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***Developments and Trends in
U.S. Securities and Class Action Litigation***

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I. Introduction

Private securities actions have been a mainstay of the U.S. litigation landscape since the early 1930's and class actions have been prevalent since the 1960's. However, in recent years, the allegations and target defendants of such suits have changed dramatically as plaintiffs' attorneys continue to chase the next big claim type. In 2008 and 2009, credit crisis and subprime-related securities actions against financial institutions dominated headlines. Credit crisis claims have since waned and the last 12 month period has seen a further shift in the types and targets of securities and class actions being filed. Industry reports confirm that fewer credit crisis-related claims are being filed. Instead, more traditional securities claims are being filed in sectors such as energy and technology and many claims focus on alleged breaches of fiduciary duty in connection with mergers and acquisitions. More particularly, this past 12 month period has seen the highest level of securities claims being filed against non-U.S. companies since 1995.

Recent developments may significantly impact the rate of future securities and class action filings. The U.S. Supreme Court issued important decisions broadening plaintiffs' ability to bring class actions in federal courts and restricting plaintiffs' rights to maintain fraud actions against non-U.S. companies. This year, the Obama administration also enacted sweeping financial reform provisions that increase incentives to whistleblowers and increase the Securities and Exchange Commission's ("SEC") and other governmental agencies' powers to detect and enforce U.S. securities laws. As in the past, increased governmental enforcement proceedings may result in a stark increase in follow-on private actions against target companies. Increased SEC investigations and

private suits will inevitably result in higher related defense costs across all industry sectors, but most significantly in the financial sector. Fueled by these recent case law and legislative developments, the plaintiffs' bar may make the coming year a year worth watching.

II. Securities Action Filing Trends in the Last 12 Months

A. The Effect of Ponzi and Credit Crisis Filings

Immediately following the discovery of the Bernard Madoff Ponzi scheme in December 2008 and the R. Allen Stanford Ponzi scheme in early 2009, a surge of related private actions were filed by investors against the alleged leaders of these schemes as well as against the investing feeder funds and financial institutions. According to Nera Economic Consulting, these claims are now declining with significantly fewer class actions relating to Ponzi schemes filed in the first half of 2010.

This decline in credit crisis and Ponzi scheme class actions has resulted in a decline in securities class actions overall. In fact, there were only 17 credit crisis securities class actions filed in the first half of 2010 for a projected 34 such claims for all of 2010.¹ This filing rate is down from the 57 such actions filed in 2009 and the 103 such actions filed in 2008. Only two class actions relating to Ponzi schemes were filed in the first half of 2010, down from 38 such actions filed in 2009. Overall, there were 101 federal securities class action suits filed in the first half of 2010 with a resulting projection of 202 for all of 2010. This is a decline from 221 filings in 2009, and 248 filings in 2008. Stanford Law School tracks a sub-category of federal securities class actions alleging fraud and reports that such filings are also continuing a downward trend since 2009.²

B. “Mega Filings”

Although fewer class action securities suits were filed in the first half of 2010 than during each of the first or second halves of 2009, several suits had significant market capitalization changes and potentially larger expected values. Cornerstone Research Group reports several of what they term “Mega Filings” were filed in the first half of 2010. According to Cornerstone, there were four filings that together alleged changes in market capitalization (the total value of all of a firm's outstanding shares, calculated by multiplying the market price per share times the total number of shares outstanding) from the date prior to the end of the class period to the day after the end of the class period of \$36 billion.³ There were also ten Mega Filings, accounting for \$305 billion in market capitalization changes from the highest value during a class period to the day after the class period. Although Cornerstone cautions that its calculations cannot be used as a measure of potential damages, it is the logical conclusion that plaintiffs’ demands in such “Mega Filings” could be significantly higher where class members saw a larger decrease in the value of their shares during the class period, or where the number of shares included in the plaintiff class are significantly larger than in other cases.

C. Private Securities Action Filing Rates Increase

The decline in the number of securities class actions is not mirrored in the filing rate of other securities actions. Securities actions, including both class actions and non-class actions, have actually increased from 36 filed in the first quarter of 2010 to 49 filed in the second quarter of 2010. Headline-grabbing events such as the BP oil spill in the Gulf of Mexico, the government investigation of Goldman Sachs and repeated Toyota automobile recalls have resulted in an increase in related securities actions.⁴ Advisen,

Ltd., a consulting firm providing data and analysis to the insurance industry, (“Advisen”) reports a surge in securities litigation in the second quarter of 2010. The energy sector was particularly hard hit, with securities suits against these companies rising 82% in the first half of 2010 as a result of suits relating to the BP/Deepwater Horizon oil spill and the explosion of the Upper Big Branch mine in West Virginia.⁵

D. Regulatory Investigations and Actions Increase

Since the beginning of the subprime and credit crisis, the SEC and other U.S. regulatory agencies have increased enforcement and begun coordination of efforts among the agencies and with authorities in other countries.⁶ Recent reports have criticized the SEC’s failure to police and detect securities violations, such as the Madoff and Stanford Ponzi schemes, and its failure to prosecute senior officers or board members. Nevertheless, the SEC, Justice Department and Federal Bureau of Investigation defend their track record of enforcement. According to the Justice Department, “nearly 3,000 defendants were sent to prison between October [2009] and June [2010] for financial fraud. The number of criminal mortgage-fraud cases filed by the agency has more than doubled so far this year compared to 2007, while new corporate-fraud cases also have surged.”⁷ It is reported that between 2008 and 2009:

- Formal investigations were up 113 percent
- Temporary restraining orders were up 82 percent
- Disgorgement of profits was up 170 percent
- Penalties were up 35 percent.⁸

U.S. officials are clearly responding to public pressure to diligently prosecute securities violations. As discussed in detail below, recent legislation also provides

government agencies with additional tools to oversee financial markets and prosecute securities violations. Investigations and actions are consequently expected to increase in coming months and years.

E. The SEC's Enforcement Action Against Goldman Sachs

In April 2010, the SEC filed suit against Goldman Sachs and Fabrice Tourre, a Goldman Sachs Vice President, alleging that they defrauded investors in connection with the sale of collateralized debt obligations (CDO's) tied to subprime mortgages. On 15 July 2010, Goldman Sachs announced an agreement to settle this SEC action for \$550 million. Investors had filed a class action suit against Goldman relating to its alleged misrepresentation regarding its marketing of CDO's and for allegedly failing to disclose receipt of a prior Wells notice from the SEC.⁹ A Wells notice is a notice from a regulator that it intends to recommend that enforcement proceedings be commenced against the notice recipient.¹⁰

The April 2010 SEC suit remains pending solely against Goldman Vice President, Fabrice Tourre. On 29 September 2010, Tourre filed a motion to dismiss the SEC action under the Supreme Court's recent decision in *Morrison v. National Australia Bank, Ltd.*, discussed in greater detail below. Essentially, Tourre argues that because the sole investor alleged in the Complaint to have purchased notes in the synthetic CDO's at issue was a foreign bank that invested overseas, the transaction was not subject to the antifraud provisions of the U.S. federal securities laws.¹¹ This motion is currently pending.

F. Madoff Investor Suits Filed Against the SEC

The SEC itself is facing private suits by investors for its failure to uncover the Madoff Ponzi scheme. Individual investors in the Madoff fund, Phyllis Molchatsky and

Steven Schneider, filed suit in Federal District Court in New York in October 2009 alleging that SEC regulators missed “countless opportunities” to stop Madoff’s Ponzi scheme. The SEC filed a motion to dismiss in December 2009 on the grounds of governmental immunity asserting “[t]he manner in which the SEC investigates suspected violations of the securities laws is grounded in policy and committed to the SEC’s discretion by Congress... Even assuming that the SEC acted negligently in the course of the Madoff investigations, the discretionary function exception would still apply.”¹²

On 24 September 2010, the Litwin Foundation, a New York based foundation that contributes to not-for-profits such as the Lincoln Center for the Performing Arts and the Brooklyn Botanical Gardens, also sued the SEC in Federal District Court for the Southern District of New York. Similar to the Molchatsky and Schneider suits, the Litwin Complaint alleges that the SEC “had countless opportunities to stop the Ponzi scheme Madoff operated over 16 years and botched all of them.”¹³ The foundation alleges “[t]he SEC failed to do so because the assigned staff committed numerous negligent, non-discretionary acts and inactions due chiefly to their inexperience, incompetence, bureaucratic pettiness, laziness, inattentiveness, and an agency culture of deference to powerful industry figures.”¹⁴ The suit seeks to recover at least \$19 million.

G. New Developments in Class Actions

1. Securities Class Actions Against For-Profit Educational Institutions

In what is being referred to by analysts as “Subprime Goes to College,” allegations of illegal recruiting practices, with significant financial impact to U.S. taxpayers, have been made against “for-profit” post-secondary educational institutions in the U.S. In an effort to secure federal student loans, such institutions have been

recruiting poorer students “literally from bus depots and casinos” and the default rates on federal student loans issued to these individuals are projected by Ira Sohn (a fund manager famous for having shorted the subprime mortgage market) at \$300 billion over the next ten years.¹⁵

On August 3, 2010, the United States General Accounting Office ("GAO") issued a report concluding that certain for-profit educational institutions engaged in illegal and fraudulent actions designed to recruit students and over-charge the federal government for the costs of their education. Although the GAO report did not name specific institutions in its initial report, the Department of Education shortly thereafter released data showing the student loan repayment percentages by specific institution. In many cases, the repayment rates were less than 10 to 20 percent of issued loans and lower than pending regulation minimums necessary to allow continued participation in federal student loan programs. A drop in share price of for-profit educational institutions followed release of this data.

The GOA report concerning illegal recruiting practices, the federal loan repayment data and the subsequent, and allegedly related, loss of stock value prompted the filing of securities class action lawsuits against various for-profit educational institutions. See, e.g., *Moreaux v. Lincoln Ed. Servs. Corp.*, 2:10-cv-04160-SRC-MAS (D.N.J.); *Karam v. Corinthian Colleges, Inc.*, 2:10-cv-06523-GHK-RC (C.D. Cal.); *Fitch v. Apollo Group Inc.*, 2:10-cv-02044-FJM (D. Ariz.); *Gaer v. American Public Education, Inc.*, 3:10-cv-00081-JPB (N.D.W.V.). The Complaints in these actions allege that the companies made false and misleading statements related to the companies'

business and operations in violation of the Securities Exchange Act of 1934, resulting in a loss of share price over the class period.

2. Walmart Class Action Ruling Appealed to U.S. Supreme Court

On 25 August 2010, Walmart Stores, Inc. ("Walmart") filed a Petition for a Writ of Certiorari with the U.S. Supreme Court requesting that the Court review a decision by the Ninth Circuit Court of Appeals granting class certification to what Walmart calls the "largest employment class action in history by several orders of magnitude."¹⁶ Walmart argues that class certification was improperly granted and that the Ninth Circuit's decision creates a three-way circuit split on the standard for determining when claims for monetary relief can be certified pursuant to Federal Rule of Civil Procedure 23(b)(2), which deals primarily with injunctive or declaratory relief. Walmart also argues that the Ninth Circuit incorrectly examined the "commonality" requirement when it granted class status to a group that it acknowledges includes "individual employees in different stores with different managers [with] different levels of pay [who] may have been denied promotion or promoted at different rates" The Supreme Court is expected to accept this case for review during its 2010-2011 term.

III. Significant U.S. Decisions/Legislation Affecting Class Actions and Securities Actions

A. U.S. Supreme Court Broadens Availability of Class Actions in Federal Courts

On 31 March 2010, the U.S. Supreme Court broadened the scope of class actions that may be filed in federal courts and restricted individual states' ability to limit the scope of such class actions. In *Shady Grove Orthopedic Assocs. v. Allstate Ins. Company*, 130 S. Ct. 1431 (Mar. 31, 2010), the Supreme Court held, in a 5-4 decision,

that Federal Rule of Civil Procedure 23 (“Rule 23”) permitted plaintiffs to maintain a class action against Allstate for failure to pay interest on late-paid claims despite the existence of a New York statute precluding class action certification for suits seeking such penalties.

Shady Grove Orthopedics provided medical services to Sonai E. Glavez for injuries sustained in an automobile accident and was assigned Ms. Glavez’s rights to insurance benefits under a policy issued by Allstate Insurance Company. Shady Grove alleged that Allstate did not pay or deny the claim within 30 days, as required by New York statute (*N.Y. Ins. Law. Ann.* § 5106 (a)). Allstate ultimately paid the claim, but refused to pay the statutorily imposed interest rate of 2%. Shady Grove filed a class action suit in the Eastern District of New York to recover the unpaid interest on its own behalf, as well as on behalf of all others to whom Allstate owed interest.

The District Court dismissed the suit for lack of jurisdiction based on New York’s Civil Practice law § 901(b), which precludes a class action “to recover a penalty, or minimum measure of recovery created or imposed by statute.” The court applied the more restrictive § 901(b) despite Rule 23 requirements that the class meet only the prerequisites of numerosity, commonality of questions of law or fact, typicality of the representative plaintiffs to the class members and adequacy of the representation. The Second Circuit affirmed the dismissal on the grounds that New York’s § 901(b) was not in conflict with any federal rule. Plaintiffs sought certification of the issue by the U.S. Supreme Court to determine whether Federal Rule 23 or the New York Statute § 901(b) controlled.

The U.S. Supreme Court held that Rule 23 addressed the requirements to obtain class certification and was in conflict with New York § 901(b). Specifically, the court found that Rule 23 provides procedural requirements to certify a class action, while New York's statute restricts a court's ability to certify a class action if the claim is for statutory penalties.

The Supreme Court's analysis as to whether Rule 23 would trump New York's § 901(b) restriction on class actions next focused on whether Rule 23 exceeded statutory authorization or Congress' constitutional rulemaking power. The Supreme Court ultimately upheld the application of Rule 23, which allows a court to adjudicate claims of multiple parties in a single suit rather than in separate suits, as both statutorily authorized and constitutional because it was a purely procedural rule that left "the parties' legal rights and duties intact and the rules of decision unchanged." Rule 23 therefore passed constitutional muster, since it merely regulated "the manner and the means" by which litigants rights were enforced. Because § 901(b) was also a facially procedural statute addressing the requirements for class action certification, the Court held that Rule 23 preempted New York statute § 901(b), and Rule 23 would therefore control class action certification in actions brought in New York federal courts.

The Supreme Court's decision in *Shady Grove* opens federal courts to class action suits that may have been otherwise precluded by state procedural laws attempting to limit the availability of such suits. The Court's bright line analysis of the procedural nature of the federal rules in this area is tempered only by the concurring opinion of Justice Stevens whose partial agreement with the four dissenting members of the Court provides a potential exception. Specifically, Justice Stevens opined that where a state's ostensibly

procedural rule actually “operate[s] to define the rights and remedies available in a case” it may be deemed to be “so bound up with the state-created right or remedy that it defines the scope of that substantive right or remedy.” Although Justice Stevens did not find a sufficient showing had been made in *Shady Grove* that § 901(b) was a substantive law that would be affected by the application of Rule 23, his opinion leaves open the argument that other state procedural laws may be deemed effectively substantive and applicable to class actions in federal courts.

Shortly after the *Shady Grove* decision was handed down, Justice Stevens retired from the U.S. Supreme Court and was replaced by the Obama administration’s nominee, Elena Kagan. It is unknown what position Justice Kagan will take on issues involving federal preemption of state law and little additional information is likely to be forthcoming during this term. Justice Kagan has recused herself from involvement in three of the four preemption cases to be decided by the Supreme Court this term on the grounds that she was involved with the case or wrote the brief when she served as Solicitor General.

Under the Class Action Fairness Act of 2005, federal courts were opened to more class actions by relaxing the diversity and amount in controversy requirements for class actions. It is possible that a shift toward a more liberal, Democratic Supreme Court, along with a similar shift at the district trial court level as a result of recent Obama judicial appointments, may result in further broadening of the federal court preemption of state laws to prevent restrictions on class actions. Plaintiffs’ counsel frequently attempt to circumvent the Class Action Fairness Act to keep their cases in State courts, however,

in cases in which state statutes attempt to restrict the availability of class actions, plaintiffs may find federal court a favorable venue under the *Shady Grove* decision.

B. Recent Decisions and Legislation Affecting Securities Suits Against Non-U.S. Companies

1. U.S. Supreme Court’s Decision in *Morrison v. National Australia Bank* Restricts Availability of Fraud Claims Against Non-U.S. Companies

In a decision likely to have wide-ranging implications in the area of U.S. securities fraud litigation, the United States Supreme Court significantly restricted the ability of non-U.S. (and potentially U.S.) plaintiffs to access U.S. courts to assert securities law violations against non-U.S. companies. In its 24 June 2010 opinion in *Morrison v. National Australia Bank Ltd.* (“*NAB*”)¹⁷, the Supreme Court established a bright line rule that allows a private cause of action under the Securities Exchange Act of 1934 (“the 1934 Act”) only if “the purchase or sale [of a security] is made in the United States, or involves a security listed on a domestic exchange.”¹⁸

In *NAB*, non-U.S. purchasers of ordinary shares of National Australia Bank, a corporation headquartered in Australia and incorporated under Australian law, brought suit against the bank and its officers alleging violation of Section 10(b)(5) of the 1934 Act. They alleged the defendants made materially false and misleading statements in SEC filings, annual reports and press releases regarding the profitability of NAB’s U.S. home loan servicing subsidiary, HomeSide. The lower court dismissed the case for lack of subject matter jurisdiction. The ruling was appealed initially to the United States Court of Appeals for the Second Circuit, which upheld the lower court’s dismissal of the action. Plaintiffs subsequently appealed to the U.S. Supreme Court.

In this “foreign cubed” action (foreign plaintiff against foreign defendant regarding foreign securities), the Second Circuit noted “when faced with securities law claims with an international component, we turn to ‘the underlying purpose of the anti-fraud provisions [of the 1934 Act] as a guide’ to ‘discern whether Congress would have wished the precious resources of the United States courts and law enforcement agencies to be devoted to’ such transactions.”¹⁹

To determine this Congressional intent, the Second Circuit looked to whether the harm was perpetrated in the U.S. or abroad and whether it affected U.S. markets and investors.²⁰ These two tests, referred to as the “conduct” and the “effects” tests, are frequently applied together “because an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court.”²¹

A majority of the Supreme Court justices specifically rejected the Second Circuit’s “conduct” and “effects” tests on the grounds that it was error to attempt to determine Congressional intent instead of determining, as the Court must, whether the Act clearly indicated that it was intended to have extraterritorial application.²² Indeed, the *NAB* Court confirmed that “[w]hen a statute gives no clear indication of an extraterritorial application, it has none.”²³

Employing this strict statutory construction and applying a presumption against extraterritorial application of U.S. laws, the Supreme Court held the 1934 Act applied only to transactions involving securities listed on U.S. exchanges or to purchases or sales in the U.S. of non-listed securities.²⁴ In so holding, the Supreme Court noted “the focus of the Exchange Act is not upon the place where the deception originated, but upon

purchases and sales of securities in the United States. Section 10(b) does not punish deceptive conduct, but only deceptive conduct ‘in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.’”²⁵ The Supreme Court went on to find that the location of the alleged fraudulent acts and the effect on U.S. investors or markets were irrelevant to the issue of statutory construction and were accordingly rejected as relevant criteria.²⁶ Plaintiffs’ suit against NAB and its officers was therefore dismissed for failure to state a claim upon which relief can be granted.

In its opinion, the Supreme Court predicted that its new bright line rule would provide predictability and prevent conflict with the securities laws of other countries.²⁷ Indeed, under the *NAB* Court’s new rule, both U.S. and non-U.S. investors may be precluded from maintaining securities fraud claims under section 10(b)(5) of the 1934 Act against non-U.S. companies whose shares are not listed on a U.S. exchange or were not purchased in the U.S.

2. The Wall Street Reform Act Addresses Jurisdiction Issues Following the *NAB* Decision

The Supreme Court’s ruling in *NAB* raised concerns that it would impede cross-border fraud enforcement efforts by U.S. regulators such as the SEC. On 21 July 2010 U.S. President Barack Obama signed into law the long-awaited Wall Street Reform and Consumer Protection Act of 2009 (“Wall Street Reform Act”). Section 929P(b) of this new legislation includes amendments to the 1934 Act that provide United States federal district courts jurisdiction over any action brought by the SEC or the United States alleging a violation of the anti-fraud provisions of the 1934 Act involving:

- (1) Conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
- (2) Conduct occurring outside the United States that has a foreseeable substantial effect within the United States.²⁸

The provisions of the Wall Street Reform Act allow a U.S. court to exercise jurisdiction over government enforcement actions so long as the alleged fraud took place in the U.S. or where the fraudulent conduct had an effect in the U.S. In essence, the Wall Street Reform Act reverts to the application of the “cause” and “effects” tests that had historically been applied by U.S. courts to provide broad access to U.S. courts by non-U.S. plaintiffs prior to the Supreme Court’s ruling in *NAB*.

Notably, the Wall Street Reform Act does not address jurisdiction over private actions against non-U.S. companies under the 1934 Act. However, under Section 929Y of the Wall Street Reform Act, the SEC is required within 18 months to conduct a study of whether private causes of action under the 1934 Act should be extended to cover conduct falling within the U.S. “cause” and “effects” tests implemented for government enforcement actions. As part of this study, the SEC is directed to consider (1) whether all actions should be so extended or instead extended only to actions by institutional investors; (2) the effect of such actions on international comity [giving effect to the laws of other nations]; (3) the economic costs and benefits of extending a private cause of action for international frauds; and (3) whether a narrower jurisdictional standard should be adopted.

In light of this mandated SEC study of the potential extension of the Wall Street Reform Act to private causes of action, supplemental U.S. legislation may be enacted that effectively overrules the Supreme Court's holding in *NAB*, subject, of course, to any constitutional challenges to such legislation that may be raised.

3. Effects of the NAB Decision on U.S. Civil Securities Litigation Against Non-U.S. Companies

The economic consulting firm, Advisen, reports that 13 percent of all securities suits filed in the U.S. in the first two quarters of 2010 were filed against non-U.S. companies and that such suits against non-U.S. companies have accounted for 10% of securities suits filed in the U.S. since 2005.²⁹ Advisen also predicts that the number of U.S. securities suits filed against non-U.S. companies will likely fall in the short-term as a result of the *NAB* decision.³⁰ However, in the event future U.S. legislation provides for expanded extra-territorial application of the 1934 Act similar to that provided to U.S. enforcement agencies, the number of civil suits against non-US companies could return to pre-*NAB* levels.

Securities filings in the U.S. have increased in the second quarter of 2010, due primarily to an increase in litigation against Goldman Sachs and against energy companies connected to the Deep Water Horizon oil spill in the Gulf of Mexico.³¹ The *NAB* decision may be particularly relevant in the context of potential suits against British Petroleum ("BP") stemming from loss of share value due to the recent oil spill. BP has approximately 18.1 billion shares traded on the London exchange, and its shareholders, even those residing in the U.S., will likely be precluded under the *NAB* decision from bringing an action in the U.S. against BP for violation of the 1934 Act. However, 3.1 billion ordinary shares of BP are also traded on the New York Stock Exchange through

BP's American Depository Receipts (ADR) program.³² The possibility exists that U.S. shareholders who purchased these ADRs may be able to bring suits against BP in the U.S.

ADR holders were recently recognized as having viable claims against a non-U.S. corporation in a class action suit against Toyota Motor Co. pending in the United States District Court for the Central District of California. In a 16 July 2010 memorandum opinion dedicated to the selection of a lead plaintiff to represent the class, the *Toyota* Court found that the claims of U.S. purchasers of shares of Toyota common stock would be precluded from maintaining their claims against Toyota under the *NAB* ruling.³³ On that basis, in selecting a lead plaintiff to represent the claims of the class, the Court chose the largest holder of Toyota American Depository Shares, suggesting that ADS holders may have a viable claim against Toyota.³⁴

Notwithstanding the above, the status of holders of ADR shares in non-U.S. companies remains uncertain following the *NAB* decision. Although the California District Court in *Toyota* accepted the ADSs as U.S.-based transactions without discussion, in a 29 September 2010 decision of the Federal District Court for the Southern District of New York, the court dismissed, on its own initiative, the 1934 Act claims of holders of ADR shares in Société Generale under the holding of *NAB*.³⁵ Citing to its pre-*NAB* decision in *Copeland v. Fortis*, the court held that “[t]rade in ADRs is considered a ‘predominantly foreign securities transaction’” such that Section 10(b) of the 1934 Act was inapplicable.³⁶ The court explained that the ADRs represent a right to receive a specified number of defendant’s ordinary shares, listed on a foreign exchange and that Société Generale’s shares “were not traded on an official American securities

exchange but rather were traded in a less formal market with lower exposure to U.S.-resident buyers.” Accordingly, the Court dismissed the 1934 Act claims of plaintiffs holding ADR shares. It is not yet known whether these plaintiffs will appeal the ruling.

Although non-U.S. defendants have not to date sought to dismiss the claims of the ADR holders under the holding in *NAB*, the New York court’s ruling in the *Société Generale* securities action may provide support for future motions to dismiss these claims. This issue will likely be litigated in future securities cases filed against non-U.S. companies.

C. Additional Provisions of the Wall Street Reform Act Affecting Securities Actions

In addition to providing expanded jurisdictional reach of the 1934 Act to governmental enforcement actions, the Wall Street Reform Act also expands private rights of action and the SEC’s and other governmental agencies’ powers to redress securities violations. Highlights of the Act are discussed below.

1. Private Right of Action Against Credit Rating Agencies

Section 933 of the Wall Street Reform Act extends a private right of action for securities act violations against nationally recognized statistical rating organizations. The Act also changes the standard to prove liability of these rating agencies by decreasing the burden of proof to a reasonableness standard. Under this new standard, plaintiffs need only plead with particularity that the rating agency “knowingly” or “recklessly” failed to conduct a reasonable investigation of the factual elements underlying its rating or failed to verify the factual elements with outside sources.³⁷ The Act also amends Section 436(g) of the Securities Act of 1933 to remove a previously included shield for credit rating agencies.³⁸ Rating agencies are made subject to liability as “experts,” similar to

accountants or lawyers, holding them responsible for their ratings. However, in response to protests and refusals by the credit rating agencies to allow their ratings to be used in connection with new bond issues, the SEC has reportedly issued a “no action” letter waiving the rating requirement for six months to allow a transition period for agencies to develop modified practices.³⁹

Rating agencies are also subject to new regulation under the newly created Office of Credit Rating Agencies at the SEC. Such regulation will include increased reporting requirements regarding the data and methodology of each credit rating as well as new rules governing the operations of credit rating agencies.⁴⁰

2. Aiding and Abetting Liability in SEC Actions

For the first time, the SEC can impose aiding and abetting liability on persons who knowingly or recklessly provide assistance to another person to violate the 1934 Act or the Investment Company Act of 1940.⁴¹ The Wall Street Reform Act does not extend such aiding and abetting liability to private actions, but such an extension is reportedly under consideration.

3. Control Person Liability in SEC Actions

The Wall Street Reform Act clarifies that the SEC, as well as private individuals, may bring enforcement actions under the 1934 Act against “control persons” for joint and several liability for violations of the controlled company. Liability in such SEC suits would be subject to the same exceptions as in private actions for a controlling person who acted in good faith and did not directly or indirectly cause the act or acts constituting the violation as is available in a private action.⁴² Typically, such “control person” claims are made against “C” level executives and Board members based on their control over the

actions of the corporation or knowledge of the alleged misrepresentations. This extension of liability for “control persons” to SEC actions may significantly increase directors’ and officers’ exposure to SEC investigations and securities actions as the SEC increases its enforcement efforts in response to public pressure. As a result, D&O insurers can expect an increase in claims for defense and indemnity by such targeted executives.

4. SEC Power to Prohibit Arbitration Clauses in Broker Contracts

The SEC is empowered by the Act to prohibit arbitration clauses for disputes between clients and their broker, dealer, any municipal securities dealer or investment advisors.⁴³ If rules to this effect are promulgated, this may result in an increase in lawsuits against such brokers and advisors.

5. Whistleblower Incentives and Protections

Perhaps the most significant provisions of the Wall Street Reform Act are those relating to the whistleblower protections that encourage persons to report securities violations to the SEC. The Act provides for a reward of between 10 percent and 30 percent of funds recovered based on the information provided if the recovery exceeds \$1 million.⁴⁴ It is believed that these provisions may create a cottage industry of start-up firms motivated by the large reward percentages. Such companies are expected to spend considerable time and resources investigating companies in hopes of earning the reward. This financial motive may ultimately result in increased governmental actions as well as follow-on private securities actions.

The Act provides protection for corporate employees who report securities law violations by their employers. Under the Act, an employer may not discharge, suspend,

threaten, harass or in any other manner discriminate against a whistleblower. The Act provides the employee with a statutory cause of action against the employer for violations of these protections.⁴⁵

D. D&O Securities Actions - Defense Costs in the Spotlight

As underwriters are aware, defense costs in Directory and Officer securities actions are frequently substantial and in large cases can exhaust one or more policy layers. For example, in the Enron case, defense costs exceeded \$100 million, over 35 percent of the available D&O limits. More typical cases are estimated to incur defense costs of 15 to 20 percent of amounts spent on indemnity.⁴⁶ Given these large dollar amounts at issue, highly contested coverage disputes in this area are inevitable. In the last year, claims for defense costs under D&O policies have been the subject of high profile U.S. appellate court decisions and bankruptcy court filings. For example, the Fifth Circuit Court of Appeals addressed a Money Laundering exclusion in the Stanford executives' coverage action and the former directors, officers and employees of now defunct Lehman Brothers sought approval to reach the next excess layers of coverage after defense fees exhausted the applicable primary and first layer excess policies.

1. The Stanford Executives Defense Cost Dispute

In a March 2010 ruling, the Fifth Circuit addressed claims for defense costs by R. Allen Stanford and other individuals insured under D&O policies issued by Lloyd's and Arch Specialty Insurance in *Pendergest-Holt v. Certain Underwriters at Lloyd's London*, 600 F.3d 562 (5th Cir. 2010). The insureds were executives in Stanford companies allegedly involved in a multi-million dollar Ponzi scheme. The SEC brought a civil suit in April 2009 against the corporate entities. The same day, a federal district court placed

the companies in receivership and seized their assets. In June 2009, the government brought a criminal case against certain insured executives alleging violation of and conspiracy to commit mail, wire and securities fraud, obstruction of and conspiracy to obstruct an SEC investigation and conspiracy to commit money laundering. All but one executive plead not guilty to the criminal charges and have trials scheduled for January 2011. The defendant underwriters agreed to advance defense costs for three of the executives “pending a final coverage determination.”

The focus of the coverage dispute between the Stanford executives and their D&O insurers is the applicability of a money laundering exclusion that precludes coverage for money laundering claims but included a clawback provision that provided:

Notwithstanding the foregoing Exclusion, Underwriters shall pay Costs, Charges and Expenses in the event of an alleged act or alleged acts *until such time that it is determined that the alleged act or acts did in fact occur*. In such event, the Directors and Officers and the Company will reimburse Underwriters for such Costs, Charges and Expenses paid on their behalf.⁴⁷

The Underwriters withdrew their agreement to provide coverage under the D&O policy based on available evidence that the alleged acts of Money Laundering, as broadly defined in the policies, did in fact occur.⁴⁸ This evidence included the SEC’s preliminary findings of good cause to believe the executives had “used improper means to obtain investor funds and assets;” the temporary restraining order and preliminary injunction that support the freezing of personal and corporate assets and appointed a receiver; the examination report and testimony of the receiver’s accounting expert that confirmed the Ponzi scheme; and the statements of the co-conspirator that pled guilty.⁴⁹ The executives then filed the present declaratory judgment action against Lloyd’s and Arch.

The District Court for the Southern District of Texas, and in fact the same judge presiding over the criminal suit against the executives, found the insurers had an obligation to continue reimbursing the executives' defense costs pending further order.

On appeal, the Fifth Circuit Court of Appeals distinguished the above claw back provision requiring payment of defense cost until the money laundering was “determined in fact” from other exclusions, including those in the same policies, that required “an adjudication in fact.”⁵⁰ The Court held that whereas an “adjudication in fact” required a judicial determination of the wrongful act in the underlying action, a “determination in fact” would be more broadly interpreted and the wrongful acts precluding coverage could be judicially determined in a separate parallel declaratory judgment action using extrinsic evidence.⁵¹ To that end, the Fifth Circuit held the Underwriters would not be permitted to rely on mere allegations in the underlying action to preclude coverage under a “determined in fact” exclusion.⁵²

The Fifth Circuit affirmed the lower court's injunction requiring the Underwriters to continue reimbursing the Stanford executives' defense costs until a determination could be made in separate proceedings as to whether the Money Laundering exclusion applied.⁵³ On remand, a different judge was required to be appointed because of the perceived impropriety in the criminal judge both deciding the declaratory judgment action and then presiding over the subsequent criminal trial.⁵⁴ If the coverage determination was made in favor of the Underwriters, such determination could be only on a “without prejudice” basis.⁵⁵ By this, the Court meant that if the executives are ultimately found not guilty of Money Laundering in the underlying action, the Underwriters' obligation to reimburse defense costs would be reinstated.⁵⁶ Essentially,

the “determination in fact” that Money Laundering had occurred (that relieves the Underwriters of a defense cost obligation) could be overridden by a later “adjudication in fact” that Money Laundering had not occurred.

The Fifth Circuit remanded the *Pendergest-Holt* case to the trial court that held that in a preliminary hearing to follow, the burden would be on the Underwriters to prove by a preponderance of the evidence that Money Laundering, as defined in the policies, had in fact occurred.⁵⁷ The Court then denied the insureds’ motion for a protective order to stay discovery against them, rejecting their arguments that responding to the Underwriters’ discovery requests would violate their Constitutional Fifth Amendment privilege against self-incrimination. The court found that a stay of discovery would deprive the Underwriters of information that may be valuable to their defense of the coverage action brought by the insureds.⁵⁸

The Fifth Circuit’s decision in *Pendergest-Holt* provides a practical roadmap for Underwriters to determine their obligations to pay defense costs under D&O policies containing “determined in fact” exclusions. When sufficient extrinsic facts exist to establish that the wrongful conduct took place, Underwriters need not wait until the outcome of the underlying action, but instead can seek a determination of their coverage obligation in a separate action. We caution, however, that not all courts will follow this decision. The law in any applicable jurisdiction must be considered in forming an exit strategy from payment of defense costs under D&O policies.

2. Lehman Bros. Bankruptcy - The Pending Motion to Advance Defense Fees

On 15 September 2008, Lehman Brothers Holdings Inc. and its affiliated companies filed for Chapter 11 bankruptcy in the Bankruptcy Court for the Southern

District of New York. In March, 2009, the Court lifted the bankruptcy stay to allow the XL primary and Chubb first layer excess policies, providing \$35 million in Directors & Officer's coverage, to pay defense costs for former directors, officers, and employees of the Lehman Brothers companies in ongoing federal securities lawsuits and regulatory and other proceedings.⁵⁹ In a 27 July 2010 motion, the Lehman entities moved to obtain an identical Order lifting the stay as to the second, third, and fourth excess policies issued by Continental, Lloyd's and U.S. Specialty, respectively. Lehman represented that each of the 2007-2008 D&O policies contained or followed form to a policy containing a priority of coverage provision that gave priority to payment of limits to the individual insureds under the policies' Side A coverage.

Most noteworthy in this July 2010 motion is the indication of the level of exhaustion of the Lehman Brothers' D&O coverage solely by the defense fees attributable to suits and investigations against the individual former employees. Both the primary and excess policies' \$35 million in coverage was alleged to be exhausted by defense bills then in Chubb's possession. The motion also indicates that the second excess policy issued by Continental (with limits of \$10 million excess of \$35 million) would be exhausted by August 2010 and the third layer excess policy issued by Lloyd's would be exhausted by end of October 2010. The individual insureds would then look to the fourth layer policy issued by U.S. Specialty (with limits of \$15 million excess of \$55 million).⁶⁰

The court granted Lehman Brothers' motion to lift the stay by Order dated 20 August 2010.

3. Market Developments in D&O Coverage for Defense Costs

Insurers have reportedly responded to increased demand for coverage for defense costs incurred in connection with the escalating number of SEC suits and investigations. Additionally, increased financial regulations, such as the Wall Street Reform Act discussed above, have reportedly and uncharacteristically resulted in an expansion, rather than a constriction of the availability of D&O coverage for defense costs.⁶¹

Some more recently marketed D&O policies reportedly expand the definition of “Claim” to include informal governmental inquiries and regulatory investigations by domestic and foreign agencies.⁶² Many include administrative or regulatory proceedings by the SEC or similar agencies or include formal investigations if a formal order of investigation has been entered. Others include investigations commenced by a target letter, Wells notice or subpoena.⁶³ In a soft D&O insurance market, such expanded defense cost coverage may differentiate the product line from competitors or may mark a trend as all insurers routinely begin to offer such coverage.

IV. Conclusion

The last year has been one of conflicting signals in the trends of securities and class actions in the U.S. Over this time period, we have seen a decrease in the number of securities class action suits as the credit crisis related claims decrease. At the same time, however, we are seeing an increase in more traditional class actions as a result of the BP oil spill and Toyota recalls. A number of Supreme Court and other federal court decisions affecting U.S. securities and class action suits have also been issued. The Supreme Court’s decision in *Shady Grove* opens the federal courts to more class action suits while its decision in *NAB* and the recently enacted Wall Street Reform Act may

significantly restrict the number of suits that can be maintained against non-U.S. companies. There are clearly a number of competing influences that could either increase or decrease a particular company's exposure to securities or class actions in the U.S. We will be closely monitoring judicial and legislative developments in this area.

¹ Dr. Jordan Milev, Robert Patton, Dr. Stephanie Plancich, Svetlana Starykh, "Trends 2010 Mid-Year Study: Filings Decline as the Wave of Credit Crisis Cases Subsides, Median Settlement at Record High." Nera Environmental Consulting, July 2010, p. 5. (hereafter "Nera Report").

² Alexander Aganin, "Securities Class Action Filings, 2010 Mid-Year Assessment," The Stanford Law School Securities Class Action Clearinghouse & Cornerstone Research, 2010, p. 3. (hereafter "Cornerstone Report").

³ Cornerstone Report, p. 14.

⁴ David Bradford, "Securities Litigation Surges Following a Quiet First Quarter, An Advisen Quarterly Report – Q2 2010," p. 1.

⁵ *Id.* at pp. 1, 11.

⁶ Advisen Report, p. 12.

⁷ Kara Scanell, Liz Rappaport and Thomas Catan, "SEC Blasted on Goldman," The Wall Street Journal, wsj.com, Sept. 23, 2010.

⁸ *Id.* at p. 13.

⁹ Nera Report, p. 6.

¹⁰ Peter J. Henning, "When Should a Company Disclose a Wells Notice?" The New York Times.com, May 12, 2010.

¹¹ Securities and Exchange Commission v. Goldman Sachs & Co., and Fabrice Tourre, Civil Action No.: 10-cv-3229, Memorandum of Law of Fabrice Tourre in Support of His Motion for Judgment on the Pleadings, filed 9/29/10, p. 1.

¹² Erik Larson, "SEC Seeks Dismissal of Madoff Victims Negligence Suit," Bloomberg.com, Dec 15, 2009.

¹³ Patricia Hurtado, "Litwin Foundation Sues SEC for 'Negligence' Over Madoff Investment Losses," Bloomberg.com, Sept. 24, 2010.

¹⁴ *Id.*

¹⁵ Tiernan Ray, "Ira Sohn: Eisman Says For-Profit Ed the New Sub-Prime," Barrons.com, May 26, 2010; Diane Bartz, "Investor who shorted subprime hits college stocks," Reuters.com, June 24, 2010.

¹⁶ *Dukes v. Walmart Stores, Inc.*, 603 F.3d 571 (9th Cir. Apr. 26, 2010), petition for cert. filed Aug. 26, 2010 (no. 10-277).

¹⁷ *Morrison v. National Australia Bank Ltd.*, 2010 U.S. LEXIS 5257, (Jun. 24, 2010)

¹⁸ *Id.* at *39.

¹⁹ *Morrison v. National Australia Bank*, 547 F.3d 167, 170 (2d Cir. 2008) (internal citations omitted).

²⁰ *Id.*

²¹ *Id.* at 171.

²² 210 U.S. LEXIS 5257 at *24-25.

²³ *Id.* at *15.

²⁴ *Id.* at *32.

²⁵ *Id.* at *34.

²⁶ *Id.* at *24.

²⁷ *Id.* at *24-*25.

²⁸ Wall Street Reform and Consumer Protection Act of 2009, Section 929P(b)(1) (hereafter "Wall Street Reform Act").

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at p. 1.

³² American Depository Receipts may also be referred to as American Depository Shares (“ADS”). The ADSs are the shares represented by the ADRs. ADR programs allow U.S. investors to purchase receipts representing a percentage of a share in a non-U.S. company without owning the non-U.S. share itself.

³³ *Stackhouse v. Toyota Motor Co.*, et al. (and related cases), U.S. District Court, Central District of California, 2010 U.S. Dist. LEXIS 79837 *4-*5 (C.D. Calif. July 16, 2010).

³⁴ *Id.* at p. 3.

³⁵ In re Societe Generale Securities Litigation, Case No.: 08 Civ 2495, 29 Sept. 2010 Decision & Order of U.S. District Judge Richard M. Berman, p. 10-11.

³⁶ *Id.* at 11.

³⁷ Wall Street Reform Act, Section 933B.

³⁸ *Id.*, Section 939G.

³⁹ Anusha Shrivastava and Fawn Johnson, “SEC Breaks Impass with Rating Firms,” Wall Street Journal/wsj.com, July 22, 2010.

⁴⁰ Wall Street Reform Act, Section 932.

⁴¹ *Id.*, Sections 929M, 929N, 929O.

⁴² *Id.*, Section 929P(c); 15 U.S.C. § 78t(a).

⁴³ *Id.* Section 921.

⁴⁴ *Id.*, Section 748.

⁴⁵ *Id.*

⁴⁶ Joseph Monteleone, “Escalating D&O Defense Costs Fuel Disputes Between Carriers, Insureds,” P&C National Underwriter, May 17, 2010.

⁴⁷ *Pendergest-Holt v. Certain Underwriters at Lloyd’s London*, 600 F.3d 562 (5th Cir. 2010).

⁴⁸ *Id.* at 562.

⁴⁹ *Id.* at 568.

⁵⁰ *Id.* at 567.

⁵¹ *Id.* at 573.

⁵² *Id.* at 574.

⁵³ *Id.* at 576.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Pendergest-Holt v. Certain Underwriters at Lloyd’s of London*, 210 U.S. Dist. LEXIS 45262, *5 (S.D. Tex. May 10, 2010).

⁵⁸ *Pendergest-Holt v. Certain Underwriters at Lloyd’s of London*, 210 U.S. Dist. LEXIS 82313, *10-*11 (S.D. Tex. Aug. 11, 2010).

⁵⁹ In re Lehman Brothers Holdings, Inc., United States Bankruptcy Court Southern District of New York, Chapter 11 Case No. 08-13555, “Notice of Debtors’ Motion, Pursuant to Section 362 of the Bankruptcy Code, for an Order Modifying the Automatic Stay to Allow Advancement Under Directors and Officers Insurance Policies by Continental Casualty Company, Certain Underwriters at Lloyd’s London and U.S. Specialty Insurance Company” filed July 27, 2010.

⁶⁰ *Id.*

⁶¹ National Underwriter Online News Service, “D&O Coverage Expanding to Meet Rising Costs of Regulatory Probes,” Aug. 13, 2010, p. 1. (<http://www.property-casualty.com>; last accessed September 28, 2010).

⁶² Howard B. Epstein and Theodore A. Keyes, “Things to Know About Your D&O Insurance Before Investigation Begins,” New York Law Journal, Expert Analysis, www.nylj.com, March 16, 2010; Rich Leavitt, “A New D&O Insurance Landscape for Public Companies – Indemnity Plus,” William Gallagher Associates, Aug. 30, 2010.

⁶³ Epstein and Keyes at p. 1.