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Second Circuit Issues New Opinion Regarding Class Action Standing and Damages Under the Securities Act

On September 6, 2012, the United States Court of Appeals for the Second Circuit issued an important decision in *NECA-IBEW Health & Welfare Fund* v. *Goldman Sachs & Co.*, 11-02762-cv (Sept 6, 2012) ("*NECA-IBEW*"), vacating in part the dismissal of a putative class action brought under §§ 11, 12(a)(2) and 15 of the Securities Act by an RMBS purchaser. The decision includes important holdings concerning both standing in the class action context and the standard for pleading a cognizable injury under the Securities Act. First, the Court ruled that, in some defined circumstances, purchasers of RMBS certificates have standing to assert claims on behalf of purchasers of certificates in other offerings. Second, the Court held that holders of a security need not allege an out-of-pocket loss to adequately plead damages under Section 11.

The Court's Standing Holding

Sections 11 and 12(a)(2) impose strict liability for a misstatement in a registration statement or a prospectus, but only persons who acquired securities in or traceable to the offering associated with the allegedly false registration statement or prospectus may bring such claims. Nonetheless, plaintiffs who have purchased in one offering by an issuer often purport to pursue class actions on behalf of purchasers in other offerings by the same issuer, in particular when multiple offerings are made pursuant to a common shelf registration containing an alleged misstatement. Defendants typically argue that a plaintiff should not be permitted to assert claims on behalf of others that it could not assert on its own behalf. Courts throughout the country have been split on this question. In *NECA-IBEW*, the Second Circuit staked out a middle ground, ruling that a plaintiff may assert claims on behalf of purchasers in other offerings when the claims of the plaintiff and those of the absent class members implicate "the same set of concerns."

Plaintiff NECA-IBEW purchased RMBS in two of seventeen offerings under a shelf registration. Each offering was made pursuant to a registration statement, including the common shelf registration and a unique prospectus supplement. The securities in the offerings were backed by mortgages from at least six different mortgage originators. NECA-IBEW purported to assert class action claims on behalf of purchasers of every security issued under the common shelf registration. The district court dismissed on the ground that NECA-IBEW did not have standing to assert claims on behalf of purchasers in offerings other than the ones in which it purchased. The Second Circuit disagreed, holding that NECA-IBEW could assert claims on behalf of purchasers of some of the securities at issue but not others.

The Court noted a "tension" in the case law as to whether a plaintiff's ability to assert Securities Act claims on behalf of purchasers in other offerings was a question of standing to be determined on a motion to dismiss or a question of whether the plaintiff met the requirements for class certification under Rule 23. After reviewing the relevant case law, the Second Circuit held that, to assert claims on behalf of a putative class, a plaintiff must plausibly allege (1) that he suffered some actual injury as a result of the allegedly illegal conduct of the defendants (*i.e.* Article III standing) and (2) that the conduct that allegedly injured the plaintiff implicates "the same set of concerns" as the conduct by the same defendants alleged to have caused injury to other members of the putative class.

Applying this standard, the Court determined that the "concerns" implicated by the complaint in *NECA-IBEW* related to the mortgage origination process and reinstated only those claims relating to securities backed by mortgages from the same originators who originated any of the mortgages backing the securities NECA-IBEW actually purchased. The Court affirmed the dismissal of claims related to securities backed by mortgages from other originators, holding that the named plaintiff lacked standing to pursue those claims because it was in no way injured by any representations made about mortgages originated by those firms. Thus, the Court made clear that determining whether a plaintiff may assert claims on behalf of purchasers in other offerings requires a nuanced and allegation-specific inquiry. Notwithstanding the Court's repeated use of the "same set of concerns" phrase, then, the actual test used is considerably narrower.

The Court's decision suggests a number of circumstances under which a plaintiff might be precluded, as a matter of the law of standing, from bringing suit on behalf of others. First, the opinion plainly indicates that the named plaintiff must itself have a claim against each defendant and so defendants have a good argument that a plaintiff may be precluded from asserting claims against underwriters, originators, or other participants in structuring or marketing securities it did not purchase. Second, in the case of multiple offerings under a common shelf registration, class plaintiffs arguably do not have standing to assert claims based on alleged misstatements in the individual prospectus supplements associated with each security rather than in the common shelf. Third, and potentially most important, significant differences in the factual context of each offering may preclude a finding that the claims involve sufficiently "common" concerns to satisfy the Court's new-fashioned standard. Most pertinently, unless the true facts against which any supposed misstatement will be judged are the same, there is an argument that there should be no standing. This is especially true for cases arising out of the financial crisis or in the context of other rapidly changing market conditions. Under those circumstances, it will often be the case that the accuracy of the representations must be continually assessed against that changing factual background, such that securities issued under common shelf registrations issued months or even weeks apart are likely to involve differing "true facts" and differing defenses.

In addition, the Court made clear that this standing determination is distinct from the criteria that the court must apply to the ensuing motion for class certification Thus, a plaintiff found to have standing to pursue claims on behalf of a class may nonetheless be found inadequate as a class representative. As a strategic matter, this distinction suggests that, at least in those circumstances in which there is an apparent overlap in issues of the sort that is likely to satisfy the NECA-IBEW test, arguments regarding the variation between a named plaintiff's claims

and those of the purported class will be better raised at the class certification stage rather than on a motion to dismiss.

It should also be noted that there remains no controlling Supreme Court precedent on this issue and the Second Circuit's decision creates a split of authorities. The First Circuit and district courts in the Eighth and Ninth Circuit have held that, as a matter law, a Securities Act plaintiff may not assert claims on behalf of an absent class of investors in other offerings, even where the offerings involved a common shelf registration statement.[1] The Second Circuit drew its "same set of concerns" language from Supreme Court jurisprudence involving class action constitutional and civil rights cases. We are aware of no other court adopting the formulation in the securities context.

The Court's Damages Holding

Section 11 allows a plaintiff to recover "the difference between the amount paid for the security" and either: (1) "the value of the security" at the time the time suit was brought, (2) the price at which the security was sold before the suit was brought, or (3) the price at which the security was sold after the suit was brought if those damages are less than the measure of damages under subsection 1.

NECA-IBEW had not sold its securities; did not allege that the securities it purchased had ever missed a payment; and did not allege that there was a decline in market price (because the securities were illiquid). As a result, the district court held that NECA-IBEW could not adequately allege damages under Section 11 because it had not suffered any out-of-pocket loss. The Second Circuit reversed. Drawing a distinction between price and value, the circuit court held that the NECA-IBEW adequately alleged that the value of its securities declined because they were revealed to have higher credit risk than initially understood. While "when market value is available and reliable, market value will always be the primary gauge of a security's worth," the Court stressed that "the value of a security may not be equivalent to its market price."

The decision is one of only a handful of concrete applications of the statute's reference to "value" in measuring damages for a plaintiff that has not sold the securities at the time the suit is brought. While this distinction between price and value inured to the plaintiff's benefit in *NECA-IBEW*, it may, in other circumstances, benefit defendants, for example, if market panic or hysteria has arguably caused a precipitous drop in market price in reaction to a revelation that did not reflect a commensurate drop in the value of a security.

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[1] *See Plumbers' Union Local No. 12 Pension Fund* v. *Nomura Asset Acceptance Corp.*, 632 F.3d 762, 771 (1st Cir. 2011); *Me. State Ret. Sys.* v. *Countrywide Fin. Corp.*, 722 F. Supp. 2d 1157, 1163 (C.D. Cal. 2010); *In re Wells Fargo Mortg.-Backed Certificates Litig.*, 712 F. Supp. 2d 958, 965 (N.D. Cal. 2010); *In re Wash. Mut., Inc. Sec., Deriv. & ERISA Litig.*, 259 F.R.D. 490, 504 (W.D. Wash. 2009); *Genesee Cty. Employees' Ret. Sys. v. Thornburg Mortg. Sec. Trust 2006-3*, 825 F. Supp. 2d 1082 (D.N.M. 2011).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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