Notable Securities Class Action Rulings From the Third Circuit in 2018

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In three opinions issued in 2018, the U.S. Court of Appeals for the Third Circuit clarified several pleading requirements for putative class action securities complaints.

One of the most consequential opinions of the past year issued by the Third Circuit was In *re Hertz Global Holdings*, 905 F.3d 106 (3d Cir., 2018). In that case, plaintiffs filed a securities fraud complaint against Hertz Global Holdings, Inc. and some of its current and former executives. The plaintiffs alleged that Hertz and these executives violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 by making materially false and misleading statements concerning the company's financial results, internal controls and future earnings projections.

In *Hertz*, the defendants issued a restatement with its fiscal year 2014 Form 10-K, which corrected errors to the company's 2011, 2012 and 2013 financial statements. The restatement revealed that between 2011 to 2013, Hertz overstated its net income by 20.23 percent and its pre-tax income by 17.58 percent, cumulatively. The restatement further acknowledged "an inconsistent and sometimes inappropriate tone at the top" that created an environment that potentially led to inappropriate accounting decisions. In the months leading up to the restatement, several executives resigned form Hertz.

The complaint averred that the defendants acted with scienter based on: the size and scope of the restatement; Hertz's admission of inconsistent and inappropriate conduct of top executives; executed Sarbanes-Oxley certifications accompanying the previous false SEC filings; the resignations of several executives just before or in the wake of a series of bad news releases which culminated in the restatement; and certain suspicious trading activity by two individual executive defendants. On motion to dismiss, the U.S. District Court for the District of New Jersey found that the plaintiffs failed to adequately plead a strong inference of scienter and dismissed the complaint.

In affirming the dismissal of the complaint, the Third Circuit reiterated that a plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Relying on the previous Third Circuit opinion in *Institutional Investors Group. v. Avaya*, 564 F.3d 242, 252 (3d Cir. 2009) and the U.S. Supreme Court opinion in *Tellabs v. Makor Issues & Rights*, 551 U.S. 308, 324, 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007), the Third Circuit noted that such strong inference must demonstrate "an attempt to deceive, manipulate or defraud," either knowingly or recklessly. Thus, a complaint adequately pleads a strong inference of scienter "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." The complaint need not include a "smoking gun," but must be viewed holistically to determine whether its allegations, taken collectively, give rise to a strong inference of scienter.

In considering each of the allegations of scienter, the Third Circuit noted: the accounting errors were spread across several different accounting categories year after year, and the size and scope of the restatement only amounted to between 9.97 percent and 32.12 percent of each year's earnings, which were not sufficient to constitute a strong inference of scienter; the admission in the restatement of an "inappropriate tone at the top" was more an admission of "mismanagement" than one of "misconduct"; the Sarbanes Oxley certifications did not add to an inference of scienter absent allegations that one or more of the signatories knew the document was false or recklessly disregarded inaccuracies in such filing; the resignations of the executives did not materially add to an inference of scienter absent specific allegations that such resignations related to fraud; and the nature of the challenged stock sales added only minimally to the inference of scienter.

The *Hertz* opinion provides putative class plaintiffs with substantial warning that courts in this circuit will not accept allegations that may be read as mismanagement, rather than actual misconduct, as a strong inference of scienter. Rather, such plaintiffs must meet a high bar to allege facts sufficient to give rise to a strong inference of scienter.

Several months later, the Third Circuit affirmed the dismissal of and denial of leave to amend a putative class action complaint against Altisource Asset Management Corp. (AAMC) and some of its former directors and officers. In *City of Cambridge Retirement System v. Altisource Asset Management*, -F. Supp. 3d-, No. 2018 WL 5931509 (3d Cir. Nov. 14, 2018), the plaintiffs alleged that AAMC—a provider of asset management and corporate governance advising services related to mortgage servicing—made material misstatements concerning its relationships with the mortgage servicing company Ocwen Financial Corp. (Ocwen). Specifically, the plaintiffs alleged that AAMC "misrepresented the benefits attributable to its relationship with Ocwen" and failed to disclose that officers "widely disregarded" AAMC's related-party transaction policy. The complaint asserted that AAMC's opinion that "access to Ocwen's servicing expertise" helped maximize the value of loan portfolios was misleading because it did not disclose deficiencies in Ocwen's services; and AAMC's chairman failed to recuse himself from related-party transactions, which was allegedly inconsistent with AAMC's Related-Party Transaction Policy.

The district court of the Virgin Islands dismissed the plaintiffs' complaint and denied their motion to amend, holding that the plaintiffs failed to allege that the defendants' statements were false. In affirming, the Third Circuit noted that statements regarding AAMC's relationship with Ocwen contained risk disclosures stating clearly that AAMC relied on Ocwen as AAMC's sole source of revenue, which would be at risk if it needed to find a different service agent. With respect to statements regarding AAMC's recusal policy, the Third Circuit found that the plaintiffs failed to allege any false statements because, even accepting the pleadings as true, AAMC actually followed its recusal policy. The court observed that the plaintiffs failed to identify a single transaction in which AAMC's chairman actually violated the recusal policy, thus the plaintiffs were engaging in "speculative fraud by hindsight."

The *AAMC* decision reiterates that allegations of falsity must be based specifically on a defendant's actual false statements about its own operations, and may not be based on mere inferences of falsity or potential falsity based on speculation.

Finally, on Dec. 26, 2018, the Third Circuit affirmed in part and vacated in part the dismissal of a putative securities class action against M&T Bank Corp. (the company) and some of its officers and directors, *see Jaroslawicz v. M&T Bank*, No. 17-3695 (3d Cir. Dec. 26, 2018). In *Jaroslawicz*, the plaintiffs alleged that the defendants omitted material information from joint proxy statement materials leading up to the merger of M&T Bank with another consumer bank. In particular, the complaint alleged that, prior to the proposed merger, the defendants omitted that: M&T advertised no-fee checking accounts to consumers but later switched those accounts to fee-based accounts (in violation of consumer protection laws); and M&T Bank exhibited deficiencies in Bank Secrecy Act/anti-money laundering compliance practices, particularly its Know Your Customer program (in violation of the Bank Secrecy Act and anti-money laundering regulations). The plaintiffs alleged that such unlawful acts posed a significant risk of regulatory scrutiny and that the omission of such violations was inconsistent with Item 503(c) of SEC Regulation S-K, which requires issuers to provide under the caption, "Risk Factors," a discussion of the most significant factors that make an offering (or proposed merger transaction) speculative or risky.

The U.S. District Court for the District of Delaware dismissed the plaintiffs' complaint for failing to allege an actionable omission. In reversing in part, the Third Circuit addressed for the first time the scope of mandatory disclosures under Item 503(c) of Regulation S-K in connection with proxy statements.

The Third Circuit found that the plaintiffs' complaint sufficiently drew an inference that the violations posed a known risk to regulatory approval of the merger. Furthermore, the court found that the risks were not disclosed in accordance with Item 503(c). The disclosures in the proxy were found to be "too generic to be adequate," because the disclosures "did not make any reference to the fraudulent practice underlying the violations, the dates the practice was in place, the extent of consumer accounts affected by the practice, or the subsequent [regulatory] investigation into the practice." Moreover, although the defendants issued a supplemental proxy to address the alleged deficiencies more particularly, there was an issue of fact as to whether the information was digested by investors because the supplemental disclosures occurred just six days before the scheduled shareholder vote. Accordingly, the Third Circuit vacated the district court's dismissal of the mandatory-disclosure claims relating to both the alleged consumer violations and the Bank Secrecy Act/anti-money laundering deficiencies.

Read together, the three recent opinions reiterate the high burden to allege falsity and scienter in putative class actions. However, where there is an affirmative obligation on an issuer to disclose information known to the issuer, such disclosures must be sufficiently specific and detailed to inform reasonable investors.

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