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Post-Financial Meltdown Securities Litigation

Law360, New York (October 23, 2008) -- Losses beget lawsuits, and the recent Wall Street calamities are no exception. Indeed, the next great wave of federal securities litigation has begun.

Just as the last big cluster of massive lawsuits filed in 2001-02 (involving the likes of Enron, Worldcom, Global Crossing, Adelphia and Tyco) appeared to be winding down, seismic tremors of scandal and failure at institutions previously thought to be impregnable — Fannie Mae, Freddie Mac and Washington Mutual, to name a few — have precipitated a tsunami of new securities suits. Not surprisingly, these suits target not only the troubled companies and their directors and officers, but an array of secondary actors that includes most of the remaining major Wall Street financial institutions.

And, as only a cursory glance at the recent financial press makes clear, this is only the beginning. As more and more investors take a step back to assess the damage to their portfolios and begin to assign blame, more litigation is inevitable.

At the head of the line are major institutional investors — state and local employee pension funds, hedge funds, investment managers, charitable foundations — whose investments in the equity and debt of financial services companies have taken a bath in the wake of the housing and credit market meltdowns.

Undoubtedly, the total losses for many institutional investors will reach into the hundreds of millions and, in some cases, billions of dollars.
As these institutional plaintiffs begin to consult their lawyers and weigh their litigation options, they will have to decide whether to bring suit on their own as individual plaintiffs, seek appointment as lead plaintiffs in a class action or simply passively await the outcome of class suits in which they are members of the putative class.

In making this decision, many such investors are likely to dust off a somewhat musty statutory provision that has been invoked infrequently since its enactment more than seventy years ago — Section 18 of the Securities Exchange Act of 1934. Section 18 offers plaintiffs unique advantages over the more familiar, judicially-implied cause of action under Section 10(b) of the Exchange Act and SEC Rule 10b-5.

The problem is that, for reasons we explain below, Section 18's rigorous actual reliance requirement is not compatible with class-wide litigation. As a result, most disgruntled investors cannot avail themselves of the statute's advantages.

But most institutional investors can, and in the current environment many have sustained losses that are sufficiently large to support individual lawsuits. The implication is that, in this next wave of securities litigation, we may see more institutional investors eschewing participation in class actions and taking advantage of Section 18 by bringing their own standalone lawsuits.

Section 18's Advantages
Section 18 provides an express statutory cause of action to any person who purchases or sells a security in “actual reliance” on a false or misleading statement of material fact included in any application, report or document filed pursuant to the Exchange Act, unless the person knew that such statement was false. 15 U.S.C. § 78r(a).

The plaintiff may sue any person who "made" the false or misleading statement, or "caused" it to be made. Ibid. Thus, to prevail, a Section 18 plaintiff must plead and prove:
(1) the defendant made or caused to be made a false or misleading statement;
(2) the statement was contained in a document filed with the SEC pursuant to the Exchange Act or any rule or regulation thereunder (e.g., 8-Ks typically do not count, and neither do registration statements or other documents filed only under the Securities Act of 1933);
(3) the plaintiff actually relied on the false or misleading statement; and
(4) the plaintiff suffered damages as a result of that reliance.

From a plaintiff's perspective, Section 18 provides a cause of action that is superior to Section 10(b) in at least two respects.

First, and most importantly, a Section 18 plaintiff does not have to plead or prove that a defendant acted with intent to defraud, recklessness or any other form of scienter. See, e.g., Deephaven Private Placement Trading, Ltd. v. Grant Thornton & Co., 454 F.3d 1168, 1172 (10th Cir. 2006). Instead, to escape liability, the defendant must prove by way of an affirmative defense at trial that he acted in good faith and did not know that the statement at issue was false or misleading. Ibid.

Given that the vast majority of securities suits that fail at the pleadings stage under the Private Securities Litigation Reform Act (PSLRA) are dismissed because the complaint's allegations are insufficient to give rise to a "strong inference" of scienter, the lack of a scienter requirement under Section 18 makes it far easier for the plaintiff to get beyond the pleadings and into discovery with relative dispatch. Moreover, because Section 18 shifts onto defendant the burden of showing his good faith and the lack of knowledge of falsity, it improves the plaintiff's chances of success at trial.

Second, Section 18's extension of liability to those actors who "cause" a false statement to be made, even though they did not actually make the statement themselves, arguably enables plaintiffs to sue persons whose degree of involvement in the fraud would otherwise render them mere "aiders and abettors" exempt from liability under Section 10(b).

The best example of this is the secondary actor — the auditor or banker — who drafts and controls the content of the issuer's 10-Q containing false statements, but does not actually sign the document. Under Section 10(b), that secondary actor has no liability because the statement is not attributable to him, i.e., he did not make it. See, e.g., Wright v. Ernst & Young, 152 F.3d 169 (2d Cir. 1998).

Depending on the circumstances, however, the secondary actor may have "caused" the false statement to be made and subjected himself to liability under Section 18. See In re Adelphia Communications Corp. Sec. & Deriv. Litig., 2007 WL 2615928 (S.D.N.Y. Sept. 10,

2007). Thus, Section 18 may enable plaintiffs to recover their losses from defendants they could not otherwise reach under Section 10(b).

Why Section 18 Has Rarely Been Used

So, if Section 18 offers such wonderful advantages to plaintiffs, why have so few claims been brought under its provisions? The answer lies in Section 18's actual reliance requirement.

Under Section 10(b), plaintiffs who did not actually read or rely on the false or misleading statement can still sue under the "fraud on the market" theory accepted by the Supreme Court in Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

Under that theory, a plaintiff who purchased a security in an efficient market can rely on the trading price as the product of all material information disclosed to the marketplace, even if she did not actually review that information herself before deciding to buy the security.

Given the difficulty of proving that each class member read and relied on a defendant's false statements (not to mention the virtual impossibility of getting such a class certified under Federal Rule of Civil Procedure 23), fraud on the market is the preferred method by which class plaintiffs seek to satisfy Section 10(b)'s transaction causation requirement.

That does not work under Section 18. If you cannot show actual, "eyeball" reliance -- i.e., that you read and relied on the truth of the false or misleading statement at issue when you decided to buy the stock or the bond -- then you cannot sue under Section 18. See, e.g., In re Suprema Specialties Inc. Sec. Litig., 438 F.3d 256, 283 (3d Cir. 2006).

Class action plaintiffs cannot establish eyeball reliance, because they either lack such proof or because having to marshal such proof would overwhelm the common questions essential to getting the class certified. As a result, class plaintiffs have avoided Section 18, which is why historically one rarely sees it pled in securities complaints or discussed in published judicial opinions.

By contrast, most institutional investors will not have a problem meeting Section 18's "eyeball" reliance requirement. Institutions typically employ or contract with professional investment managers who make the decisions about what securities to buy and sell on the institution's behalf.
These investment professionals make it their business to read all publicly-available information about a company and use that information when making investment decisions for their clients.

Even where the investment manager is an outside firm hired to perform such services for the institutional investor, such reliance through an agent who reads all of the material and relies on it to purchase and sell securities on the institution's behalf is sufficient for purposes of Section 18. In re Adelphia, 2007 WL 2615928, at *11.

Moreover, one court has held that, unlike Section 10(b), Section 18 has no "reasonable" or "justifiable" reliance requirement.

So long as the plaintiff actually relied on a specific statement in a specific document and had no knowledge that the statement on which he relied was false, he may sue under Section 18 even if he was aware of questions concerning the falsity of other statements in the same document. In re Adelphia Communications Corp. Sec. & Deriv. Litig., 542 F. Supp. 2d 266, 267-68 (S.D.N.Y. 2008). But see Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid

Corp., 315 F. Supp. 2d 666, 685 (E.D. Pa. 2004) (explaining that the Court understands "the loss and reliance elements of Section 10(b) and 18 to be coterminous").

This makes the statute even more plaintiff-friendly for entities, like most institutional investors, that can satisfy its requirement for actual reliance.

The Revival Of Section 18

In an environment where institutional investors are suffering nine- and even ten-figure investment losses, the attractiveness to such investors of the remedy provided under Section 18 vis a vis Section 10(b) should prompt securities practitioners who counsel such investors — as well as those who defend the likely targets of their lawsuits — to crack open their copy of Title 15 of the United States Code and give Section 18 a read.

The existence of this remedy may prompt many institutions to opt to bring their own standalone suits rather than participate actively or passively in a class action. Not only could increased use of Section 18 by institutional investors inure to their benefit and improve their recoveries, but it could also change the face of federal securities litigation by increasing the number of mega-cases filed by a single institutional investor plaintiff (or maybe even small groups of such investors) without aspirations of representing a class.

Were such a trend to materialize, it would in turn call into question a central objective of the PSLRA, which was to put institutional investors in charge of class action lawsuits brought under the federal securities laws.

In any event, securities practitioners should expect to see more Section 18 claims in the future. And, anyone representing or advising an institutional investor in connection with potential securities litigation should give serious consideration to Section 18's applicability to the client's claim.

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Disclaimer: This article cites to two opinions issued in the Adelphia Communications securities litigation pending in the United States District Court for the Southern District of New York. Lowenstein Sandler PC represents parties in that litigation.

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