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August 16, 2000

Securities Law Developments

The "In Connection With" Requirement Under Section 10(b) and Rule 10b-5: Third Circuit Adopts "Materiality and Public Dissemination" Approach

In a broadly worded opinion that should concern anyone making public statements on matters of interest to investors, the United States Court of Appeals for the Third Circuit recently decided that a corporation's misleading disclosures about itself may subject it to civil liability to the shareholders of another corporation to whom those statements were significant. In *Semerenko v. Cendant Corp.*, 216 F.3d 315 (3d Cir. 2000), *as amended*, 2000 WL 1131928 (3d Cir. Aug. 10, 2000), the court expressly rejected the argument that a misleading statement is actionable under Section 10(b) of the Securities Exchange Act only if it directly pertains to the issuer of the particular security bought or sold by the plaintiffs. Instead, the court held that any statement made in any medium upon which investors presumably rely is made "in connection with" the purchase or sale of a security, regardless of the relationship between the statement and the traded security, provided that the statement is material.

Factual Background

In early 1998, Cendant Corporation ("Cendant") made a successful tender offer for all outstanding shares of American Bankers Insurance Group, Inc. ("ABI"), with which it subsequently entered into a $ 3.1 billion merger agreement. During and shortly after the bidding, Cendant filed disclosures with the SEC that overstated Cendant's income during prior financial reporting periods. About a month after the execution of the merger agreement, Cendant announced that it had discovered potential irregularities in its accounting; that it had engaged accountants and outside counsel to mount an investigation; and that it would restate its annual and quarterly earnings for the 1997 fiscal year.

Shortly thereafter, Cendant publicly announced that the bulk of its business was unaffected by the accounting irregularities and that it was committed to completing all of its planned acquisitions, including the ABI transaction. In the months that followed, however, Cendant announced that the accounting irregularities were more far-reaching than originally stated, and that the problems affected its earnings not only for 1997, but also for 1995 and 1996. Despite its accounting difficulties, Cendant affirmed its commitment to completing the ABI deal. But in October 1998, Cendant and ABI announced that they were terminating the merger.

The plaintiffs, arbitrageurs who purchased ABI stock between January and October 1998, then commenced a class action lawsuit in the United States District Court for the District of New Jersey alleging that Cendant, its former officers and directors, and its accountants violated Section 10(b) and Rule 10b-5 by misrepresenting Cendant's financial condition and its willingness to complete the merger. The plaintiffs claimed that Cendant's misrepresentations artificially inflated the price of ABI stock, which fell when news of Cendant's financial condition worsened and the merger was terminated. The defendants moved to dismiss the plaintiffs' complaint, arguing that the statements about Cendant were not made "in connection with" the plaintiffs' purchases of ABI stock as required by the statute and rule.[1] The district court granted the

[1] Section 10(b) prohibits the "use or employ, *in connection with the purchase or sale* of any security,…[of] any manipulative or deceptive device or contrivance…." 15 U.S.C.A. § 78j(b) (West 1997) (emphasis added). Rule 10b-5 (cont'd)

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motion, reasoning that intervening events -- for instance, the existence of a competing tender offer for ABI -- rendered the relationship between the defendants' alleged misrepresentations and the plaintiffs' purchases of ABI stock too attenuated to satisfy the "in connection with" requirement. On appeal, the Third Circuit vacated the order dismissing the complaint and remanded the case for reconsideration under its interpretation of the statute.

Materiality and Public Dissemination

Prior to *Semerenko*, the Third Circuit had not addressed the circumstances under which the publication of misleading information to the investing public-at-large might be "in connection with" the purchase or sale of a specific security. In fashioning an interpretation of the statute to resolve such cases, the court acknowledged its desire for a rule that recognized that material, public misstatements may have a direct, causal effect on the public's desire to trade in particular securities. Borrowing from recent decisions in the Second and Ninth Circuits, the court held that "where the fraud alleged involves the public dissemination of information in a medium upon which an investor would presumably rely, the 'in connection with' element may be established by proof of the materiality of the misrepresentation and the means of its distribution."[2]

In applying this rule to the plaintiffs' complaint, the court flatly rejected the defendants' contention that the alleged misrepresentations did not directly relate to the investment value of ABI stock -- because the statements were about Cendant, not ABI -- and so could not have been made "in connection with" the purchase or sale of ABI stock. Instead, the court held that the alleged misrepresentations could have been made "in connection with" the plaintiffs' purchases of ABI stock because "10(b) and Rule 10b-5 encompass misrepresentations beyond those concerning the investment value of a particular security."[3] So long as the statements were material, the court concluded, they could be actionable, provided that they were disseminated in a medium upon which investors tend to rely. Given the expansive interpretation afforded the materiality requirement,[4] the Third Circuit appears to have decided that any misleading statement about any matter potentially significant to investors may support a Section 10(b) action, regardless of the relationship (or lack thereof) between the alleged misrepresentation and the issuer of the security actually traded.

The application of a "materiality and public dissemination" approach to false statements that lack any clear relationship to the issuer of the traded security represents an extension of Section 10(b) liability without direct support in precedent. The Second and Ninth Circuit decisions upon which the court relied rest on facts entirely distinct from those in *Semerenko*. Those opinions involved the "classic" securities fraud case in which the defendants "deliberately or recklessly…saturat[ed] the market with misleading information in an effort to prop up the price of [the issuer's] stock," not a situation in which a defendant's misrepresentations about itself are claimed to have injured an investor in the securities of a *different* company.[5] Similarly, although courts have recognized that Section 10(b) reaches misrepresentations beyond those related to a particular *security* (e.g., misrepresentations about a company's preferred stock can be "in connection with" the purchase or sale of that company's common stock), to hold that liability should attach to statements that are

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provides that it is unlawful for any person to "make any untrue statement of a material fact…*in connection with the purchase or sale* of any security." 17 C.F.R. § 240.10b-5(b) (2000) (emphasis added).

[2] *Semerenko*, 216 F.3d at 326 (relying on *McGann v. Ernst & Young*, 102 F.3d 390, 392-93 (9th Cir. 1996) and *In re Ames Dep't Stores, Inc. Stock Litig.*, 991 F.2d 953, 965 (2d Cir. 1993)). With respect to their claim against Cendant's accountants, the court held in its amended opinion that the plaintiffs must also show that the accountants knew or should have known that Cendant would disseminate their work product when making the tender offer. *See Semerenko*, 2000 WL 1131928, at *9.

[3] *Id.* (citing *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 942-44 (3d Cir. 1985) and *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 508 (3d Cir. 1988)).

[4] A statement is material if it is substantially likely to be viewed by a reasonable investor as having significantly altered the total mix of available information. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

[5] *Ames*, 991 F.2d at 962; *see also McGann*, 102 F.3d at 397 (permitting Section 10(b) liability against outside accountants who knew that issuer would use its materially false audit opinion in a form 10-K).

unrelated to the particular *issuer* whose securities were bought or sold is an entirely different matter. The *Semerenko* opinion provides neither authority nor analysis for the latter proposition, upon which its decision necessarily depended.[6]

The SEC's Position

Semerenko is also noteworthy as a measure of how the SEC might perceive similar cases from an enforcement perspective. In an *amicus curiae* brief filed with the Third Circuit, the SEC argued that the district court's focus on "intervening events" imposed a requirement that the alleged misrepresentations be causally connected to the plaintiffs' stock purchases, thereby conflating the "in connection with" and causation elements of the Section 10(b) cause of action. The Commission maintained that, although the "in connection with" requirement applies equally to private claims and SEC enforcement proceedings under Section 10(b), causation is an element only in private actions. If it required a causal relationship between a misrepresentation and a particular stock purchase, the SEC claimed, the court would indirectly "compel the Commission to prove that investors relied on a misrepresentation and that it caused them harm, in spite of the firmly established principle that the Commission need not prove such matters."[7]

The SEC took the position that a misrepresentation is made "in connection with" the purchase or sale of securities whenever the false statement is made in a manner or forum that may influence a reasonable investor. Like the *Semerenko* court, the SEC apparently rejected the notion that the misleading statement must bear some direct relationship to a particular issuer or security in order to run afoul of Section 10(b). Thus, the SEC's interpretation of the "in connection with" requirement grants the agency a virtually limitless enforcement mandate: the SEC may commence an enforcement action whenever any public misrepresentation might influence a reasonable investor, regardless of whether the statement was related to any particular security or issuer or whether the statement actually caused someone to purchase or sell a security.

Potentially Limited Scope

It is possible to give the *Semerenko* decision a more narrow reading. Cendant's alleged misrepresentations were made during the course of a merger with ABI and a tender offer for its stock, circumstances in which statements concerning Cendant's intentions and financial condition could reasonably be expected to affect the investment value of ABI's securities. Indeed, in this context the price of ABI stock would be likely to respond at least as much to events bearing on the value of Cendant stock as those bearing on ABI's own future business prospects. Accordingly, in the merger context, Section 10(b) and Rule 10b-5 have been read to reach the misrepresentations of an acquiring company because of their effect on the price of the target company's stock.[8] Limited to its facts, therefore, the court's decision in *Semerenko* seems justified by the particular circumstances of the case.

That said, the sweeping language of the court's opinion goes well beyond this more restrained interpretation. Rather, it appears that the Third Circuit has adopted a rule that could impose Section 10(b) liability upon any person who knowingly or recklessly makes a public, false statement about any matter significant to an investor's decision to trade in the securities of any corporation. In this regard, one area of interest in which *Semerenko* could serve as meaningful precedent

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[6] The two decisions cited by the *Semerenko* court, *see supra* n.3, are not analogous. *Angelastro* involved a brokerage firm that misrepresented the interest terms for its margin accounts; the court held that those misrepresentations satisfied the "in connection with" requirement, despite the fact that they did not pertain to any particular security, because they involved a "course of dealing in securities." 764 F.2d at 944. *Deutschman* held that a purchaser of call options had standing to pursue a Section 10(b) claim based upon an issuer's misrepresentations concerning the investment value of its own securities, which were the subject of the options. 841 F.2d at 505.

[7] Brief of the Securities and Exchange Commission, Amicus Curiae at 9, *Semerenko* (Nos. 99-5356; 99-5355) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363 n.4 (9th Cir. 1993); and *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985)).

[8] *See, e.g., In re MCI Worldcom, Inc. Sec. Litig.*, 93 F. Supp.2d 276, 281 (E.D.N.Y. 2000) (finding defendant's false denials of merger discussions sufficient to warrant Section 10(b) claim by shareholders of target company); *In re Columbia Sec. Litig.*, 747 F. Supp. 237, 245-46 & n.6 (S.D.N.Y. 1990) (dictum) (same).

involves the potential liability of chat room participants or other persons disseminating misinformation over the Internet.[9] In these cases, the crucial issue under *Semerenko* may be whether such postings are material in light of their source, content, and means of distribution.

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[9] *See, e.g.*, *SEC v. Hoke*, Litigation Release No. 16266, 1999 WL 670961 (Aug. 30, 1999) (SEC enforcement action under Section 10(b) and Rule 10b-5 involving Internet posting falsely claiming that publicly traded company was being acquired by a foreign concern). For a contrasting case, see *Cadiz Land Co., Inc. v. Waste Management, Inc.*, in which the plaintiff alleged that the defendants, in an effort to gain leverage in a zoning dispute, attempted to "adversely effect" the plaintiff's stock price by publicly "bad-mouth[ing]" it on the Internet and elsewhere. CV 97-7827, Order Dismissing Claims at 7, 22 (C.D. Cal. Apr. 14, 1998). The court dismissed the securities fraud claims with prejudice, reasoning that the "in connection with" requirement had not been satisfied because the defendants played "no role in the stock transaction" and "were akin to members of the public." *Id.* at 23, 30. The plaintiff appealed, and the case is presently under submission to the United States Court of Appeals for the Ninth Circuit. *See Cadiz Land Co., Inc. v. Waste Management, Inc.*, No. 99-55141 (9th Cir. filed Dec. 15, 1998).