Id.*

AOL Time Warner. In a one-page decision issued on February 28, 2003, Judge Shirley Wohl Kram, quoting and citing the decisions in *Enron* and *WorldCom* discussed above, granted plaintiff's application to lift the PSLRA's stay of discovery "with regard to copies of certain documents and materials which Defendants . . . have produced to any committee of the legislative branch of the United States government or to any entity of the executive branch, including the Department of Justice and the SEC." *In re AOL Time Warner, Inc. Sec. & ERISA Litig.*, 2003 WL 715752, at *1 (S.D.N.Y. Feb. 28, 2003). Without discussion, Judge Kram found that plaintiff was "'not in any sense engaged in a fishing expedition or an abusive strike suit,' and would be substantially prejudiced by the maintenance of the stay. . . . The requested discovery has already been produced by Defendants and providing a copy to Lead Plaintiff will not constitute a burden upon them." *Id.*

The fact that Judge Kram lifted the stay without discussion of the particular facts of the case before her raises the specter that some courts will be inclined automatically to lift the PSLRA stay for materials already produced to governmental entities by defendants in class action securities litigations.

Vivendi. Despite the holdings in *Enron*, *WorldCom* and *AOL*, the court in one recent case has declined to lift the PSLRA stay in similar circumstances. *See In re Vivendi Universal*,

S.A., *Sec. Litig.*, 2003 WL 21035383, at *1 (S.D.N.Y. May 9, 2003). In *Vivendi*, the court refused to lift stay on “documents already produced by defendants to the United States Department of Justice, Securities and Exchange Commission, Commission des Operations de Bourse . . . and Association of Active Small Investors in France . . .,” because plaintiff could show no “exceptional circumstances” warranting such a step in light of the fact that defendants had “represent[ed] in open court” that documents produced to such agencies had been and would continue to be preserved. *Id.*

B. Discovery Of Work Product Materials Produced To Government Agencies

Recognizing the peril faced by defendants when producing documents to government agencies, many defense counsel now ask the government for written agreements that such productions will not be deemed to constitute a waiver of work product or attorney-client privilege protections. These requests are particularly important where, as is now frequently the case, a company has conducted an internal investigation, and agrees to produce a written report or other summary or synthesis of the results of such an investigation, which may include witnesses interviews, compilations of important documents, database summaries of facts, and chronologies. The SEC generally has responded favorably to such requests for work product protection. In fact, the SEC recently issued a report in which it “recommends amending the Exchange Act to allow parties who choose to produce privileged or protected material to do so without fear that their production to the Commission will be deemed to waive privilege or protection as to anyone else.” *SEC Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002*, at 45 (the “*Section 704 Report*”).²⁸

In several very recent cases, the courts have addressed whether SEC confidentiality agreements are enforceable against the demands of civil plaintiffs’ counsel to have such materials produced in the civil cases, notwithstanding any agreement between the company and the government that such materials were not meant to be shared with private plaintiffs.

McKesson HBOC. In a case in the Delaware Chancery Court, the court adopted a selective waiver rule for disclosures of work product made to law enforcement agencies pursuant to a confidentiality agreement. *See Saito v. McKesson HBOC, Inc.*, No. Civ. A. 18553, 2002 WL 31657622, at *11 (Del. Ch. Nov. 13, 2002). The court noted the conflicting caselaw on this issue

²⁸ The *Section 704 Report* states that the SEC favors such an amendment to the securities laws because “a company that retains outside counsel to conduct an internal investigation concerning possible violations may be willing to share the investigative report with the Commission. That report, while no substitute for the Commission’s investigation, may supply the Commission with very useful information. Under current law, however, a party who produces privileged or protected material to the Commission runs a risk that a third party, such as an adversary in private litigation, could obtain that information by successfully arguing that production to the Commission waived the privilege or protection.” *Section 704 Report*, at 45.

in other jurisdictions, including in the courts of appeals,²⁹ *see id.* at *7, however it determined that public policy supported a selective waiver rule because such a rule encourages cooperation with law enforcement investigations.

In this case, the plaintiffs in a derivative action brought a motion to compel production of certain documents, including materials that had been prepared by counsel while conducting an internal investigation at the request of the audit committee of the board of directors of McKesson HBOC, Inc. (“McKesson”). Among the documents sought were materials that had been produced by defendant to the SEC and the United States Attorney’s Office (“USAO”) after these law enforcement agencies had both entered into a confidentiality agreement with McKesson. Defendants asserted work product privilege as to all of the documents in question, and attorney client privilege as to some of them. *Id.* at *1-2.

Initially, the court determined that the documents in question clearly qualified as work product, and that the only remaining issue was whether McKesson had waived its privilege by producing these materials to the SEC and/or the USAO, notwithstanding the existence of the confidentiality agreement. *Id.* at *2. The court noted that, like any privilege, the protection of work product may be waived, but that such waivers were rarely granted in Delaware because of their harsh result. *Id.* at *3, 7. To waive protection for work product, the holder must know of the right, and voluntarily and intentionally choose to relinquish it. Further, disclosure of protected work product to a third party does not waive the privilege if the disclosing party had a reasonable expectation of privacy when it made the disclosure. *Id.* at *4. The party’s expectation of privacy in the disclosure is considered “reasonable” if: (1) the party believed its disclosure was confidential; and (2) the law sanctions that expectation. *Id.*

The court rejected McKesson’s argument that it had a reasonable expectation of privacy in its disclosures pursuant to the confidentiality agreement because it shared a common interest with the SEC and/or the USAO of “weeding out” wrongdoing at the company. *Id.* at *4-5. Cooperating voluntarily with the investigation did not transform McKesson’s relationship with the investigative agencies to a friendly one in which it had a reasonable expectation that privileged materials would be held in confidence.

However, the court accepted McKesson’s next argument, that it had a reasonable expectation of privacy when it made its disclosures to the SEC and/or the USAO because they were made pursuant to a confidentiality agreement. *Id.* at *6.³⁰ Pursuant to such an agreement,

²⁹ One case cited by the court in *Saito* is particularly noteworthy. In *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289 (6th Cir. 2002), the court expressly rejected the concept of selective waiver in all forms. The court found that the defendant had waived the work product privilege for documents produced to the Department of Justice even though the disclosure was made pursuant to a confidentiality agreement. *Id.* at 307. In so doing, the court reasoned that waiver of the work product privilege is a “tactical litigation decision,” and allowing selective waiver would permit attorneys to use the privilege “as a sword rather than as a shield.” *Id.*

³⁰ The SEC had filed an amicus brief supporting McKesson’s position. *See* 2002 WL 31458233, at *8 n.55.

McKesson’s attorneys could reasonably expect that their preparations for litigation would not be used against them. Further, this expectation of privacy is one that the law should sanction, because “public policy seems to mandate that courts continue to protect the confidentially disclosed work product in order to encourage corporations to comply with law enforcement agencies.” *Id.* at *6. Because McKesson’s expectation of privacy was reasonable, its production of documents to the agencies pursuant to the agreement did not waive the work product privilege as to those agencies.

The court noted that other jurisdictions do not permit selective waiver of the work product privilege – that is, continuing to assert the privilege against other parties once the protected material has been disclosed to any party. *Id.* at *7. However, the court reasoned that such a rule is not basically unfair, as disclosing protected material to one adversary does not prejudice another adversary any more than if the initial waiver had not been made. *Id.* at *6. Further, the rule here is narrow, permitting selective waiver only of work product produced to a law enforcement agency after a confidentiality agreement is in place. Finally, public policy favors a narrow rule of selective waiver, as it encourages cooperation with law enforcement. *Id.* at *7. On this final point, the court observed that a delicate balance already exists between a corporation’s interest in cooperating with an investigation in hopes of obtaining more lenient treatment, and forcing a law enforcement agency to “do its own legwork” at the risk of receiving harsher treatment. *Id.* at *8. If courts do not permit selective disclosure, and “amplify the risk of disclosure to include future private plaintiffs, the scales begin to tip further in favor of corporate noncompliance with investigative agencies.” *Id.*

The Delaware court’s decision in *McKesson* followed on the heels of a similar case, also involving McKesson, in state court in Georgia. *See McKesson HBOC, Inc. et al. v. Adler*, 254 Ga. App. 500, 504 562 S.E.2d 809, 814 (2002). There, the trial court granted a shareholder plaintiff’s motion to obtain documents generated by McKesson during an internal investigation of the company’s financial reports led by the audit committee of the board of directors. *Id.* at 500. These documents had been produced to the SEC pursuant to a confidentiality agreement, and McKesson argued that they were covered by both work product protection and the attorney client privilege. *Id.* The Georgia Court of Appeals remanded to the district court the question of whether the documents were privileged under the work product doctrine, *id.* at 504, but found that the documents were not protected by the attorney client privilege, *id.* The court reasoned that because McKesson’s audit committee authorized its attorneys and accountants to cooperate with the SEC in its investigation, the company “contemplated that the documents would be provided to a third party almost from the inception of the investigation,” and thus the privilege did not apply. *Id.* Though the court did not explicitly mention the confidentiality agreement in its analysis, this reasoning suggests that the court would consider such an agreement ineffective to prevent a waiver of the privilege, and indeed positive evidence that the party did not intend the communications to be confidential.