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TRENDS IN SECURITIES LAW AND CORPORATE GOVERNANCE

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The Critical Role Played by Private Enforcement of the Securities Laws on Behalf of Taft-Hartley Pension Plans in the Aftermath of the Mortgage-Backed Securities Crisis– A Case Study

BY STEVEN J. TOLL AND MICHAEL B. EISENKRAFT

While plaintiffs' securities lawyers are often vilified by the U.S. Chamber of Commerce, elected officials of the Republican party, and other persons and entities associated with the political right, the use of private attorneys to help enforce the nation's securities laws is actually in synch with a number of the core beliefs typically advocated by those groups.

This use of private attorneys to protect the public constitutes a classic outsourcing of a traditional government function to the private sector, substituting an entrepreneurial group of businesses (private law firms), both motivated and restricted by their need to generate enough revenue to cover their costs, for government employees acting as regulatory enforcers.

It also gives investors—including Taft-Hartley pension plans—that most American of privileges: the ability to defend themselves and their property without relying on the government to initiate action.

Steven J. Toll (stoll@cohenmilstein.com) is the managing partner of Cohen Milstein Sellers & Toll PLLC and co-head of its Securities Fraud/Investor Protection practice group. He works in the firm's Washington office. Michael B. Eisenkraft (meisenkraft@cohenmilstein.com) is a partner at Cohen Milstein Sellers & Toll PLLC and a member of its Securities Fraud/Investor Protection practice group. He works in the firm's New York office.

Critics often describe plaintiffs' lawyers as pirates, but a much more apt analogy is the privateer. Privateers were private vessels given permission by their government, via a Letter of Marque or a Privateer Commission, to attack and capture enemy vessels during war. This enabled the country to effectively expand the size and reach of its navy by deputizing private ships and giving these private vessels the opportunity for profit, as they were permitted to keep the enemy vessels and cargo they seized. [1]

The "time-honored practice of privateering . . . encouraged patriotic private citizens to harass British shipping while risking their lives and resources for financial gain," and played a pivotal role in the Revolutionary War, with the Continental Congress issuing Letters of Marque and Privateering Commissions to private vessels responsible for capturing or destroying about 600 British ships.[2]

"Plaintiffs' lawyers are the 21st century version of privateers, allowing the government to expand resources devoted to fighting securities fraud without straining the public purse and encouraging patriotic private attorneys to police the securities markets while risking their own work and resources for potential financial gain."

Plaintiffs' lawyers are the 21st century version of privateers, allowing the government to expand resources devoted to fighting securities fraud without straining the public purse and encouraging patriotic private attorneys to police the securities markets while risking

[1] John Frayler, *Privateers in the American Revolution*, Salem Maritime Nat'l Historic Site, NPS, (Dec. 4, 2008), http://www.nps.gov/revwar/about_the_revolution/privateers.html.

[2] *Id.*

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their own work and resources for potential financial gain.

This description of the role of plaintiffs' securities lawyers may seem self-serving coming from plaintiffs' securities lawyers, but the value of the government's effective deputization of the private securities bar as supplementary enforcers of the American securities laws has also been recognized by the U.S. Supreme Court and Congress, as well as the Securities and Exchange Commission (''SEC'') itself–the primary governmental agency responsible for policing the American securities markets.

Specifically, the Supreme Court has, in its words, ''repeatedly []emphasized that implied private actions provide 'a most effective weapon in the enforcement' '' of the securities laws and are ''a necessary supplement to Commission action.''[3]

Congress has made similar remarks. In the House Report for the Private Securities Litigation Act, it was recognized that ''[P]rivate lawsuits promote public and global confidence in our capital markets and help . . . to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs'' and are ''an indispensable tool'' used to ''protect investors and to maintain confidence in the securities markets.''[4]

The SEC has also been supportive of the efforts of private litigants. In testimony before the Senate, SEC Chairman Arthur Levitt recognized that ''[P]rivate rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program.''[5]

''Many Taft-Hartley plans, motivated by their fiduciary duty to recover funds potentially lost to violations of the securities laws, have stepped into that breach and acted as lead plaintiff in a number of the most important securities cases extant.''

Importantly, however, none of this supplemental enforcement power can come into play if investors are unwilling to hire lawyers, bring suit, and act as a lead plaintiff. Fortunately for investors, securities class action attorneys working for plaintiffs are generally willing to work on a purely contingent basis, collecting a fee only if the class recovers and taking that fee out of the recovery. That being said, acting as a lead plaintiff is not costless–it takes time and effort for a lead plaintiff to monitor the counsel they retain and the lawsuit, preserve and produce documents, and, if necessary, testify at a deposition or trial.

As discussed below, many Taft-Hartley plans, motivated by their fiduciary duty to recover funds potentially lost to violations of the securities laws, have stepped into that breach and acted as lead plaintiff in a number of the most important securities cases extant, bringing into play the supplemental resources of the private securities bar to help investors pursue a recovery.

The importance of this supplemental private enforcement firepower to investors is best explained by viewing it from three angles: globally, by examining and comparing the resources available to the government and its enforcement efforts with those by the private securities bar; topically, by studying the response to the recent mortgage crisis; and specifically, by describing how a private law firm operating on contingency litigates a securities case and what that can mean for investors, including Taft-Hartley plans.

Global View: Comparison of Resources

Globally, the statistics are stark. In 2013, the SEC's budgetary authority stood at $1.3 billion.[6] This is the SEC's entire budget, all the money they have–not only to track down and punish fraudsters but also to monitor, regulate, and administer the securities markets of the United States. To put this into perspective, the top three hedge fund managers last year made $3.5 billion (David A. Tepper of Appaloosa Management), $2.4 billion (Steven A. Cohen of SAC Capital Advisors whose firm has pled guilty to securities law violations this year, paid a fine of $1.2 billion, and will turn into a private family office managing Steven Cohen's wealth after this year), and $2.4 billion (John A. Paulson of Paulson & Company) respectively.[7]

In other words, the three most highly paid hedge fund managers last year ***each*** made almost twice as much ***as the entire budget of the SEC***.

''To put it simply, the SEC is completely outnumbered and outgunned by the securities industry it regulates and polices–to say nothing of the private armies of high powered attorneys the securities industries hire to defend and protect themselves.''

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[3] *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964), quoting *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985). *See also Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 778 (2008)(15 PBD, 1/24/08; 35 BPR 256, 1/29/08)(''private litigation under § 10(b) continues to play a vital role in protecting the integrity of our securities markets.'').

[4] H.R. Conf. Rep. No. 104-369, at 31(1995).

[5] S. Rep. No. 104-98, at 8 (1995), quoting SEC Chairman Arthur Levitt.

[6] Sec. & Exch. Comm'n, FOIA Document; Budget History (May 7, 2013).

[7] Alexandra Stevenson, *Hedge Fund Moguls' Pay Has the 1% Looking Up*, The New York Times, (May 6, 2014, 2:06AM). http://dealbook.nytimes.com/2014/05/06/hedge-fund-moguls-pay-has-the-1-looking-up/.

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powered attorneys the securities industries hire to defend and protect themselves. The SEC itself recognizes this problem, admitting to Congress that the ''current levels of resources is not sufficient to keep pace with the growing size and complexity of the securities markets and of the agency's broad responsibilities.''[8]

What's more, this imbalance has been getting worse, not better. The number of investigative attorneys at the SEC dropped 11.5 percent between 2004 and 2008, from 566 to 501. ''In interviews and small group meetings, Enforcement management and investigative attorneys agreed that resource challenges have affected their ability to bring enforcement actions.''[9]

Other government agencies, themselves facing resource strains, have been less able to assist the SEC. For instance, ''The F.B.I., which assigned dozens of agents to Enron, had shifted resources to terrorism'' and the ''Postal Service wound down an elite unit that had specialized in complex financial investigations.''[10]

This lopsided resource imbalance inevitably has repercussions on enforcement. Between 2004 and 2008, the SEC brought on average 175 actions per year.[11] By 2013, the SEC was down to 73 enforcement actions. *Id*.

According to Cornerstone Research, the SEC docket dedicated to securities fraud enforcement has fallen from 28 percent in 2004 to 13 percent in 2013.[12] According to one federal judge, ''the SEC has been hard hit by budget limitations'' which caused the SEC to ''focus on the smaller, easily resolved cases that will beef up their statistics when they go to Congress. . .'' [13]

Luckily for investors and the integrity of the securities markets, the resources of private plaintiff's attorneys have helped make up the gap–especially against larger companies with more serious violations that present potentially the greatest rewards for plaintiffs' attorneys—along with, of course, the heightened difficulty and risk present when a company can, and does, hire hordes of the most expensive attorneys available to defend themselves.

According to a recent law review article, private actions ''provide greater deterrence against more serious securities law violations compared with the SEC.''[14] This reliance on private actions holds true for some of the biggest frauds in recent history. In actions related to the giant Enron fraud, the SEC recovered $440 million, while private attorneys recovered around $7.3 billion for investors.[15]

Similarly, in suits related to the accounting fraud at Worldcom, the SEC recovered $750 million,[16] while private attorneys representing investors recovered $6.1 billion[17]for their clients. In an even more dramatic example, private attorneys recovered approximately $3.2 billion for investors harmed by the massive fraud at Cendant and the SEC recovered nothing—though the Department of Justice did prosecute, convict, and send to prison Cendant's Chief Executive Officer.[18]

In addition to the deterrence effect provided by private attorneys, private actions also supply almost all of the relief available to defrauded investors as most of the fines and penalties imposed by the SEC go to the government as opposed to victims of securities fraud. In 2013 the SEC ''obtained total penalties and disgorgements of $3.4 billion,'' but only returned $54 million of this to investors.[19]

In contrast, in 2012, private suits recovered $2.9 billion, generally all of which (save for the monies used to pay attorneys and reimburse expenses) was returned to investors.[20]

Topical View: Response to Mortgage Crisis

The importance of private actions to investors and the securities market is perhaps best illustrated, however, by investigating the response of private attorneys and the government to the recent mortgage crisis—first by examining the macro picture and then by focusing on a single case as an exemplar of a private securities action.

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Residential mortgage-backed securities (''MBS'') are essentially bonds collateralized by pools of mortgages.

[8] Sec. & Exch. Comm'n, FY 2014 Congressional Budget Justification 4 (April 10, 2013), http://goo.gl/es0FWM.

[9] U.S. Gov't Accountability Office, GAS-09-358, Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement 4 (2009).

[10] Jesse Eisinger, *Why Only One Top Banker Went to Jail for the Financial Crisis*, The New York Times, (April 30, 2014), http://www.nytimes.com/2014/05/04/magazine/only-one-top-banker-jail-financial-crisis.html?emc=eta1&_r=0.

[11] Sec. & Exch. Comm'n Year-by-Year Enforcement Statistics (Dec. 17, 2103).

[12] Cornerstone Research, Securities Class Action Filings: 2012 Year in Review 23 (2013)

[13] Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, The New York Review of Books (Jan. 9, 2014). http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions.

[14] Choi & Pritchard, SEC Investigations and Securities Class Actions: An Empirical Comparison, U. Mich. L. & Econ. Research Paper No. 12-022, at 39 (2012).

[15] Compare Securities and Exchange Comm'n, Enron, http://www.sec.gov/divisions/enforce/claims/enron.htm. with Kristen Hays, ''Enron Settlement: $7.2 Billion to Shareholders,'' Houston Chronicle, http://www.chron.com/business/enron/article/Enron-settlement-7-2-billion-to-shareholders-1643123.php. (Sept. 9, 2008).

[16] *SEC v. WorldCom, Inc.*, 273 F. Supp. 2d 431, 435 (S.D.N.Y. 2003).

[17] *In re WorldCom, Inc. Sec. Litig.*, 388 F. Supp. 2d 319, 322 (S.D.N.Y. 2005).

[18] See *In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001); http://www.nytimes.com/2007/01/18/business/18cendant.html.

[19] Sec. & Exch. Comm'n, 2013 Agency Fin. Report 2, 96 (Dec. 12, 2013).

[20] Ryan & Simmons, Cornerstone Research, Securities Class Action Settlements: 2012 Review and Analysis 2 (2013)

When homeowners make their mortgage payments on time, those payments flow through to the MBS investors, who get their money back, plus interest. However, if too many mortgages default or become delinquent, MBS investors can lose money. The MBS income stream can dry up, the trading price of the MBS can plummet, or both.

When they were issued, MBS were generally rated AAA, indicating that they were the safest and most secure investment—equivalent to U.S. Treasury bonds. As time went on, however, the standards that were supposed to be followed when issuing mortgages were largely ignored as loan originators began doling out mortgages to people who had little chance of paying them back. Once it became clear that the guidelines purportedly used to originate the underlying loans had been systematically disregarded, the rating agencies dramatically downgraded the MBS to junk status and their prices collapsed.

The massive tidal wave of abuse that fed the MBS bubble peaked with a balance of $2.2 trillion worth of MBS in 2007,[21] followed quickly by the collapse of the American economy in the credit crisis and the Great Recession of 2008. In turn, this cataclysm generated a wave of litigation by MBS investors who lost billions of dollars seeking compensation for their losses from the investment banks and other financial institutions who sold them.

Plans at Forefront of Private Action Wave. At the forefront of the litigation wave are several Taft-Hartley pension plans represented by private attorneys who sued the largest banks in the world on behalf of MBS investors. Specifically, there are a series of cases currently pending in federal court in New York alleging violations of Sections 11 and 12 of the Securities Act of 1933, which claim that defendants failed to inform investors that the loan underwriting guidelines supposedly in place to ensure the quality of the mortgages were systematically disregarded. There, at least 13 class actions were brought on behalf of investors in different MBS[22] in addition to a number of other lawsuits in jurisdictions around the country. Many of these lawsuits involve claims of billions and, in some cases, tens of billions of dollars of MBS.

The government took a much more conservative approach in responding to the MBS problem. In a recent New York Times article, it was reported that only a single ''Wall Street executive [was] sent to jail for his part in the financial crisis,'' despite much allegedly wrongful conduct by investment banks and the fact that the federal judge who sentenced this one executive noted that his conduct only comprised, ''a small piece of an overall evil climate within the bank and with many other banks.'' [23]

The SEC also took a less aggressive approach, generally standing back and allowing private attorneys to take the lead in bringing Securities Act cases against the major investment banks for their disregard of underwriting guidelines when issuing MBS. So, how do these cases work? How does a private law firm bring a case under the Securities Act against some of the world's biggest financial institutions when the government itself has chosen not to expend its overstretched resources to prosecute? The best way to do so, as noted above, is to give an insider's view of one case—*N.J. Carpenters Vacation Fund v. The Royal Bank of Scotland, PLC*, No. 08-5093 (HB) (S.D.N.Y.) (the ''Harborview case''). [24]

Insider's View: Securities Act Case

In the *Harborview* case, a class of plaintiffs, led by the N.J. Carpenters Vacation Fund and the Boilermaker Blacksmith National Pension Trust, sued The Royal Bank of Scotland (''RBS''), one of the world's largest banks, on May 14, 2008, alleging that the bank, in its role as underwriter of a number of mortgage-backed securities (the Harborview securities), violated Sections 11 and 12 of the Securities Act by, *inter alia*, failing to disclose in the offering documents for these mortgage-backed securities that the underwriting guidelines purportedly used to originate the mortgages collateralizing these MBS were systematically disregarded.

After filing a federal securities case, the Private Securities Litigation Reform Act mandates a 60-day notice period, wherein—after publication of an announcement in the media, any putative member of the asserted class may move to serve the class as lead plaintiff and to appoint their counsel lead counsel for the putative class. In securities matters involving solvent defendants, there are, in many cases, multiple competitors for the status of lead plaintiff and lead counsel. Often, the number of competitors for lead plaintiff and lead counsel is affected by the size of the case and its perceived difficulty—with more parties interested the bigger and easier a case is perceived to be.

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[21] National Association of Insurance Commissioners and the Center for Insurance Policy and Research, ''Capital Markets Special Report,'' http://www.naic.org/capital_markets_archive/120809.htm.

[22] *See, e.g.*, *In re Lehman Brothers Securities and ERISA Litigation*, 09-md-2017, (S.D.N.Y.) [48 EBC 1838] (22 PBD, 2/4/10; 37 BPR 320, 2/9/10) [51 EBC 2823] (195 PBD, 10/7/11; 38 BPR 1867, 10/11/11) [54 EBC 2868] (232 PBD, 12/5/12; 39 BPR 2355, 12/11/12); *In re IndyMac Mortgage-Backed Sec. Litig.*, 09-cv-4583 (S.D.N.Y.); *In re Bear Stearns Mortgage Pass-Through Certificates Litig.*, 08-cv-8093 (S.D.N.Y.); *Fort Worth Employees' Ret. Fund v. JPMorgan Chase & Co., Inc.*, 09-cv-3701 (S.D.N.Y.); *City of Ann Arbor Employees' Ret. Sys. v. Citigroup Mortgage Loan Trust, Inc.*, 08-cv-1418 (E.D.N.Y.); *Mass. Bricklayers & Masons Funds v. Deutsche Alt-A Sec.*, 08-cv-3178 (E.D.N.Y.); *In re Morgan Stanley Mortgage Pass-Through Certificates Litig.*, 09-cv-2137 (S.D.N.Y.)(160 PBD, 8/20/10; 37 BPR 1884, 8/24/10; 185 PBD, 9/23/11; 38 BPR 1773, 9/27/11; 10 PBD, 1/15/13; 40 BPR 197, 1/22/13); *New Jersey Carpenters Health Fund v. Home Equity Mortgage Trust 2006-5*, 08-cv-5653 (S.D.N.Y.); *Public Employees' Retirement System of Mississippi v. Merrill Lynch & Co.*, 08-cv-10841 (S.D.N.Y.); *Tsereteli v. Residential Asset Sec. Trust 2006-A8*, 08-cv-10637 (S.D.N.Y.); *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 08-cv-10783 (S.D.N.Y.); *Publ. Employees' Ret. Sys. of Miss. v. Goldman Sachs Group, Inc.*, 09-cv-1110 (S.D.N.Y.); *New Jersey Carpenters Health Fund, et al. v. Residential Capital, LLC, et al.*, 08-CV-8781 (HB) (S.D.N.Y.); *N.J. Carpenters Vacation Fund v. The Royal Bank of Scotland, PLC*, No. 08-cv-5093 (HB) (S.D.N.Y.); *New Jersey Carpenters Health Fund v. NovaStar Mortgage, Inc., et al.*, No. 08-cv-5310 (S.D.N.Y.)

[23] *See* http://www.nytimes.com/2014/05/04/magazine/only-one-top-banker-jail-financial-crisis.html?emc=eta1&_r=0.

[24] Cohen Milstein Sellers & Toll PLLC, where both of the authors of this article are partners, served as lead counsel in this case.

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In this case, after filing the requisite notice, not a single party came forward to contest the motion of the New Jersey Carpenters Vacation Fund and the Boilermaker Blacksmith National Pension Trust. This raised the question—was this case too risky to pursue?

Simple Question, No Simple Answer. A quick review of the litigation that followed illustrates how complex and unpredictable the answer to this seemingly simple question can be. The defendants filed a motion to dismiss the entire case on July 15, 2009, and on March 26, 2010, the court granted in part and denied in part defendants' motion to dismiss in a way that made it difficult to decide which side should be deemed the victor.

On the one hand, the district court dismissed 13 of the 15 MBS offerings from the case on standing grounds because the two lead plaintiffs hadn't purchased in those offerings and dismissed plaintiffs' claims based on the allegations that credit rating models were outdated, that credit enhancements were inadequate, and that defendants purportedly omitted disclosure of material conflicts of interest with the rating agencies.

On the other hand, the court upheld the core allegation for the remaining two MBS offerings in the case, that lead plaintiffs adequately alleged violations of the Securities Act by alleging defendants' failure to disclose that the mortgage originators systematically disregarded the applicable underwriting guidelines. So, the plaintiffs' case survived, but the district court shrunk its size and scope dramatically.

" The result, a $275 million settlement, was achieved without any assistance from the SEC or any other government enforcer and will, upon approval of the Court be distributed to investors allegedly harmed by these violations of the securities laws."

To restore some of the 13 dismissed MBS offerings in the case, the Laborers Pension Fund and Health and Welfare Department of the Construction and General Laborers District Counsel of Chicago and Vicinity, the Midwest Operating Engineers Pension Trust Fund, and Iowa Public Employees' Retirement system, all filed motions to intervene. The district court granted the motion on December 22, 2010, restoring six more of the MBS Offerings to the case.

This victory for plaintiffs was, however, shortly followed by a devastating defeat. On January 18, 2011, the district court denied plaintiffs' class certification motion. For a securities case like this one, where the litigation can easily cost millions of dollars in fees and expenses, the inability to move forward as a class makes litigating the case uneconomical and could sound an effective death knell for the case. In response, plaintiffs filed a motion for interlocutory appeal to the Second Circuit under Federal Rule of Civil Procedure 23(f), requesting that the Second Circuit permit plaintiffs the unusual remedy of filing an immediate appeal of the certification decision.

The Second Circuit granted the petition, reviving the hopes of plaintiffs and our firm. On April 30, 2012, in another mixed decision, the Second Circuit affirmed the denial of class certification, but did so ''without prejudice to further motion practice in the District Court.''

This point in the litigation presented one of the most difficult strategic problems in the case. Plaintiffs faced a situation where the district court denied class certification and that determination was *upheld* by the Second Circuit. Despite the small opening left by the Second Circuit's seeming invitation to engage in ''further motion practice in the District Court,'' there seemed little chance that the district court would reconsider its prior decision.

Construction of Class Definition. In order to maximize that small chance, plaintiffs deliberately constructed a new class definition to address the problems identified by the district court and the Second Circuit while minimizing the harm to the class. The District Court found the potential knowledge of Fannie Mae and Freddie Mac, given their special roles in the mortgage markets, troubling—so the class definition eliminated them. The fact that certain class members purchased MBS after some data about the performance of the MBS also gave the district court and the Second Circuit pause.

To address this concern, plaintiffs could have taken the conservative route and proposed a class definition restricted to right around the offering date. Plaintiffs took a more aggressive approach, however, keeping in the proposed class any investor who purchased before the MBS were downgraded by the rating agencies. The thought behind this approach was that the court could always shrink the class definition, but would be highly unlikely to expand it.

After multiple rounds of briefing and decisions, the district court granted plaintiffs' motion for class certification for a class limited to those who purchased MBS within 10 trading days of the public offering on January 3, 2013, a number it reached after first *sua sponte* restricting the class definition to purchases on the day of the offering.

Around this time, plaintiffs received a dose of undiluted good news. A recent decision by the Second Circuit in another MBS case, *NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co.*, 693 F.3d 145 (2d Cir. 2012) (''*NECA*''), reversed the decision on standing in that case—a decision which had direct import for the *Harborview* case. Plaintiffs promptly filed a motion for reconsideration of the original dismissal decision.

After the Supreme Court denied *certiorari* in NECA, the district court granted lead plaintiffs' reconsideration motion on April 30, 2013, restoring 12 of the original MBS offerings in the case. On December 27, 2013, the district court granted to lead plaintiffs' motion to expand the class, including all 14 remaining offerings in the class. Of course, during much of this time, along with this motion practice (and a number of other motions, too numerous to summarize), the parties were engaging in intensive discovery.

By the winter of 2014, and more than six years of litigation, plaintiffs had completed the following:

- briefed and argued three separate motions to dismiss,

■ briefed and argued class certification three times before this court, as well as fully briefing four Rule 23(f) petitions to the Second Circuit;

■ fully litigated an appeal before the Second Circuit regarding class certification;

■ conducted discovery in connection with class certification following the Second Circuit ruling;

■ briefed and argued a motion for intervention;

■ briefed and argued a motion for reconsideration,

■ briefed and argued discovery motions;

■ completed full fact discovery, including the review of over 5.8 million pages of documents and taking/defending a total of 13 depositions throughout the case relating to 12 RMBS offerings;

■ prepared of expert reports, including a report from an expert in statistics and sampling; a loan origination expert who re-underwrote a sample of the more than 18,000 loans at issue; an expert on investment banking due diligence; and an expert on damages.

At this point, however, on Valentine's Day of 2014, the parties reached an agreement on a settlement facilitated by the Honorable Layn R. Phillips, an experienced and highly respected mediator and former Federal Judge and United States Attorney for $275 million—at that point the third largest monetary settlement of an MBS class action ever.

Success Without Government Assistance.

This case and the settlement illustrate all of the points described above. It was a private action, brought by private plaintiffs and private attorneys working on a purely contingent basis, brought against one of the biggest banks in the world alleging violation of the American securities laws governing public offerings in connection with a small portion of the MBS whose collapse in value helped cause the Great Recession.

The result, a $275 million settlement, was achieved without any assistance from the SEC or any other government enforcer and will, upon approval of the Court, be distributed to investors allegedly harmed by these violations of the securities laws after payment of expenses and fees to the private law firm that litigated the action.

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Supreme Court Overturns Moench Presumption in *Fifth Third Bancorp v. Dudenhoeffer*

Introduction

The U.S. Supreme Court on June 25, 2014, unanimously ruled that fiduciaries of Employee Stock Ownership Plans ("ESOPS") are not entitled to a "presumption of prudence," overturning the longstanding Moench presumption that had previously insulated ESOP fiduciaries from liability in stock drop cases. While we are pleased with the Court's decision to overrule the presumption, our satisfaction with the opinion is tempered by the fact that the Court arguably created a more stringent pleading standard for alleging a breach of the duty of prudence.

Facts and Background

In *Dudenhoeffer*, participants in Fifth Third Bank's ESOP alleged that the ESOP's fiduciaries breached their duty of prudence by continuing to purchase Fifth Third stock even though the fiduciaries knew, based on both public and inside information, that the stock was overvalued and that the economy was on the brink of collapse, as the subprime mortgage lending bubble was on the verge of bursting. Given this knowledge, the participants alleged that the ESOP's fiduciaries should have sold at least some of the ESOP's holdings in Fifth Third Bank. The fiduciaries failed to do so, instead continuing to purchase Fifth Third stock. Thus, when the market did eventually crash, Fifth Third's stock dropped precipitously, thereby eliminating much of the participants' retirement savings.

Relying on the Moench presumption, the United States District Court for the Southern District of Ohio dismissed the participants' complaint, holding that when a lawsuit challenges an ESOP fiduciary's investment decisions, "the plan fiduciaries start with a presumption that their decision to remain invested in employer securities was reasonable." The district court held that the presumption applied at the pleading stage, and the complaint's allegations were insufficient to rebut it.

The Court of Appeals for the Sixth Circuit reversed, holding that although ESOP fiduciaries are entitled to a presumption of prudence, the presumption is an evidentiary tool, not a pleading tool and did not apply when ruling on a motion to dismiss. Accordingly, the Sixth Circuit simply examined the allegations in the complaint and held that they were sufficient to state a claim for breach of the fiduciary duty of prudence.

Holding, Analysis, and Implications

The crucial holding in this case, and the one getting the most media attention, is the Court's decision to overturn the Moench presumption by holding that ESOP fiduciaries are not entitled to a presumption of prudence. Rather, they are subject to the same strict duty of prudence applicable to all fiduciary decision-making. The Court explained that while it recognized that the Employee Retirement Income Security Act

("ERISA") must strike a balance between participants' rights under a plan and fostering a regulatory environment that encourages employers to create and maintain plans, it did not believe that the presumption was "an appropriate way to weed out meritless lawsuits or to provide the requisite 'balancing'. . . .[because] such a rule does not readily divide the plausible sheep from the meritless goats." This holding is a victory for plan participants, who were previously stymied by the presumption when attempting to hold ESOP fiduciaries accountable for failing to sell company stock when the stock dropped.

This victory is tempered by the remainder of the opinion, however, which arguably made winning a motion to dismiss for breach of the duty of prudence more difficult. The Court explained that weeding out meritless claims is best accomplished "through careful, context-sensitive scrutiny of a complaint's allegations," and provided a roadmap of issues that lower courts should consider when ruling on a motion to dismiss. First, the Court explained that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over-or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances." The Court, however, failed to define what constitutes "special circumstances." Whether pleading such circumstances will impose a difficult burden on participants going forward will ultimately be determined by how lower courts interpret the phrase.

With regards to allegations that fiduciaries should have bought or sold stock based on nonpublic information, the Court was clear that the duty of prudence "cannot require an ESOP fiduciary to perform an action . . . that would violate the securities laws" and directed lower courts to consider the extent to which a fiduciary's decision to buy or sell based on inside information or to disclose inside information "could conflict with the complex insider trading and corporate disclosure requirements imposed by the federal securities laws or with the objectives of those laws." Finally, the Court noted that when reviewing such claims, lower courts should also "consider whether the complaint has plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases – which the market might take as a sign that insider fiduciaries view the employer's stock as a bad investment – or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and concomitant drop in the value of the stock already held by the fund." In other words, participants' ability to demonstrate a breach of prudence for inside information claims is confined to circumstances where they can establish that a fiduciary's disclosure of inside information or decision to stop purchasing company stock would not violate the securities laws and would not cause more harm than good to the fund.

The implications of the Opinion will be forthcoming as lower courts interpret the Supreme Court's decision. We will continue to monitor the developments and provide updates as necessary.

COHEN MILSTEIN

A Safe Harbor for Lying?

Warning Investors About Knowingly False Predictions

The day before a major public announcement the CEO of Widgets, Inc. is informed that the development of its highly anticipated new line of SuperWidgets has experienced a significant and unexpected setback: the supplier of a key component is about to go belly-up, and it will take months, if not more than a year, to provide suitable alternatives. She is told that, as such, it will take a minor miracle for Widgets, Inc. to actually meet its promised delivery date. The following day, however, the CEO of Widgets, Inc.—a woman of unsurpassed faith—boldly announces to investors: "Widgets, Inc. fully expects that the SuperWidget program will be completed on time!" Spurred by a gnawing of conscience and perhaps a fear of liability, however, she issues the following simultaneous warning: "Of course, there any number of things that could hypothetically cause delay. The economy could crash; our employees could go on strike; our suppliers could go out of business; our factories could be destroyed in an earthquake; who knows." Satisfied, she takes her leave.

Days later, news of the supplier's collapse—and the inevitable delay of SuperWidgets—reaches the market. Widgets, Inc.'s stock plummets in response, and investors sue.

Did the CEO's confident but clearly misleading prediction constitute securities fraud? Under the Private Securities Litigation Reform Act ("PSLRA"), predictions are deemed "forward-looking statements," and if they are "accompanied by meaningful cautionary statements" that disclose "important factors" that could cause the prediction to fail, then no matter how spectacularly wrong the prediction, it is protected from liability by a "safe harbor."

Here, the CEO *did* explicitly tell investors "our suppliers could go out of business," which "could hypothetically cause delay." And, of course, that is exactly what happened. Thus, she did disclose to investors an "important factor" that could cause, and did cause, her prediction to fail. Thus, the safe harbor would seem to apply.

And yet something feels wrong about this conclusion: the supplier had *already* gone out of business, and she *knew* it! Sure, she told investors that might happen—but that implies a non-zero probability it might *not* happen, as well. So, should the fact that she knew the supplier had already gone out of business affect our analysis of whether her warnings were adequate?

On this question, the courts are of two minds. On one side, the Sixth, Ninth, and Eleventh Circuits say no.[1] The Second and Seventh Circuits, meanwhile, say yes.[2] What do they base their positions on? The text of the statute itself, which uses the formless words "meaningful" and "important," is not especially illuminating.

The courts that say no, it doesn't matter that the CEO knew the supplier was already out of business, make two main arguments.

First, they cite legislative history—what Congress said when it passed the law. Legislative history is not controlling, but courts frequently consider it when trying to figure out what Congress intended the words of a statute to mean. In the case of the safe harbor, the most cited legislative history is the Conference Report, which is an agreement on legislation negotiated between the House and Senate. In this case, the Conference Report for the PSLRA included the following comment: "The use of the words 'meaningful' and 'important factors' are intended to provide a standard for the types of cautionary statements upon which a court may, where appropriate, decide a motion to dismiss, without examining the state of mind of the defendant. The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement." [3] This argument is relatively straightforward: Congress didn't mean for courts to consider state of mind when analyzing cautionary statements, so we shouldn't.

But the text of the statute, not the Conference Report, is the law, so these courts generally cite a second, more textual rationale for disregarding state of mind, based on the logic and structure of the statute itself. According to this rationale, taking state of mind into consideration when assessing cautionary language would make the cautionary language defense meaningless. This is so because the safe harbor creates at least two independent defenses for forward-looking statements. First, there is the meaningful cautionary language defense. Second, regardless of whether there is cautionary language, there is no liability if the defendant did not have "actual knowledge" that the forward-looking statement was false. Since lack of actual knowledge is a complete defense, if plaintiffs fail to allege that defendants knew of falsity, plaintiffs will lose, even if there is no cautionary language. Thus, plaintiffs always have to allege knowledge in a case involving forward-looking statements. But if having knowledge makes cautionary language less meaningful, the argument goes, that means that no defendant will ever be able to take advantage of the cautionary language defense, because the inevitable allegation of knowledge will

[1] *See, e.g.*, *Harris v. Ivax Corp.*, 182 F.3d 799 (11th Cir. 1999); *Miller v. Champion Enters., Inc.*, 346 F.3d 660 (6th Cir. 2003); *In re Cutera Sec. Litig.*, 610 F.3d 1103 (9th Cir. 2010).
[2] *See, e.g.*, *Slayton v. Am. Exp. Co.*, 604 F.3d 758 (2d Cir. 2010); *Asher v. Baxter Int'l Inc.*, 377 F.3d 727 (7th Cir. 2004), *as amended* (Sept. 3, 2004).
[3] H.R. Rep. No. 104-369, at 44 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 743.

foreclose that possibility. Thus, for the statute to make sense, it must be that knowledge should not enter into the cautionary language analysis. Or so goes the argument anyway.

Meanwhile, the courts on the other side of the debate rely on a more diverse set of rationales. The fairest way to describe this side's reasoning is probably to say that considering state of mind is at least *consistent* with the safe harbor's text, if not required. Plus, it just seems wrong to say that a warning that doesn't reveal the full extent of the dangers of which you're aware can really be "meaningful." Indeed, as one district court has observed, Congress cannot have intended to grant safe harbor to defendants who knowingly lied to investors.[4]

Both sides' arguments have strengths and weaknesses. The side that eschews state of mind has the benefit of some pretty clear legislative history. Their main weakness is that their position grants safe harbor to some pretty bad behavior, such as the one described above. Additionally, their strongest textual argument, that taking state of mind into consideration would render the cautionary language defense superfluous, is probably wrong. A company could still find safe harbor protection for making knowingly false and misleading prediction if the company paired that prediction with something like a statement that the company doesn't have much faith in the prediction, or at least with disclosures that would allow the investing public to readily figure that out for themselves. For example, suppose the CEO had said "Widgets, Inc. fully expects that the SuperWidget program will be completed on time! Of course, any number of things might cause delay, including a key supplier going out of business. By the way, that just happened yesterday. But we're still projecting an on-time delivery!" In this scenario, the CEO has actual knowledge of falsity, so the complaint can't get dismissed on that basis. But the CEO also warned about the very fact that made her prediction false and misleading in the first place. Thus, even taking the CEO's state of mind into consideration, the complaint would still likely get dismissed because of there was meaningful cautionary language.

Of course, defendants will object that this is a crazy scenario—no company or executive would ever undermine or embarrass themselves that way, and it's unrealistic to expect as much. But even if that's true, the fact remains that the text and structure of the statute plainly doesn't preclude such a scenario. And perhaps more importantly, that criticism misses the point of the safe harbor, which is, after all, to avoid misleading investors by making sure companies disclose all relevant risk factors. So, if you want the protection of cautionary language, don't lie in your projections, and, if you do, hedge your predictions appropriately.

Meanwhile, the side that champions state of mind has the benefit of common sense. If you make a prediction to investors you know is unlikely to come true, issuing warnings that minimize the real

[4] *In re SeeBeyond Technologies Corp. Sec. Litig.*, 266 F. Supp. 2d 1150, 1165 (C.D. Cal. 2003)

probability of failure shouldn't get you off the hook. The main weakness for this side is, of course, the legislative history. As far as legislative history goes, it doesn't get much more authoritative than a Conference Report. And the Conference Report makes pretty clear that when analyzing cautionary language, "[c]ourts should not examine the state of mind of the person making the statement."

Yet, as the Second Circuit pointed out, the Conference Report also required that "cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement." Surely, if a speaker knew that a risk had already materialized, that is "substantive information about [a] factor[] that realistically could cause results to differ materially from" the projection, no? Still, the more specific directive for courts not to consider state of mind is difficult to overcome, and the majority of the circuits have acted accordingly.

So who, if anyone, is right? The realistic answer is, it depends on the judge, the Circuit, and ultimately, the Supreme Court, should it decide to resolve this debate between the Circuits. Of course, Congress could also simply amend the statute to make it clearer—an unlikely scenario in this partisan climate to be sure.

But for the investing public, the *preferred* reading is obvious. If a company issues a prediction it knows is false because something bad has already happened, or will almost certainly happen, they should not be given safe harbor merely for offering cautionary hypotheticals that minimize the true extent of the risk. In the story outlined above, the CEO of Widgets, Inc. lied to investors by making a prediction she knew to be misleading, and her breezy warnings were a wholly inadequate substitute for the truth. Since the safe harbor can readily be interpreted to make her liable for harming investors with her bad behavior, it should be.