A Perfect Storm? Potential Changes to Securities Fraud Litigation and the New Regulatory Landscape Under the Trump Administration

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"It was the storm of the century, . . . a tempest created by so rare a combination of factors that meteorologists deemed it the perfect storm."[1]

One of the primary causes of the financial meltdown of 2008 and the Great Recession that followed was the decades-long unraveling of the financial regulatory system. Behind the 2008 catastrophe were "gigantic financial institutions embarking on an almost unprecedented binge of risk-taking, recklessness, and at times, illegal conduct."[2] Financial losses to the U.S. economy have been estimated at $20 trillion, with public pensions heavily impacted. Indeed, many plans have been unable to recover.[3]

In the years following the crisis, Congress and the Obama administration enacted a series of reforms which helped curb some of the worst abuses in the financial sector. With the election of President Donald Trump, the country is likely to take a markedly different path in the areas of financial regulation and enforcement. Critics view the new administration's prospective changes as the beginnings of a "perfect storm," creating a self-regulated corporate environment ripe for the next Enron-type debacle. This article explores the potential impact of the Trump administration on securities fraud litigation and investor rights.

The Securities and Exchange Commission: A New Mandate

The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ushered in a new era of financial regulation. Considered one of the most comprehensive financial reform measures since the Great Depression, Dodd-Frank's primary purpose was to strengthen the U.S. banking system by subjecting financial institutions to stringent regulations and increased government oversight. Dodd-Frank also provided the Securities and Exchange Commission and aggrieved investors with additional tools to combat corporate misconduct.

Throughout the 2016 presidential campaign, Donald Trump accused Dodd-Frank of hindering economic growth and job creation by making it "impossible for bankers to function."[4] In an effort to drastically reduce regulations, President Trump signed a directive aimed at overhauling major provisions of Dodd-Frank.[5]

It seems clear that the SEC is likely to shift course on a number of key issues that directly affect securities litigation.[6] As part of Dodd-Frank, Congress granted the SEC authority to bypass federal courts and impose civil monetary penalties through administrative proceedings, a process that is inherently more efficient. But the use of administrative proceedings has been the subject of much dispute, and Republican lawmakers have already introduced legislation that would give

defendants the option of removing an administrative enforcement action to federal court, curtailing the quick-fix of the SEC administrative proceedings.[7]

Dodd-Frank's whistleblower program is also likely to see changes. Under Dodd-Frank, the SEC may grant whistleblower awards to tipsters that were involved in wrongdoing but not subjected to criminal prosecution. But Congressional Republicans seem intent on precluding co-conspirators from receiving whistleblower awards for successful tips, a measure that would discourage individuals who were intricately entwined in corporate misconduct from reporting violations to the SEC.[8]

Fairness in Class Action Litigation Act of 2017 and Other Potential Legislation

Recently introduced legislation[9] pending before the U.S. House of Representatives seeks to purportedly "diminish abuses in class action and mass tort litigation that are undermining the integrity of the U.S. legal system."[10] The legislation passed the House on March 9, 2017. Similar legislation narrowly passed the House in 2016 but failed to gain traction in the Senate as President Obama vowed a veto. With President Trump viewed as a likely supporter of the bill, the legislation's fate could be different this time around.

The bill has several provisions which could adversely impact securities fraud litigation, including:

* Mandating that all class members suffer the "same type and scope of injury";

* Requiring the disclosure of relationships between class counsel and class representatives;

* Staying discovery during the pendency of motions to transfer, dismiss, etc.; and

* Allowing immediate appeals from orders granting or denying class certification.

Troublingly, the original version of the bill included provisions which would have been a knock-out blow to public pension funds serving as lead plaintiffs. Former Section 1717(b)(2), sought to bar any federal court from certifying "any class action in which any proposed class representative or named plaintiff . . . is a present or former client of (other than with respect to the class action), or has any contractual relationship with class counsel."[11] As originally drafted, class counsel could not have formerly represented the class representative in any matter nor provided portfolio monitoring services to the class representative, despite the acknowledged utility of these services in aiding plan trustees in the exercise of their fiduciary duties.

Also noteworthy is the likelihood of additional delay to what is often already protracted and complex litigation. As Professor John C. Coffee, Jr., director of the Center on Corporate Governance at Columbia Law School recently opined:

> H.R. 985 will also slow the pace of class actions to a crawl. First, proposed Section 1723 permits appeals of orders granting or denying class certification as a matter of right. Today, such interlocutory appeals are discretionary with the appellate court (and are infrequently granted). The burden on appellate courts will be substantial. Second, discovery is halted if a defendant makes any of a variety of motions (see proposed Section 1721).[12]

Additionally, the provision requiring that all class members must have suffered the same "type and scope" of injury would hamper class certification, since it seeks to limit certification of class actions to only those suits where the court has determined, after a "rigorous analysis of the evidence presented," that each member of the proposed class has suffered the same "type and scope of injury as the named class representative." This would be a departure from the current framework, which permits certification of classes even where there are a variety of injuries across the class.

State blue sky laws may also be impacted by the Trump administration, which has indicated that it may target New York's Martin Act and other similar state laws by drafting legislation that would make state laws secondary to less stringent federal statutes.[13] The Martin Act, which dates back to 1921, gives extraordinary powers to the state's attorney general when fighting financial fraud and has been used to prosecute fraud when federal prosecutors have been unwilling or unable to act. Indeed, New York Attorney General Eric Schneiderman has openly expressed concern that the incoming administration will undermine state securities laws nationwide, laws that he characterized as "investors' first line of defense against exploitation."[14]

The Supreme Court: Will The Tide Turn Against Shareholder Litigation?

The past ten years have seen considerable changes in securities fraud litigation, with the U.S. Supreme Court playing a vital role. President Trump's nomination of Judge Neil M. Gorsuch of the Tenth U.S. Circuit Court of Appeals to the Supreme Court has raised a host of questions with respect to the future of securities class actions.[15]

As a lawyer in private practice for a decade, Judge Gorsuch focused on securities, antitrust and class action litigation, largely representing corporate interests.[16] In 2004, Gorsuch wrote an amicus brief for the United States Chamber of Commerce in *Dura Pharmaceuticals v. Broudo*, advocating for a heightened loss causation requirement as a "key safeguard" against meritless suits.[17]

In 2005, Judge Gorsuch co-authored a working paper, *Settlements in Securities Fraud Class Actions: Improving Investor Protection*, where he harshly criticized securities class actions and how corporate defendants "pay dearly to settle such claims." Gorsuch stated in the paper that "with such pressure to settle meritless suits comes, unsurprisingly, a concomitant incentive to bring them."[18] When securities fraud suits are filed, Gorsuch added, "new corporate investments

are deferred, the efficiency of the capital markets is reduced, and the competiveness of the American economy declines."[19] Gorsuch proposed several reforms, many of which have been implemented, including enforcing the loss causation requirement and increasing the use of the lodestar method for calculating fees.[20]

During his Tenth Circuit tenure, Judge Gorsuch analyzed Section 11 of the Securities Act of 1933 in *MHC Mutual Conversion Fund, L.P. v. Sandler O'Neill & Partners L.P.*[21] In *MHC Mutual*, Judge Gorsuch addressed exactly what was required under Section 11 to establish liability for statements of opinion, exploring several possible readings of the statute. Ultimately, Judge Gorsuch came to the conclusion that "a plaintiff must show *both* that the defendant expressed an opinion that wasn't his real opinion (sometimes called "subjective disbelief") *and* that the opinion didn't prove out in the end (sometimes called "objective falsity"),"[22] a position later referenced by the Supreme Court in *Omnicare Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*.[23]

Judge Gorsuch's text-based approach and narrow view of securities fraud liability demonstrates a decidedly censorious mindset against securities litigation in general. If appointed, Gorsuch's presence on the bench could significantly tip the scales toward a more corporate friendly environment in at least two relevant areas. First, In *California Public Employees' Retirement System v. ANZ Securities, Inc.*,[24] the Court will decide whether *American Pipe* tolling[25] applies to class action claims subject to the three-year time limitation in Section 13 of the Securities Act of 1933. A finding that *American Pipe* tolling does not apply would frustrate the principal function of class action lawsuits, as potential class members would be induced to file protective motions to intervene or separate actions before a case is preliminarily settled.

Second, Gorsuch may have the opportunity to rule on class certification and damage issues. The applicability of the price maintenance theory, often critical to establishing class-wide damages, also seems destined for Supreme Court review. The Second, Seventh and Eleventh Circuits have concluded that alleged misstatements need not correlate with simultaneous stock price increases to have price impact, a position rejected by the Eighth Circuit.[26] If the issue constitutes a true circuit split, the Supreme Court may address it. Requiring a stock price increase with each materially false statement would forgive long-lasting frauds by excusing lies which predate a class period but which nonetheless maintain the levels of artificial inflation.

Conclusion

Protecting the retirements of public plan participants is an issue which should cross all party lines. As George W. Bush stated after the collapse of Enron:

> Through stricter accounting standards and tougher disclosure requirements, corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct.[27]

Private securities fraud and SEC enforcement actions result in billions of dollars of recovery every year. But storm clouds are gathering across the securities fraud landscape. Given what may be the relaxing of financial oversight under a new regime, investors must remain vigilant in monitoring relevant pending legislation.

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[1] Sebastian Junger, *The Perfect Storm* (W.W. Norton 1997).

[2]Better Markets, *The Cost of the Crisis*, July 2015 https://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

[3] Liz Farmer, "Even With Stock Market's Rise, Many Pensions Haven't Recovered From Recession," *Governing the States and Localities*, Dec. 17, 2014.

[4] Emily Flitter and Steve Holland, "Trump Preparing Plan to Dismantle Obama's Wall Street Reform Law," Reuters, May 18, 2016, http://www.reuters.com/article/us-usa-election-trump-banks-idUSKCN0Y900J.

[5] Ben Protess and Julie Hirschfeld David, "Trump Moves to Roll Back Obama-Era Financial Regulations," *The New York Times*, Feb. 3, 2017.

[6] Carmen Germaine, "SEC's Belt to Tighten Under New Administration," Law360, Feb. 28, 2017, https://www.law360.com/articles/896600/sec-s-belt-to-tighten-under-new-administration.

[7] Peter J. Henning, "How Trump's Presidency Will Change the Justice Dept. and S.E.C," *The New York Times*, Nov. 9, 2016.

[8] Carmen Germaine, "House GOP Taking Aim At SEC Whistleblower Program," Law360, Feb. 10, 2017, https://www.law360.com/articles/891068/house-gop-taking-aim-at-sec-whistleblower-program.

[9] Fairness in Class Action Litigation and Furthering Asbestos Claim Transparency Act of 2017, H.R. 985, 115th Cong. (2017).

[10] Joel Rothman, "Proposed Class Action Fairness Act Could Negatively Affect Institutions' Securities Class Action Recovery," *National Law Review*, March 2, 2017. The text of the bill can be found at https://www.congress.gov/bill/115th-congress/house-bill/985.

[11] https://www.congress.gov/bill/115th-congress/house-bill/985/amendments.

[12] John C., Coffee, Jr., "How Not to Write A Class Action "Reform" Bill," The CLS Blue Sky Blog, Feb. 21, 2017, http://clsbluesky.law.columbia.edu/2017/02/21/how-not-to-write-a-class-action-reform-bill/.

[13]http://www.jonesday.com/what-impact-will-the-new-trump-administration-have-on-state-attorney-general-activity-01-10-2017/.

[14] Suzanne Barlyn and Tim McLaughlin, "New York Attorney General Concerned Trump May Gut Anti-Fraud Law," Reuters, Nov. 17, 2016, http://www.reuters.com/article/usa-trump-securities-idUSL1N1DI1ZZ.

[15]Carmen Germaine, "Gorsuch Likely No Friend to Securities Suits," Law360, Feb. 1, 2017, https://www.law360.com/classaction/articles/887199/gorsuch-likely-no-friend-to-securities-suits?nl_pk=5f5424a0-ca9e-457d-aeef-ffb03398e744&utm_source=newsletter&utm_medium=email&utm_campaign=classaction.

[16] Lawrence Hurley, "As Private Lawyer, Trump High Court Pick Was Friend to Business," Reuters, Feb. 1, 2017, http://www.reuters.com/article/us-usa-court-gorsuch-business-idUSKBN15G5PZ.

[17] Brief for Chamber of Commerce of the United States as Amicus Curiae Supporting Petitioners, *Dura Pharm., Inc. v. Broudo*, No. 03-932, 2004 WL 2069560, at *2 (Sept. 13, 2004).

[18] Neil M. Gorsuch and Paul B. Matey, "Settlements in Securities Fraud Class Actions: Improving Investor Protection," Washington Legal Foundation, April 2005.

[19] *Id.*

[20] *Id*.

[21] 761 F.3d 1109 (10th Cir. 2014).

[22] *Id.* at 1114.

[23] 135 S. Ct. 1318, 1328-31 (2015).

[24] *In re Lehman Bros. Sec. & Erisa Litig. (CalPERS)*, 655 F.App'x 13 (2d Cir. 2016), *cert. granted sub mon. Cal Pub Emps.' Ret. Sys v. ANZ Sec. Inc*., No 16-373, 2017 WL 125670 (U.S. Jan. 13, 2017).

[25] *American Pipe & Construction v. Utah*, 414 U.S. 538 (1974).

[26] Kevin LaCroix, "Vivendi: A Victory for Plaintiffs on the Price Maintenance Theory and on Loss Causation," The D&O Diary, Oct. 4, 2016, http://www.dandodiary.com/2016/10/articles/uncategorized/vivendi-victory-plaintiffs-price-maintenance-theory-loss-causation/.

[27] President George W. Bush, State of the Union Address (Jan. 29, 2002).