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# Alleging Fraud in a Financial Crisis: The Second Circuit Articulates a Less Stringent Pleading Standard for Loss Causation

Loss causation has emerged as a central obstacle to post-financial-crisis fraud cases. The loss causation element of a fraud claim requires plaintiffs to show, in addition to detrimental reliance, that the facts or circumstances concealed by a fraudulent statement caused an ascertainable portion of their losses. In the aftermath of the 2008 financial crisis, plaintiffs have struggled at times to convince state and federal courts that their losses were caused by the alleged fraud, rather than the larger marketwide downturn. The most challenging cases have arisen from losses in asset classes that experienced a broad-based deterioration in value, such as mortgage-related securities and derivatives. If *all* assets in a particular class lose value during a financial crisis, how does a defrauded plaintiff distinguish the losses attributable to the fraud, as opposed to the crisis?

Two recent decisions out of the Second Circuit Court of Appeals have made the task easier for fraud victims. In *Financial Guarantee Insurance Co. v. Putnam Advisory Co.* and *Loreley Financing (Jersey) No. 3 Limited v. Wells Fargo Securities, LLC*, the Second Circuit has roundly repudiated strict requirements for pleading loss causation, deferring knotty causation issues out to later stages of the litigation where plaintiffs have the benefit of a more developed factual record. Quinn Emanuel represents the plaintiff in *Putnam*.

***Background on Loss Causation in Fraud Cases***

There are five elements to a fraud claim under New York common law and federal securities law. They are (1) a material misrepresentation or omission of fact, (2) knowledge of that fact's falsity (also known as *scienter*), (3) a connection with the purchase or sale of securities,

*(continued on page 2)*

## INSIDE



## Charles Verhoeven and Kevin Johnson Named Top IP Litigators by the *Daily Journal*

San Francisco partner Charles Verhoeven and Silicon Valley partner Kevin Johnson were named to the *Daily Journal*'s annual list of "Top Intellectual Property Litigators." Verhoeven was recognized for his $283 million verdict on behalf of ViaSat in *ViaSat v. Space Systems/Loral*; Johnson, for his trial win for Marvell Semiconductor in *France Telecom v. Marvell Semiconductor,* where Marvell was found not liable for infringement. Q

## Standout White Collar Lawyer Kristin Tahler Joins Firm in Los Angeles

Kristin Tahler, a distinguished white collar litigator, has joined Quinn Emanuel as a partner in the firm's Los Angeles office. Ms. Tahler, formerly a senior member of the white collar group at Skadden, has represented a variety of individuals, companies, boards, and special committees in civil and criminal actions, including criminal and regulatory government investigations; internal corporate investigations; government contracting fraud allegations; insider trading allegations; False Claims Act litigation; securities litigation; and class action antitrust litigation. A principal focus of her practice in recent years has been representing clients in the Middle East whose activities are being investigated by U.S. regulators. Ms. Tahler also serves on the board of directors of Mental Health Advocacy Services, a nonprofit organization that provides legal services to children and adults with mental disabilities. She received her A.B. from Princeton University and her J.D. from the University of Southern California Gould School of Law. Q

(4) reasonable reliance (sometimes referred to as "but for" or "transaction causation"), and (5) loss causation. *See Dodona I, LLC v. Goldman, Sachs & Co.*, 847 F. Supp. 2d 624, 639 (S.D.N.Y. 2012) (federal and New York law). Historically, the loss causation element has come into focus in the aftermath of financial crises, where broad declines in market prices can make it more difficult to identify a causal relationship between an alleged fraud and losses sustained on a specific asset or investment.

In the late 1990s and early 2000s, courts in the Second Circuit endorsed a liberal reading of the loss causation requirement. So long as "the defendants' misrepresentations spoke directly to the quality of the specific security or purchase at issue," loss causation was satisfied at the pleading stage. *Laub v. Faessel*, 981 F. Supp. 870, 872 (S.D.N.Y. 1997). For example, in *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, the Second Circuit held that loss causation was satisfied by allegations that the defendant, a securities broker, altered a report about a company, for which it was soliciting investors, in order to conceal historical facts that called into question the general aptitude of a principal executive at that company for managing debt and maintaining adequate liquidity. 250 F.3d 87, 97-98 (2d Cir. 2001). Because that company's ultimate losses were caused by a liquidity crisis at the company, the fraudulent concealment of facts related to the ability of its key personnel to manage liquidity was sufficiently tied to the loss to satisfy the element of loss causation. *Id.* at 98.

The pendulum swung back in defendants' favor following the collapse of the dot-com bubble in 2001, which resulted in a wave of lawsuits over losses on internet stocks. In a key decision from this period, the Second Circuit affirmed the dismissal of a multidistrict litigation consolidating "some 140 class-action complaints" against Merrill Lynch for allegedly biased analyst reports recommending investment in internet companies that were actual or prospective investment banking clients of the firm, for failure to plead loss causation. *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 164-165 (2d Cir. 2005). The Court held that even if Merrill Lynch analysts had knowingly published overly optimistic reports about certain internet companies and caused unwarranted inflation in their stock prices, this conduct would not satisfy loss causation because plaintiffs had not alleged that the inflated stock prices caused the general collapse in the value of internet stocks. *Id.* at 177.

In the aftermath of the 2008 financial crisis, defendants quickly turned to *Lentell* and its progeny to defend against fraud allegations related to losses on mortgage-related securities. Defendants argued, with some success, that widespread losses on mortgage-related securities in the financial crisis could not be tied to misrepresentations as to any particular mortgage-related security. The district court decision in *Putnam* was a leading authority endorsing this reasoning.

***District Court's Dismissal of the* Putnam *Complaint***

In 2012, the Financial Guaranty Insurance Company ("FGIC") sued the Putnam Advisory Company, LLC ("Putnam") for mismanagement of a collateralized debt obligation ("CDO") called Pyxis ABS CDO-2006-1 ("Pyxis"). A CDO is an investment vehicle that purchases a portfolio of assets, which are financed by the investments of noteholders who are entitled to a portion of the cash generated by those assets. Pyxis invested exclusively in mortgage-backed securities ("MBS").

Pyxis was conceived as a "managed CDO," meaning a "collateral manager" with investing expertise was supposed to select its constituent assets, with an eye towards responsibly managing the CDO's risk profile and overall performance. Putnam was the Collateral Manager for Pyxis. FGIC insured $900 million of senior notes issued by Pyxis, guaranteeing payment of interest and repayment of principal owed on those notes. It alleged that its agreement to supply insurance for the Pyxis notes was predicated on Putnam's assurance that it would responsibly select collateral for Pyxis, driven by the best interests of Pyxis's long-term investors.

Unbeknownst to FGIC, Putnam allegedly ceded control over collateral selection to Magnetar Capital LLC ("Magnetar"), a hedge fund that had placed significant bets that the Pyxis collateral would perform poorly. Magnetar's bets against the collateral held by Pyxis placed its interests directly at odds with those of the CDO's long-term investors and insurers. According to FGIC, Magnetar acted on these perverse incentives to fill Pyxis with high-risk MBS that it expected to perform poorly. Pyxis suffered an Event of Default just eighteen months after its formation, and was forced to liquidate at a significant loss in the midst of the 2008 financial crisis, causing FGIC to suffer losses on its insurance obligations. Unsurprisingly, FGIC claims that it would never have agreed to insure Pyxis had it known that Magnetar, and not Putnam, was selecting the collateral going into the Pyxis portfolio, and it sued Putnam for fraud.

Despite the compelling nature of FGIC's fraud claim, the district court for the Southern District of New York dismissed it on the pleadings for failure to adequately allege loss causation. The court reasoned that all MBS-backed CDOs suffered significant losses during the 2008 financial crisis, and found that there were no allegations in the complaint tying the losses on the Pyxis CDO to Putnam's misrepresentations, rather than the economic downturn that caused losses on other, similar investments. To plead loss causation in the backdrop of a marketwide downturn," the Court wrote, "the complaint must allege facts that support an inference that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud." *Fin. Guar. Ins. Co. v. Putnam Advisory Co., LLC*, 2014 WL 1678912, at *10 (S.D.N.Y. Apr. 28, 2014) (internal citation omitted). On this standard, the complaint failed to show that any "pool of collateral … could have avoided default while still conforming to Pyxis's detailed eligibility criteria." *Id.* at *12. Thus, the Court concluded that the wider mortgage crisis would have caused Pyxis's default regardless of who selected its collateral, so FGIC's losses were not fairly attributable to Putnam's misrepresentations.

### *Second Circuit's Reversal and Reinstatement of FGIC's Claims*

On appeal, the Second Circuit reversed. While endorsing the district court's definition of loss causation—FGIC had to plausibly allege it "would have been spared all or an ascertainable portion of [its] loss absent the fraud"—the Second Circuit held that it "misapplied the standard" by conflating pleading loss causation and proving it at trial. *Fin. Guar. Ins. Co. v. Putnam Advisory Co. LLC,* 783 F.3d 395, 404 (2d Cir. 2015). The Court clarified that, at the pleading stage, "[t]he purpose of the loss causation element is 'to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind,' not to make a conclusive proof of that causal link." *Id.* at 404 (quoting *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 346 (2005)).

Applied to FGIC's claims against Putnam, FGIC was "not required to establish that the collateral it has identified as selected by Magnetar was the exclusive cause of its losses; rather, it need only allege sufficient facts to raise a reasonable inference that Magnetar's overall involvement caused an ascertainable portion of its loss." *Id.* On a close reading of the complaint, the Second Circuit found that FGIC had adequately alleged loss causation, citing, among other things, FGIC's claim that, notwithstanding the downturn across all MBS, specific assets Magnetar selected performed worse than assets that Putnam would have selected acting independently, and that assets selected by Magnetar defaulted more quickly than other assets in Pyxis' portfolio. The holding suggests that allegations that an investment performed poorly relative to similar assets not subject to the misrepresentation will satisfy, at least at the pleading stage, the requirements of loss causation in the context of a marketwide downturn.

In an interesting footnote, the Court of Appeals also raised a possible alternative theory of loss causation for fraud victims whose losses coincide with a marketwide downturn. Noting that the Financial Crisis Inquiry Commission had concluded that the manipulation of CDOs by hedge funds like Magnetar "'contributed significantly' to the financial crisis," the court "observe[d] that there may be circumstances under which a marketwide economic collapse is itself caused by the conduct alleged to have caused a plaintiff's loss." *Id.* at 404 n.2. Though it refrained from ruling on the issue, the court suggested that FGIC might have been able to show loss causation simply by demonstrating that Putnam's specific misrepresentations in this case were a contributing cause of the wider mortgage crisis itself. *Id.* If adopted, this alternative theory of loss causation would excuse fraud victims from the burden of establishing a causal nexus between their loss and a fraudulent statement where a systemic downturn can be tied back to the type of fraud alleged in the complaint.

### **Loreley** *Decision*

Just three months later, the Second Circuit issued a second impactful decision on loss causation, further liberalizing the pleading standard for such claims. The facts of *Loreley Financing (Jersey) No. 3 Limited v. Wells Fargo Securities, LLC* were remarkably similar to *Putnam*. *Loreley* involved two other CDOs for which Magnetar allegedly selected the collateral while simultaneously betting against it—despite representations that an expert, third-party collateral manager with aligned incentives with noteholders would be doing so—as well as a third CDO allegedly tainted by similar improprieties in the asset selection process. *See Loreley*, 2015 WL 4492258, at *4 (2d Cir. Jul. 24, 2015). Plaintiffs in *Loreley* were investors in these CDOs. *Id.* Their claims were dismissed on a number of grounds, but the district court did not address loss causation. *Id.* at *18. Nonetheless, the defendants raised loss causation arguments on appeal, which were addressed in detail by Judge Guido Calabrese, who prior to his ascendance to the federal bench was widely recognized as one of the world's foremost experts on issues of causation in tort. *See* Guido Calabrese, *Concerning Cause and the Law of Torts*, 43 U. Chi. L. Rev. 69, 72 (1975) (a widely cited law review article by then Professor Calabresi, which he cites several times in the *Loreley* decision).

Judge Calabresi took the analysis from *Putnam* a step further, finding that plaintiffs at the pleading stage need only plead "causal tendency" to satisfy the requirements of loss causation. Causal tendency exists where the facts or circumstances concealed by a fraudulent statement "can … be shown to have made [an] investment, in fact, more disposed to suffer the alleged harm ..." *Id.* at *20. The Court then provided three examples of loss causation pleadings, each pertaining to the destruction of a house in an earthquake. *Id.* at *22-23. In the first example, Buyer purchases a house based on Seller's misrepresentation that the house was once owned by Abraham Lincoln. *Id.* at *22. In the second example, Buyer purchases a house based on a misrepresentation regarding the sturdiness of the house—*e.g.*, that the house was "well-built," when it was not. *Id.* at *23. In the third example, Buyer purchases a house based on a misrepresentation that the house was "earthquake proof." *Id.* The first of these examples is inadequate to satisfy loss causation, because Lincoln's ownership in no way tends to increase the likelihood that the house could survive an earthquake. *Id.* The latter two examples, however, are sufficient at the pleading stage. *Id.* "It then falls to defendant to proffer facts indicating that a well-built house, or even an earthquake-proof one, would have been destroyed in *this* earthquake," but these are "evidentiary matters for later in the litigation for later phases of [the] lawsuit." *Id.*

Applied to the facts of *Loreley*, the Court found "that the allegations themselves give Defendants 'some indication' of the risk concealed by the misrepresentations that plausibly materialized in Plaintiffs' ultimately worthless multimillion-dollar investments in these CDO notes." *Id.* at *24. In particular, the Court credited plaintiff's allegation "that Magnetar was actively undermining the constellation CDOs by selecting marginal collateral to capitalize on eventual defaults." *Id.* This satisfied their pleading burden. The court rejected the idea that plaintiffs had to allege that the misrepresentations caused losses independently of the marketwide downturn: "[t]he requirement … to plead *a* causal link does not place on Plaintiffs a further pleading obligation to rule out other contributing factors or alternative causal explanations." *Id.*

### *Impact of* Putnam *and* Loreley *on Pleading Loss Causation*

Loss causation continues to be a sticky issue for fraud plaintiffs who experience losses during a marketwide downturn. Numerous unanswered questions remain: How does a plaintiff prove that an "ascertainable portion" of its losses were caused by the fraud, and not the financial crisis? Is the plaintiff's recovery limited to that ascertainable portion, or once the loss causation box is checked, is the plaintiff entitled to all out-of-pocket losses? If the plaintiff's fraud was a contributing cause to the financial crisis, does this do away with the loss causation requirement, as hinted at by the Second Circuit in *Putnam*?

Now, though, plaintiffs can proceed with greater certainty that these questions will be resolved at a later stage of the proceeding, with the benefit of fact development through discovery. Allegations showing that the concealed or misrepresented facts or circumstances tend to cause the losses alleged in the complaint, even absent allegations addressing the role of an intervening financial crisis in those losses, should be enough to survive a motion to dismiss. In addition, plaintiffs may wish to take up the *Putnam* court's invitation and allege that the defendant's misrepresentations partially caused the wider economic downturn, potentially obviating the need for separate loss causation analysis. Q

# NOTED WITH INTEREST

## D.C. Circuit Reinforces Attorney-Client Privilege Applicable to Internal Investigations

On August 11, 2015, the United States Court of Appeals for the District Court of Columbia issued a decision of importance to all companies that seek to maintain privilege with respect to internal investigations. The D.C. Circuit granted a writ of mandamus vacating a district court's decision which had held that a corporation waived attorney-client privilege by permitting an in-house lawyer to review documents from an internal investigation before his deposition and by referring to the investigation in a motion for summary judgment. *In re Kellogg Brown & Root, Inc. et al.*, No. 14-5319, 2015 WL 4727411 (D.C. Cir. Aug. 11, 2015). In vacating the district court's rulings, the D.C. Circuit observed that, if the district court's decision was allowed to stand, it "would ring alarm bells in corporate general counsel offices throughout the country about what kinds of descriptions of investigatory and disclosure practices could be used by an adversary to defeat all claims of privilege and protection of an internal investigation" and that these "alarm bells would be well founded." *Id.* at *12.

***"But For" Test Rejected***

In 2005, Harry Barko filed a complaint against defense contractor Kellogg Brown & Root, Inc. (KBR) under the False Claims Act alleging that KBR defrauded the U.S. Government by inflating its costs and accepting kickbacks while administering military contracts in wartime Iraq. Barko sought documents related to KBR's internal investigation into the alleged fraud. KBR argued that the internal investigation had been conducted for the purpose of obtaining legal advice and that the documents were therefore protected from discovery by the attorney client privilege. The federal district court for the District of Columbia rejected the assertion of privilege based on the finding that the investigation was undertaken pursuant to certain regulatory requirements, rather than for the purpose of seeking legal advice—and that KBR had failed to show that the documents at issue would not have been created "but for" seeking legal advice. *United States ex rel. Barko v. Halliburton Co.*, 37 F. Supp. 3d 1, 5 (D.D.C. 2014).

On June 27, 2014, the D.C. Circuit Court of Appeals granted KBR's first application for a writ of mandamus. *In re Kellogg Brown & Root, Inc., et al.*, 756 F.3d 754 (D.C. Cir. 2014). The D.C. Circuit held that KBR's assertion of the privilege was "materially indistinguishable" from the assertion of privilege in the U.S. Supreme Court's landmark decision in *Upjohn Co. v. United States*, 449 U.S. 383 (1981). *Id.* at 757. The D.C. Circuit stated, "As in *Upjohn*, KBR initiated an internal investigation to gather facts and ensure compliance with the law after being informed of potential misconduct. And as in *Upjohn*, KBR's investigation was conducted under the auspices of KBR's in-house legal department, acting in its legal capacity. The same considerations that led the Court in *Upjohn* to uphold the corporation's privilege claims apply here." *Id.* The D.C. Circuit further stated that the district court "erred because it employed the wrong legal test. The but-for test articulated by the District Court is not appropriate for attorney-client privilege analysis. Under the District Court's approach, the attorney-client privilege apparently would not apply unless the sole purpose of the communication was to obtain or provide legal advice. That is not the law." *Id.* at 759. The D.C. Circuit held that the proper test is the "primary purpose" test which "sensibly and properly applied, cannot and does not draw a rigid distinction between a legal purpose on the one hand and a business purpose on the other." *Id.* The D.C. Circuit ruled that this test was satisfied, and remanded the case to allow the district court to entertain other arguments for why the privilege should not attach to the documents at issue (aside from the argument that they were not prepared primarily for purposes of seeking legal advice). *Id.* at 764.

***Balancing Test Rejected***

On remand, the district court held that KBR had waived privilege. *United States ex rel. Barko v. Halliburton Co.*, Case No. 05-cv-1276, 2014 U.S. Dist. LEXIS 181353 (D.D.C. Nov. 20, 2014) [Dkt. 205]. The district court found waiver based on the fact that a corporate 30(b)(6) designee reviewed certain privileged documents in preparation for his deposition testimony. The district court applied Federal Rule of Evidence 612, which provides that where a witness has used a writing to refresh memory before testifying, the adverse party is entitled to have it produced and to introduce into evidence any portion that relates to the witness's testimony "if the court decides that justice requires the party to have those options." Fed. R. Evid. 612. The court engaged in a balancing test and, after identifying several factors supporting and several factors militating against disclosure, concluded that "fairness considerations support disclosure." *Barko*, 2014 U.S. Dist. LEXIS 181353, at *41. The district court also found waiver based on the fact that, in a footnote in KBR's summary judgment brief, KBR stated not only that it conducted an internal investigation into Barko's claims and did not report any wrongdoing to the government, but also that when KBR discovers wrongdoing during investigations, "KBR makes such disclosures." *Id.* at *25-26. The district court concluded KBR had waived privilege by putting the content of the privilege investigation documents "at issue." *Id.* at *31.

KBR made a second application for a writ of mandamus, which the D.C. Circuit granted on August 11, 2015. *In re Kellogg Brown & Root, Inc. et al.*, No. 14-5319, 2015 WL 4727411 (D.C. Cir. Aug. 11, 2015). The D.C. Circuit held that it was improper to apply the balancing test in determining whether privilege was waived with respect to the documents reviewed by the deponent, because there was no showing that the documents were used to refresh the witnesses' memory, which rendered Federal Rule

*(continued on page 11)*

of Evidence 612 inapplicable. *Id.* at *4. The D.C. Circuit further stated that, even if the balancing test had been appropriate, the district court's conclusion was precluded by *Upjohn*, which teaches that "[a]n uncertain privilege, or one which purports to be certain but results in widely varying application by the courts, is little better than no privilege at all." *Id.* at *5 (quoting *Upjohn Co. v. United States*, 449 U.S. 383, 393 (1981)). As for the footnote in KBR's summary judgment motion, the D.C. Circuit observed that the footnote constituted a "recitation of facts" and not "an argument"; that, in any event, it is not the D.C. Circuit's practice to "indulge cursory arguments made only in a footnote"; and that, the district court was required to draw all inferences against KBR as the movant on the motion for summary judgment, and that the district court therefore should not have drawn an inference in KBR's favor that the internal investigation revealed no wrongdoing. *Id.* at *9.

***"General Counsel Offices Throughout the Country"***
The D.C. Circuit's decision was explicitly motivated by a desire to avoid "injecting uncertainty into application of attorney-client privilege and work product protection to internal investigations." *Id.* at *1. As the D.C. Circuit itself suggested, "corporate general counsel offices throughout the country" will find the *KBR* decision instructive "about what kinds of descriptions of investigatory and disclosure practices" may be used by companies which seek to preserve privilege in litigations concerning their internal investigations. *Id.* at *12. Q

# PRACTICE AREA NOTES

## White Collar Litigation Update

***Recent Developments in Insider Trading Law.*** For the last 30 years, the seminal insider trading case discussing tipper/tippee liability has been the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983). In *Dirks*, the Supreme Court found that for insider trading liability to attach there must be a breach of a fiduciary duty by an insider who received a personal benefit in exchange for disclosure of material, nonpublic information. Put another way, "absent some personal gain, there has been no breach of duty" and thus no tipper liability. Additionally, tippee liability—liability of the individual who traded on the insider's information—is derivative of tipper liability, so absent a tipper's breach, which necessarily includes a personal benefit, there can be no liability. Tippee liability also requires that he or she has knowledge of the tipper's breach.

The personal benefit requirement of insider trading law has been the subject of recent court opinions and commentary, particularly with respect to whether mere friendship, without any financial incentive or gain, suffices for insider trading liability. In *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), the Second Circuit answered a qualified "no" to that question. That is, in *Newman*, the court found that inferring personal benefit from a relationship between the tipper and tippee requires "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." The court further found that inferring a personal benefit requires evidence of "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter]." *Id.* at 452.

Any clarity on the personal benefit requirement from *Newman* was short-lived, as reflected in *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015) a case that has added yet another chapter to the uncertainty surrounding insider trading law. The case involved trading by Michael Kara on insider information obtained by his brother, Maher Kara, a former Citigroup healthcare investment banker. Michael Kara, in turn, provided the information to Bassam Yacoub Salman, whose sister had become engaged to Maher Kara. Salman, with another brother-in-law's assistance, ultimately traded on the inside information. In 2011, in connection with this alleged familial insider trading scheme, Salman was indicted for conspiracy and securities fraud. A jury later found him guilty on all five counts. Salman appealed his conviction, but did not raise *Newman* because the Second Circuit had not yet issued its opinion. Following *Newman*, Salman moved for leave to challenge his conviction based on *Newman*, and the Ninth Circuit accepted this additional ground for appeal, finding that the government was not prejudiced by Salman's eleventh hour reliance on *Newman*, as both parties had fully briefed and argued the issues raised by *Newman*.

On appeal, Salman claimed that his conviction could not stand in light of *Newman* because the government had failed to prove that Maher Kara had disclosed confidential information for a tangible benefit or that Salman knew of any such benefit. The Ninth Circuit rejected Salman's position and affirmed his insider trading conviction. Sitting by designation and writing the Ninth Circuit's *Salman* opinion was United States Senior Judge for the Southern District of New York, Jed S. Rakoff. Ironically, Judge Rakoff's opinion first recognized that *Newman*, a Second Circuit opinion, is not binding on the Ninth Circuit. Nevertheless, Judge Rakoff—who is exceedingly familiar with Second Circuit insider trading law (*see, e.g.*, *SEC v. Payton*, No. 14 Civ. 4644, 2015 U.S. Dist. LEXIS 44732 (S.D.N.Y. Apr. 6, 2015), *United States v. Gupta*, No. 11 Cr. 907 (JSR), 2015 U.S. Dist. LEXIS 86635 (S.D.N.Y. July 2, 2015))—noted that the Ninth Circuit "would not lightly ignore [*Newman*], the most recent ruling of our sister circuit in an area of law that it has frequently encountered." *Salman*, 792 F.3d at 1092.

Recognizing *Newman*'s relevance, however, did not mean extending it to the circumstances in *Salman*, which Judge Rakoff refused to do, finding that "[t]o the extent *Newman* can be read to go so far [as Mr. Salman had suggested], we decline to follow it. Doing so would require us to depart from the clear holding of *Dirks* [*v. SEC*, 463 U.S. 646 (1983) *Id.* at 1093.]," the seminal Supreme Court insider trading case. Judge Rakoff recognized that "[o] f particular importance" to the *Salman* case was the Supreme Court's finding in *Dirks* that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information as to a trading relative or friend." *Id.* Judge Rakoff further noted that "*Newman* itself recognized that 'personal benefit is broadly defined to include not only pecuniary gain, but also, inter alia, …the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.'" *Id.* at *6 (quoting *Newman*).

At its core, the Ninth Circuit seemed reluctant to extend *Newman*: "[i]f Salman's theory were accepted and this evidence found to be insufficient, then a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided only that she asked for no tangible compensation in return." *Id* at 1094.

The *Salman* opinion, and its arguable inconsistency with *Newman*, also could be viewed as reinforcing Judge Rakoff's previously-stated belief that congressional action to define the outlines of insider trading liability is necessary. Indeed, the absence of statutes specifically proscribing insider trading has been a focus of Judge Rakoff, who has noted in prior opinions "if insider trading is to be properly deterred, it must be adequately defined" and … "[t]he appropriate body to do so, one would think, is Congress." *Payton*, 2015 U.S. Dist. LEXIS 44732, at *1. It will be interesting to follow in the coming sessions whether Congress accepts Judge Rakoff's call to action and seeks to clarify the murky waters of insider trading law through statute. It also will be interesting to see if the Supreme Court accepts the government's petition for review of the *Newman* case, which it filed on July 30, 2015, particularly given the daylight between *Salman* and *Newman*, as well as the host of recent and to come insider trading cases.

## Appellate Update

***Postscript to the U.S. Supreme Court's October 2014 Term.*** The Supreme Court of the United States completed its October 2014 term in June, having decided a number of matters of wide public interest. Among the most notable was *King v. Burwell* (No. 14-114), which upheld, over a vigorous dissent, an agency rule that, if vacated, would have had significant consequences for the Patient Protection and Affordable Care Act, also known as ObamaCare. And in *Texas Department of Housing & Community Affairs v. Inclusive Communities Project* (No. 13-1371), the Court held in a 5-4 decision that disparate-impact claims are cognizable under the Fair Housing Act, consistent with earlier rulings affirming such liability under other anti-discrimination statutes.

Several decisions receiving less widespread public attention will have significant implications for business litigation. A major patent case, *Teva Pharmaceuticals USA, Inc. v. Sandoz, Inc.* (No. 13-854), overturned the Federal Circuit's long-standing practice of reviewing all aspects of a district court's patent claim construction *de novo*. The district court upheld Teva's patent covering a manufacturing method for a drug, concluding that the patent term "molecular weight" was not indefinite, relying on expert testimony that those skilled in the art would understand its meaning. The Federal Circuit reversed on *de novo* review, and the Supreme Court then vacated that reversal for failing to grant appropriate deference. The Court explained that while the *ultimate* construction of a patent claim is a legal question subject to *de novo* review under *Markman* v. *Westview Instruments, Inc.*, 517 U.S. 370 (1996), a district court's subsidiary factual findings, made after considering extrinsic evidence, can only be reviewed for clear error under Federal Rule of Civil Procedure 52(a)(6). That Rule provides that a district court's "[f]indings of fact" cannot be "set aside" unless they are "clearly erroneous." The Court reasoned that district courts are better positioned to make findings of fact, particularly in complex patent cases, and there is no basis for deviating from Rule 52(a)(6)'s "clear command." Justice Thomas, joined by Justice Alito, dissented. Claim construction often turns on extrinsic evidence and this change in practice is thus likely to have significant consequences and, in particular, render district court *Markman* proceedings even more important than before.

To the surprise of many, the Supreme Court reached the merits of *Dart Cherokee Basin Operating Co. LLC v. Owens* (No. 13-719), handing down a victory for class-action defendants sued in state court who seek removal to federal court under the Class Action Fairness Act, which permits removal even absent complete diversity when the amount in controversy exceeds $5 million. Questioning at oral argument suggested the Court likely would dismiss the case as improvidently granted: the Tenth Circuit's basis for refusing to entertain an appeal of the district court's order remanding the case to state court was unclear, and that refusal was the only ruling under further review. Four Justices ultimately advocated for such dismissal, but in dissent—the majority interpreted the Tenth Circuit's refusal as approving the district court's reasoning, and thus reached that reasoning. And the Court swiftly rejected it. The district court had remanded the removed case back to state court because Dart failed to provide *evidence* showing the amount in controversy with his notice of removal, as required by prior Tenth Circuit decisions. But, the Court held, a removing class action defendant need only plausibly *allege* that the amount in controversy exceeds the $5 million jurisdictional threshold. To impose an evidentiary requirement would be inconsistent with the statutory language requiring only a "short and plain statement of the grounds for removal." Moreover, a plaintiff's good-faith allegation of the amount in controversy is accepted without more, and the same practice should be extended to defendants.

Finally, in *Omnicare, Inc. v. Laborers District Council Industry Pension Fund* (No. 13-435), the Court took a balanced approach in addressing when statements of opinion can, and cannot, give rise to liability for false statements in a registration under Section 11 of the Securities Act of 1933. The defendant had expressed an opinion in its registration statement that its practices complied with federal regulations. That turned out to be untrue, but there was no allegation that the defendant *knew* its practices did not comply. The district court thus dismissed the case, reasoning that a statement of opinion cannot be false unless the registrant knows the facts are otherwise. The Sixth Circuit took the opposite view, holding that a plaintiff bringing a Section 11 claim need not prove false intent and that even genuine expressions of belief that turn out to be untrue can give rise to liability. And the Supreme Court took a middle road, distinguishing between false statements of opinion, on the one hand, and misleading omissions underlying those opinions, on the other. As long as a registrant subjectively holds the opinion, an expression of belief or opinion cannot be false so as to give rise to liability. But, the Court explained, a registrant's statement of opinion implies that it has some reasonable *foundation* for that opinion, and if it did not, that can support liability. The absence of a reasonable foundation can thus be an actionable omission. This opinion is likely to alter, substantially, the way Section 11 cases based on statements of opinion are pleaded and litigated.

## Product Liability Litigation Update

***Ninth Circuit Restricts Scope of CAFA's "Local Single Event" Exception.*** In *Allen v. Boeing Co.*, 784 F.3d 625 (9th Cir. 2015), the Ninth Circuit recently held that a case did not fall within the Class Action Fairness Act's "local single event" exception because the plaintiffs' claims did not arise from a "single happening." *Id.* at 627. CAFA's local single event exception provides that the term "mass action" does not include a civil action in which all of the claims in the action arose "from an event or occurrence in the State in which the action was filed." 28 U.S.C. §1332(d)(11)(B)(ii)(I). In reversing the district court's remand, the court explicitly rejected the broad interpretation of the exception adopted by the Third Circuit and also declined to apply a similarly broad rule recently delineated by the Fifth Circuit. Until it is resolved, this circuit split has important practical implications for potential mass tort defendants, as the Ninth Circuit will likely exercise significantly broader jurisdiction over mass actions than its sister circuits.

The Third Circuit has determined that CAFA's "local single event" exception applies not only to suits where liability arises from a discrete one-time occurrence, but also more broadly to those alleging harm resulting from a "continuing set of circumstances." In *Abraham v. St. Croix Renaissance Grp., L.L.L.P.*, 459 plaintiffs filed a tort action against the owner of a former alumina refinery, claiming that (1) the refinery allowed hazardous chemicals to be released into the air and groundwater; and (2) the defendant took no steps to remove these chemicals from its premises. 719 F.3d 270, 272-73 (3d Cir. 2013). In affirming the remand to Virgin Islands Superior Court, the Third Circuit held that both alleged acts qualified as a "single event," noting that "where the record demonstrates circumstances that share some commonality and persist over a period of time, these can constitute an 'event or occurrence' for purposes of the exclusion in §1332(d)(11)(B)(ii)(I)." *Id.* at 276.

The Fifth Circuit has similarly declined to restrict the local single event exception to events occurring at a specific moment in time. In *Rainbow Gun Club, Inc. v. Denbury Onshore, LLC*, 760 F.3d 405, 409 (5th Cir. 2014), the plaintiffs alleged five separate acts of negligence in order to show that holders of oil and gas leases breached their "duty to act as a reasonable and prudent operator of the well that was drilled under these leases." *Id.* at 407. On appeal from the district court's remand, the Fifth Circuit held that CAFA's local single event exception applied because the five alleged negligent acts "gave causal substance to [a single] event—the failure of the [w]ell—from which the [p]laintiffs' claims arise." *Id.* The court held that "[a] single event or occurrence may [ ] be constituted by a pattern of conduct . . . leading to a single focused event that culminates in the basis of the asserted liability." *Id.* at 412 (emphasis added).

In sharp contrast to the Third and Fifth Circuits, the Ninth Circuit recently made clear that CAFA's local single event exception applies only to a narrow category of suits where "all claims arise from a *single* event or occurrence . . . such as an environmental accident, that gives rise to the claims of all plaintiffs." *Allen*, 784 F.3d at 628 (emphasis in original) (citing *Nevada v. Bank of America Corp.*, 672 F.3d 661 (9th Cir. 2012)). In *Allen*, plaintiffs filed a state tort action against Boeing and Landau Associates Inc., claiming that they incurred property damage as a result of (1) Boeing's negligence in allowing leeching of hazardous chemicals over a 40-year period from its Auburn, Washington plant; and (2) Landau's failure to remediate the effects of Boeing's conduct. *Id.* at 627-28. After defendants removed the case, the district court applied the interpretation adopted by the Third Circuit in *Abraham* and remanded based on CAFA's local single event exception. *Id.* at 629.

The *Nevada* court previously determined that a complaint alleging "widespread fraud in thousands of borrower transactions" did not fall within CAFA's "local single event" exception. 672 F.3d 661. However, because the *Nevada* decision was issued in 2012—one year before *Abraham*—the court did not previously have an opportunity to address the Third Circuit's alternative view. Considering itself bound by its prior decision in *Nevada*, the panel explicitly rejected the Third Circuit's interpretation. *Id.* at 633 ("[E]ven were we free to interpret the phrase as we would, we would not adopt the Third Circuit's approach . . . [because] in the context of determining whether a legal cause of action concerns an 'event' or an 'occurrence' for purposes of CAFA, the terms most commonly and reasonably refer to a singular happening."). The court held that its more narrow interpretation comported better with CAFA's overall structure and legislative intent. *Id.* at 632 ("[E]xceptions to CAFA are to be strictly intrerpreted") (citing, inter alia, S. Rep. No. 109-14, at 7 (2005)). The court also explained that, unlike the conduct underlying the Fifth Circuit's *Rainbow Gun Club*, the plaintiffs in Allen "[did] not allege a single event or occurrence resulting from [the defendants'] acts." *Allen*, 784 F.3d at 633. The court conceded that had the plaintiffs sued each defendant separately, as was the case in *Rainbow Gun Club*, the single event exception might have applied to each separate case. However, because the plaintiffs in Allen sued both defendants for two separate activities—Boeing's forty-year pattern of pollution and Landau's subsequent failure to remediate the harm that Boeing caused—that exception did not apply. *Id.*

The *Allen* decision has two key practical implications. First, defendants in mass tort actions brought in state courts within the Ninth Circuit should be able to successfully remove cases to federal district court if a plaintiff alleges "ongoing" liability-generating activity that can be separated into distinct "events" occurring at separate moments in time. Second, at least in the Ninth Circuit, toxic tort plaintiffs with claims against one defendant for the initial pollution, and another defendant for a subsequent failure to remediate, may choose to file separate lawsuits in state court, rather than face the prospect of removal. Given the Supreme Court's demonstrated interest in CAFA, it seems likely that circuit split will soon be headed for a resolution. Q

## RICO Victory for Morgan Stanley

On June 2, 2015, the United States Court of Appeals for the Fifth Circuit affirmed the dismissal of a RICO case against Morgan Stanley Real Estate Advisor ("MSREA") and its related entity PPF Safeguard, LLC, ("PPF") by former minority shareholders in a self-storage company, Safeguard LLC, that is now wholly owned by PPF. The plaintiffs had alleged that the Morgan Stanley entities had engaged in a criminal conspiracy to defraud them out of their six-percent interest in Safeguard by allegedly not actively pursuing an insurance litigation on Safeguard's behalf (the proceeds of which the plaintiffs alleged would have come to them), and by exercising PPF's contractual right to buy out plaintiffs' interest in Safeguard.

The Fifth Circuit held that the plaintiffs were collaterally estopped from alleging that they had suffered any damages as a result of the buy-out because, in a prior proceeding, they had agreed to a stipulated judgment which had adjudged that MSREA's invocation of the buy-out procedure "was proper" and the purchase price had been "appropriately" set. The Court thus held that the plaintiffs had been fully compensated for their interest in Safeguard, as well as any interest they may have had in the insurance litigation, and thus could allege no damages. Because the plaintiffs had suffered no harm, the Court dismissed the complaint for lack of standing.

The decision is a significant victory for MSREA and PPF because it releases any cloud over their full ownership of Safeguard, and puts an end to a long-running series of lawsuits pursuant to which the plaintiffs' were seeking more than $100 million in damages.

## Pro Bono Victory – Prosecutor Disbarred for Misconduct in Death Penalty Case

The firm successfully represented Anthony Graves pro bono in his grievance to the State Bar of Texas to have the prosecutor who put him on death row disbarred for unethical conduct that came to light during post-conviction exoneration proceedings. Anthony Graves spent 18 years in prison in Texas, with 12 on death row, after being convicted of multiple murders in 1994 in a trial that the U.S. Court of Appeals for the 5th Circuit eventually determined (through the work of other lawyers) was tainted by prosecutorial misconduct. Texas ultimately declared Anthony actually innocent. With co-counsel, Quinn Emanuel helped Anthony to initiate a proceeding before the State Bar of Texas to have his prosecutor disbarred for deliberately hiding evidence, suborning false testimony from key witnesses, and other wrongdoing. After the State Bar determined that there was "just cause" to believe the prosecutor violated ethical rules, Quinn Emanuel represented Anthony in the disbarment proceedings, including preparing him for his testimony, providing assistance and strategy to the State Bar attorneys prosecuting the action, and representing him during the evidentiary hearing in May 2015. The grievance panel agreed to the shocking breadth of the misconduct at Anthony's trial and disbarred the prosecutor in a judgment in June 2015. Disbarment was the limit of the panel's jurisdiction, so this was a complete victory and rare result.

## Pre-Discovery Victory for Hedge Fund

The firm obtained a complete dismissal, on behalf of hedge fund BlueCrest Capital Management, of claims brought by a former employee, Nicholas O'Grady. Mr. O'Grady was a portfolio manager in BlueCrest's U.S. Equities Division from December 2013 until he was terminated on June 4, 2014.

On February 15, 2015, Mr. O'Grady filed suit in the Southern District of New York, asserting claims against BlueCrest for breach of contract, breach of an implied contract, unjust enrichment, promissory estoppel, breach of good faith and fair dealing, violations of New York's labor laws, and an accounting. His complaint alleged that he was fired "without cause," and claimed that under his employment contract, he was entitled to over $1.3 million in bonus and severance payments. He sought an additional $1.3 million in damages for violations of New York's Labor Law, as well as attorneys' fees.

Quinn Emanuel moved to dismiss, arguing that Mr. O'Grady's complaint failed to state a legally cognizable claim. We argued that Mr. O'Grady's employment agreement expressly stated that bonuses were paid at BlueCrest's sole discretion, and that Mr. O'Grady failed to allege that he was actively employed at the time of payment, as required by the contract. We also argued that his claims for breach of an implied contract, unjust enrichment, promissory estoppel, breach of good faith and fair dealing, and an accounting were fatally deficient and duplicative of his breach of contract claim, and that New York's Labor Law does not apply to unpaid bonus compensation.

On June 9, 2015, during a routine scheduling hearing, Judge Stein elected to hear argument on BlueCrest's motion to dismiss. On June 15, 2015, just five days after hearing oral argument, Judge Stein issued a ruling dismissing each one of Mr. O'Grady's claims and declining to allow amendment of the complaint as futile. Mr. O'Grady has appealed the dismissal to the Second Circuit Court of Appeals.

## Quinn Wins Bet for Avanir in "Bet-the-Company" Case

The firm recently secured a key victory at the United States Court of Appeals for the Federal Circuit ("Federal Circuit") for our client Avanir Pharmaceuticals, Inc. ("Avanir"), an innovator pharmaceutical company, in a "bet-the-company" Hatch-Waxman patent litigation relating to Avanir's flagship Nuedexta® product. The judgment affirmed the District Court of Delaware's holding that Nuedexta® is entitled to patent protection until 2026. Nuedexta® is a combination of two drugs, dextromethorphan ("DM") and quinidine ("Q"), that is used for the treatment of pseudobulbar affect, or PBA—a devastating neurological disorder characterized by episodes of involuntary laughing and crying that are unrelated to the patient's mood.

The case began in July 2011, when Avanir received its first notice that a generic (Par) had submitted an application to the FDA to market a generic version of Nuedexta®. Five other generics (Actavis, Wockhardt, Impax, Watson, and Ranbaxy) quickly followed Par's lead. Avanir's patents claim the use of low-dose DM and Q combinations for the treatment of PBA—with DM as the therapeutic ingredient and Q acting to inhibit the body's metabolism of DM. The generics argued that Avanir's patents were invalid as obvious in view of earlier patents that broadly claimed the use of DM and Q to treat PBA, but at much higher doses.

Quinn Emanuel quickly identified that the generics' obviousness theories were based entirely on hindsight—starting with Avanir's patents and working backwards to piece together the claimed inventions. Throughout discovery, the firm sought to highlight the hindsight-based nature of the generics' theories, including that persons skilled in the art at the time would not have ignored the prior art's teachings that much higher amounts of DM and Q were believed to be required to treat PBA. The firm obtained key admissions from the generics' experts that persons skilled in the art at the time of invention would not have had any reason to lower the doses of DM and Q used in the prior art to treat PBA, and that even if they did, they would not have reasonably expected that the claimed lower dose combinations could effectively treat PBA.

The firm's litigation strategy was so effective that only two generics remained when the case proceeded to trial; two of the generics settled just days before trial. After a six-day bench trial in front of Judge Leonard P. Stark and extensive post-trial briefing, the district court ruled in Avanir's favor, holding the patents valid and infringed.

After the district court's decision, one of the remaining two generics bowed out. The last generic standing (Par) appealed the district court's validity ruling. Oral argument was held on Friday, August 7, 2015. During argument, the three-judge Federal Circuit panel was highly critical of Par's obviousness theories, relying heavily on the flaws that Quinn Emanuel pointed out in appellate briefing. The morning of Monday, August 10, 2015—less than one business day after the argument—the Federal Circuit issued a Rule 36 affirmance of the district court's decision.

Both the district court and appellate victory were critical to Avanir's future. Nuedexta® provided virtually all of Avanir's revenue, and many analysts predicted that Avanir would have had to shut its doors if it suffered defeat in this litigation. Instead, as a result of Quinn Emanuel's victory, Avanir was acquired by Otsuka Pharmaceuticals, and Nuedexta® remains protected by its core patents until 2026. Q

## John B. Quinn Named "Transatlantic Law Firm Leader of the Year" at *The American Lawyer*'s Transatlantic Legal Awards

Quinn Emanuel founding and managing partner John B. Quinn was named "Transatlantic Law Firm Leader of the Year" at *The American Lawyer*'s inaugural Transatlantic Legal Awards ceremony, which honored preeminent firms and individual lawyers for their achievements in transatlantic matters. *The American Lawyer* noted that with Mr. Quinn at the helm, the firm has become one of the legal market's greatest success stories. In recognizing Mr. Quinn, the publication cited the firm's financial stability, its strong transatlantic presence, as well as its rapidly growing intellectual property, product liability, and international arbitration practices. Q

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# business litigation report
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