Legal Opinion Letter

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RULING INJECTS COMMON SENSE INTO RUNAWAY SECURITIES FRAUD SUITS

by
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In a recent, well-reasoned opinion, Senior Judge Milton Pollack of the United States District Court for the Southern District of New York dismissed several class action suits accusing Merrill Lynch & Co. of inflating the price of Internet stocks with overly optimistic research reports. The decision, *In re Merrill Lynch & Co. Inc.*, Nos. 02 MDL 1484 MP, 02 CV 3210 MP, 02 CV 3321 MP, 2003 WL 21500293 (S.D.N.Y. June 30, 2003), has far-reaching implications both for lawsuits relating to the burst of the Internet stock bubble of the 1990s and for securities fraud actions arising from stock analysts' reports.

In *Merrill Lynch*, Judge Pollack held that the plaintiffs, non-client investors in 24/7 Real Media Inc. and Interliant Inc., had "utterly" failed to establish the requisite elements for private claims of securities fraud under Section 10 and Rule 10b-5 of the Securities Exchange Act of 1934. The centerpiece of the court's opinion was its holding that the plaintiffs had failed to demonstrate that their financial losses were in fact caused by the actions of Merrill Lynch and its former Internet stock analyst Henry Blodget.

To establish causation in a private securities fraud action, plaintiffs needed to show that the economic harm they suffered was both a foreseeable and direct result of the alleged misrepresentations by Merrill Lynch. Judge Pollack concluded that the burst of the Internet market bubble was an intervening cause that had brought about the drop in plaintiffs' stock price. In discussing the loss causation issue, the Southern District Senior Judge noted in particular that there was no evidence that plaintiffs had actually even *seen* the allegedly misleading analyst reports, or that they had even purchased securities from Merrill Lynch. Judge Pollack also criticized plaintiffs for failing to acknowledge the "unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue," and for their efforts to "twist the federal securities laws into a scheme of cost-free insurance." *Id.* at * 3. Making his contempt for plaintiffs' case clear, Judge Pollack further wrote:

> Plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation

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> in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners . . . The facts and circumstances fully within this Court's proper province to consider on a motion to dismiss show beyond doubt that plaintiffs brought their own losses upon themselves when they knowingly spun an extremely high-risk, high-stakes wheel of fortune. *Id.* at *3.

Judge Pollack also faulted plaintiffs for failing to either specifically identify the misrepresentations and omissions in the analysts' reports that had allegedly triggered their losses, or to establish a sufficient basis for their allegations as to the allegedly self-serving motivations behind the reports. Noting that the court had charitably taken upon itself "the burden of threshing through all of the chaff in search of any kernels that might emerge from the complaints," Judge Pollack concluded that "[n]owhere . . . is it specifically alleged precisely *which* analysts had *which* conflicts of interest involving *which* investment banking deals leading to *which* 24/7 research reports being misleading, to what degree, and when." *Id.* at *13-14. The court further held that plaintiffs had failed to sufficiently allege that Merrill Lynch's compilation of analysts' reports represented "fraud on the market," as the alleged conflicts of interest and stock ratings issues raised by the investors were both well known to the market and adequately disclosed in the analysts' reports. As a result, the court held that plaintiffs had failed to plead fraud with the particularity required for claims under Section 10(b) and Rule 10b-5.

Finally, Judge Pollack found that the class actions were barred by the one-year statute of limitations for securities fraud claims. The judge premised this ruling on the fact that plaintiffs had been exposed to newspaper reports discussing stock analysts' conflicts of interests and a dearth of "sell" ratings issued by analysts for more than one year before filing the lawsuit. This wealth of discussion about the analysts' alleged conflicts, the judge reasoned, put the plaintiffs on notice of their potential claims and, accordingly, commenced the running of the statute of limitations. "The plethora of public information would have required a blind, deaf or indifferent investor to take notice of the purported alleged 'fraud'," Judge Pollack wrote in his opinion rejecting the plaintiffs' motion to reconsider. "Every investor of reasonable intelligence would have been absolutely on inquiry notice."

In so ruling, Judge Pollack set the law squarely in line with common sense. To allow a federal securities fraud claim to every stock purchaser who has previously read an analyst's report would render the national securities markets into one giant insurance pool. The trading of stocks would be no more risky than the swapping of surety contracts. By requiring the plaintiffs to tie their losses into the alleged wrongdoing in the analysts' reports — a feat even clever plaintiffs' lawyers could not accomplish in *Merrill Lynch* — Judge Pollack focused on precisely the issue that ought to govern in these cases. Even assuming, as a judge on a motion to dismiss must, that the analysts' reports *all* were dishonestly made, the judge recognized that they could not possibly have caused any legally recognizable harm in light of all the other possible influences that exist to convince a potential investor to buy a particular stock.

Judge Pollack's decision in *Merrill Lynch* also demonstrates the gatekeeper role a federal judge ought to play at the outset of a securities case. Federal securities class actions are enormously expensive endeavors that tax the time and pocketbooks of the named defendants and their insurers from the outset *even if the claims are baseless*. It is, unfortunately, inevitable in their post-Enron age that some courts have fallen prey to the notion that every company is corrupt and that each corporate executive is a villain. Sensible judges, however, make distinctions and demand a connection between alleged wrongdoing and claimed losses. For those judges, Judge Pollack in *Merrill Lynch* has written a soundly reasoned model.