Securities Update

EXECUTIVE SUMMARY

Stock options backdating cases are changing the way securities litigation is handled. The first half of 2008 saw a wave of settlements. But courts and litigants have become more sophisticated and special litigation committees are playing an increasingly pivotal role. In addition, courts are now dealing with the practical impacts of Supreme Court decisions and judges are asking hard questions about topics like loss causation, scienter, and have even overturned jury verdicts. Our panel of experts from Northern and Southern California discuss these developments. They are Bruce G. Vanyo and Richard H. Zelichov of Katten Muchin Rosenman; Joy A. Kruse from Lieff Cabraser Heimann & Bernstein; Sean T. Prosser of Morrison & Foerster; Joseph E. Floren from Morgan, Lewis & Bockius; Jim Kramer and Robert R. Varian of Orrick, Herrington & Sutcliffe. The roundtable was moderated by former judge Diane Wayne, a neutral with JAMS, The Resolution Experts.

MODERATOR: In the Northern District, Judge Alsup initially rejected settlements in both *In re: Zoran Corporation Derivatives Litigation* and *In re CNET Networks, Inc. Shareholder Deriv. Litigation* and Judge Whyte asked further questions in the *In re Integrated Silicon Solutions, Inc. Deriv. Litigation* settlement. What is the reaction to the judges' desire to ensure that in options backdating cases that it's not just lawyers who are compensated? And how do you define therapeutic value so that a judge will buy in?

KRAMER: Judges are taking seriously the obligation to protect the class and to ensure that settlements deliver value back to the company. So the lesson, for defense and plaintiffs lawyers, is to make sure that you clearly document the nature of the value being delivered back to the company. For example, if adopting corporate therapeutics as part of a settlement, the lawyers need to establish that the company's agreement to the therapeutics is tangible, i.e., the company is agreeing to real therapeutics for a certain period of time.

ZELICHOV: *Zoran* is complicated because the court believed that the plaintiff was trying to take credit for therapeutics already implemented by a special committee that had investigated alleged options backdating at Zoran. It may thus not apply in cases where there was not a prior special committee investigation.

MODERATOR: What about other settlement benefits to a corporation, like not being in trial or having to deal with bad publicity?

VARIAN: While the *Zoran* and *CNET* decisions contained language that was problematic for people trying to settle cases in the real world, *Zoran* ultimately did settle and the settlement was approved by Judge Alsup. The terms of the settlement he approved take some of the edge off the statements that gave us concern. His original decisions raised issues about whether you could settle a case before it was established that the plaintiff had standing to represent the company, meaning that demand was futile.

It would be a huge problem if in every case you had to resolve that issue before you could settle the case. Similarly, the *CNET* decision said there needs to be a clear basis on which the court and the plaintiffs can evaluate the litigation claims and the value being conferred on the company. That was troublesome because you could envision a long and expensive process before anybody could even talk seriously about settlement.

MODERATOR: How practical is it for a judge to require deep discovery?

KRUSE: There were a couple of cases in front of Judge Whyte recently, *In re Integrated Silicon Solutions, Inc. Shareholder Derivative Litigation* and *In re Sigma Designs, Inc. Derivative Litigation*—in which both plaintiffs and defense counsel argued that when it is a small case, it's important to be efficient and not do the extensive discovery that you would do in a *Brocade* or *Broadcom*.

PROSSER: Plaintiffs ironically are becoming victims of their own overpleading in some instances. We've seen it particularly in derivative cases where more than 20 individuals in the corporate chain are alleged to have engaged in bad acts, when in reality, there may be a decent claim against a much narrower group. When plaintiffs build up this huge supposed fraud throughout the corporation, it's difficult for a judge to rationalize a small settlement early on even though it may be proper and reasonable resolution.

KRAMER: When it's not a particularly bad case (i.e., the defendants' rights to indemnity from the company will remain intact) if you were to litigate downstream and all the individuals have lawyered up with independent counsel, which can cost the company an extraordinary amount of money—in such a situation, it may be in the best interest of the company and the plaintiff lawyers to resolve the case early, taking those factors into account.

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PARTICIPANTS

BRUCE G. VANYO is national co-chair of the Securities Litigation Practice at Katten Muchin Rosenman. He has practiced securities litigation for 33 years and defended more than 250 major securities cases. He has represented clients from such diverse industries as high tech, life sciences, airlines, motion pictures, banking and insurance, including Krispy Kreme Doughnuts, Dell Computer, Boeing Company, Fluor Corp., Amdocs Limited, and Genentech. He was named to the *National Law Journal*'s 2006 list of 100 Most Influential Lawyers in America.
bruce@kattenlaw.com

RICHARD H. ZELICHOV is a partner in Katten Muchin Rosenman's Securities Litigation Practice Group in Los Angeles. His practice encompasses a wide range of commercial litigation matters, with particular emphasis representing public companies and their directors and officers in securities class action and derivative litigation in both federal and state courts throughout the United States. He also has significant experience handling matters before the SEC and with internal investigations.
richard.zelichov@kattenlaw.com

FLOREN: One could read the *CNET* ruling to suggest that a derivative plaintiff cannot drop a case, even one that turns out to be of potentially dubious merit, without doing the pick-and-shovel work in discovery to ascertain the strength of those claims. Plaintiffs who survive a motion to dismiss have to be careful what they wish for, as they may be forced to litigate a case that doesn't have value in terms of potential damages. But the real message is that to get one of these settlements approved, the plaintiff and, in some cases, often the defendants need to create a clear record.

Sometimes that's going to require confirmatory discovery so the court can be satisfied that the reasonable analysis has been done with respect to the strength or weakness of claims. Some of this information is in the hand of the defendant, such as costs to be avoided through settlement, and they can help create a record of that.

In the *Integrated Silicon Solutions* and *Sigma* cases, both of which are still in midstream, it seemed that the record was simply incomplete, and Judge Whyte was looking for more information.

VANYO: Judge Alsup is a very active judge and he scrutinized the settlement probably more than most judges do. Many options backdating cases have settled without any real challenges by the court. There's nothing particularly new about what Judge Alsup did in the sense of requiring some showing that the plaintiffs provided a benefit for the corporation before the case could get settled. But in *Zoran*, it needed to be tidied up and more money was put into it. It got settled. *CNET*, of course, got solved a different way with the potential acquisition of the company. These cases are interesting, but I don't think they are the norm.

PROSSER: One result of the increased judicial scrutiny into whether a derivative settlement provides a real benefit to the company is that you are seeing the insurance companies more willing to put money into the settlement on behalf of insured individuals. Generally, it has been difficult to get the insurers to put money into a settlement where money will go to the company.

KRUSE: In evaluating options backdating settlements, Judge Whyte and Judge Alsup are scrutinizing the role of the outside attorneys. Judge Alsup asked for further briefing on the authority of parties to release Zoran's former counsel and its accounting firm. Judge Whyte in *Sigma Designs* asked for a declaration from Pillsbury [Winthrop Shaw Pittman], explaining that the firm had found no basis for a claim against the company's outside counsel. "No basis for a claim" is a pretty high bar.

FLOREN: In the *Sigma* Designs case, the issue was to some extent invited by a comment from counsel at the prior hearing on the settlement. So it's not a question of a judge actively inquiring into the issue of releases of counsel. Generally, a company in a derivative case will always want the settlement to cover claims against counsel and accountants unless there's a reason not to. In some cases, the company and the plaintiffs need to document that there's been an appropriate process to consider the issue, with independent directors and possibly independent counsel.

KRAMER: The test is whether it is in the best interest of the company to pursue litigation, which is fundamentally different than "there is no basis." There may be a situation where facts exist that forms the basis of a claim. Again, that's not the test. The test is: Is it in the best interest of the company to engage in litigation?

ZELICHOV: *Sigma Designs*, *Integrated Silicon Solutions*, and *Brocade* are interesting because the courts are scrutinizing the role of outside counsel. Up until now, it was really inside general counsel who have found themselves subject to scrutiny concerning option grants, both by the special committees and the SEC. We've seen a number of enforcement proceedings brought by the SEC against company's general counsel for doctoring minutes or for allowing or furthering backdating.

PROSSER: It's not necessarily outside counsel getting a free pass. Rather, special committee investigations typically will focus on the auditors or outside counsel only when someone is relying on them as a defense or where there is some other indication or evidence of their involvement.

FLOREN: Even though the options backdating situation involved essentially an accounting issue, you've seen very few cases in which claims have been asserted against the auditors. There is usually a lack of evidence, a lack of any reason to believe they were involved or culpable.

MODERATOR: How many of these options backdating cases have gone to trial and what are typical

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results? Given that the Northern District is somewhat a world unto itself, is there going to be a chilling effect on settlements?

KRAMER: These cases take a long time to settle, and there are a number where the settlements started nine months ago and we are going to start to see them pop out in the next few months. But the lasting legacy is going to be new law on the attorney-client privilege and attorney work product.

Many of us are representing former general counsel in SEC proceedings and one of the key issues is what communications were there with outside counsel and what communications of outside counsel were shared with the SLC, the government, or plaintiffs lawyers. All of that is going to bear on what gets produced in civil discovery, and there is going to be a continued evolution of law.

PROSSER: In August, in the Fourth Appellate District in San Diego, the panel ruled there was no waiver of attorney-client privilege by a voluntary disclosure of privileged information to the Department of Justice, because the disclosure was evaluated under the coercion language of the California Evidence Code. Essentially, the party was compelled to reveal this information to protect itself. The decision contradicts a few other cases so it may be reviewed at the higher level.

FLOREN: That case, *Regents of the University of California v. Superior Court* [165 Cal.App. 4th 672] is a remarkable decision. It may be limited to its facts because it relied upon the former Department of Justice policy under the Thompson Memorandum, which has now been reversed, whereby they were more coercive in requiring waivers as the price of cooperation.

MODERATOR: What are the changing roles of special litigation committees?

VARIAN: It's a hot area, and it will be interesting to see how motions by special litigation committees to terminate stock option cases litigation are ruled upon, and whether the rules that are applied are in line with the traditional standards. When there's a ruling, it will be important.

VANYO: Because of the attention being drawn to these cases, the special committees feel they have to take an active role in the litigation. Historically, that's been an unusual event where a special litigation committee takes over the case. We'll probably see some more examples of that.

ZELICHOV: It will depend what happens in the first couple of decisions regarding termination by a special litigation committee. If courts apply stricter standards and deny motions to terminate filed by special committees, we could see more cases like *Brocade*, where the special committee takes over and brings claims against individual defendants, and that would be a sea change from what's happened before.

KRUSE: The federal judge in *UnitedHealth* certified to the Minnesota Supreme Court the question of how much deference he owes to the special litigation committee's approval of the settlement in that case. If you have the special litigation committee and plaintiff going in and recommending the settlement together, what does that do in terms of the deference the court has to give the settlement?

FLOREN: *UnitedHealth* shows that the special litigation committee does not have to take control of and prosecute litigation to achieve an aggressive result. No one with a straight face could claim that that was anything but a good result for the company.

MODERATOR: Going back to the *In Re: Apollo Group, Inc. Securities Litigation* case, was it surprising that the $277 million jury verdict was overturned by the district court judge?

VARIAN: I was surprised not because it was the wrong result, but because the judge had grappled with the pivotal issue on summary judgment and it was unlikely that he was going to have a different view at the end of trial. The reversal was on a very technical loss causation question, not the fun stuff that we are used to thinking about in securities fraud cases. The Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo* may have more impact than some of us thought. That was the sole basis for reversal of the jury verdict.

ZELICHOV: *Apollo* and the Ninth Circuit's decisions in *Metzler Investment GMBH v. Corinthian Colleges, Inc.*, and *In re Gilead Sciences Sec. Litigation* suggest that analysts' reports may be an important part of connecting the dots in the loss causation analysis.

PARTICIPANTS

JOY A. KRUSE is a partner in Lieff Cabraser Heimann & Bernstein, LLP's Securities and Financial Fraud Practice Group. Ms. Kruse played a leading role in the litigation and successful resolution of the *McKesson, America Online, Peregrine*, and *Network Associates* cases. She is presently Lead Counsel with Richard Heimann in the *Broadcom* stock options backdating derivative litigation. From 1992–1996, Ms. Kruse was an Assistant Federal Public Defender in the Northern District of California (San Jose Division). She is a member of the editorial board of *Securities Litigation Report*.
jakruse@lchb.com

JOSEPH E. FLOREN is a partner in Morgan Lewis's Litigation Practice. He focuses on corporate and securities litigation, including the defense of class and derivative actions and representation of securities broker-dealers, investment managers, and other financial services companies in all aspects of litigation and related regulatory matters. Mr. Floren has tried more than 20 cases to verdict or award, and he regularly represents securities industry clients and issuers of securities in investigations and enforcement proceedings before federal and state securities regulators and self-regulatory organizations.
jfloren@morganlewis.com

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PARTICIPANTS

SEAN T. PROSSER is a partner in Morrison & Foerster's San Diego office. Mr. Prosser, a former SEC enforcement attorney, defends companies and their officers and directors, as well as public accounting firms, in shareholder class action, derivative and corporate control lawsuits, and in enforcement investigations and proceedings by the SEC, FINRA, CFTC, stock exchanges, and state securities regulators. Mr. Prosser also frequently represents companies, board committees, and individuals in connection with internal investigations.
sprosser@mofo.com

JIM KRAMER is a partner in Orrick's Securities Litigation and Regulatory Enforcement Group. His practice focuses on representing companies and individuals in securities class actions, derivative actions, M&A related litigation, SEC enforcement proceedings, and other complex commercial litigation. Recent litigation results include obtaining a ruling completely favorable to NVIDIA Corporation in a complex M&A/creditor's rights dispute, and dismissals of securities class actions at the pleading stage for clients Micrus Endovascular and Ikanos Communications. Mr. Kramer was named among America's leading litigation attorneys by *Benchmark: Litigation*.
jkramer@orrick.com

VANYO: Loss causation is in a state of chaos in the Ninth Circuit because Judge Hawkins in *Gilead Sciences* has said you should never resolve a case at the pleading stage on loss causation. The panel in *Metzler* saw it differently.

VARIAN: The issue of how it's going to be dealt with at the pleading stage is key because you don't want to go through a trial to find out how it's going to be dealt with at the end. It is unclear how *Dura* is going to be applied in the Ninth Circuit at the pleadings stage, which is the critical juncture.

PROSSER: On *Metzler* and others where you have the continuing partial disclosures, it does seem that a particular level of detail tying everything together is going to be necessary.

KRAMER: For defense lawyers, the lesson is: Do an event study. Figure out what happened when and what information is out there, because these are the tools you have to educate the court and plaintiffs counsel on what caused or didn't cause stock price to move.

FLOREN: On the *Metzler* case, another way to look at the same issue is to what extent at the pleadings stage are courts going to take judicial notice of the market, such as what news was out there and what articles were out there, before an alleged corrective disclosure occurred? Second, how aggressively will courts require the loss be tied to the revelation of the alleged fraud?

VARIAN: There's either an efficient market that incorporates that information quickly or there isn't, and if there isn't for loss causation purposes, then there shouldn't be for purposes of dispensing with the reliance requirement under 10 (b). We have to go a long way before the fraud on the market presumption is in danger, which would be OK with some of us, but analytically they are two sides of the same coin.

MODERATOR: What does *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* tell us about scienter?

KRUSE: Plaintiffs are asserting that a tie goes to plaintiffs. When the decision came out, Professor [Joseph] Grundfest blogged on the *Wall Street Journal* that *Tellabs* essentially means, as in baseball, tie goes to the runner, meaning the plaintiff.

PROSSER: *Tellabs* made it clear that you need to look at all the facts, the whole complaint, and you mu st evaluate the competing inferences for both parties.

KRAMER: You've got to comply with *In Re: Silicon Graphics, Inc. Securities Litigation* and allege the elements of your claim with great particularity as required under Private Securities Litigation Reform Act of 1995. On top of that requirement, you then need to balance out the inferences.

In some of the decisions that we are seeing, these foundational allegations don't appear to be plead with the particularity required by the Reform Act. We've seen some courts say, "I can just weigh everything in a general sense." Under the Reform Act, that's enough. That's not what Silicon Graphics stands for; that's not the right pleading standard.

ZELICHOV: What some courts have done in emphasizing the tie-goes-to-the-plaintiff aspect of *Tellabs*, is ignore that *Tellabs* says the inference of scienter must be cogent and as compelling as opposing inferences.

VANYO: We are seeing an erosion of the pleading requirements. Not just as to scienter, but also as to falsity. The problem is once you get past the idea that in fact, something was misrepresented, the inference of scienter becomes easier.

In the *Tellabs* decision on remand, Judge Posner was saying, "We are going to assume this problem existed and it was a serious problem and we don't believe that the manager of the company would not have been aware of this problem."

VARIAN: There's no collective scienter under traditional Ninth Circuit rules. You need to have an identified human being who made a false statement with fraudulent intent, and you have to plead scienter with specificity.

In Re: LDK Solar Securities Litigation blew right past that requirement to the "I can't believe management didn't know about something this important," and relied on scienter in the ether, not by a particular person who spoke materially false or misleading statements. That's directly contrary to Ninth Circuit law.

ZELICHOV: It becomes difficult to bring coherence to the decisions because the cases are not decided by the same panel of judges. It would be interesting to see the same panel grant a motion to

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dismiss in one case and reverse in another to see where the judges are drawing their lines. The decisions are not always based on political leanings either. Judge Fletcher wrote the *Metzler* decision and she's viewed as liberal, and Judge Kozinski wrote *Berson* and he's viewed as less liberal. Also, while the initial Seventh Circuit *Tellabs* decision was not friendly to defendants, the *Tellabs* decision on remand is possibly even worse for defendants.

VARIAN: *Tellabs* is not a step forward for the defense in this jurisdiction. It's a good development for the plaintiffs in other circuits.

KRUSE: Partly what motivated the *LDK Solar* decision denying the motion to dismiss is that Judge Alsup got turned off by what he perceived as defendants' credibility attacks on the whistleblower. In his order denying defendants' motion for reconsideration, he says essentially, "You are asking me to do a credibility assessment of this whistleblower and I won't."

PROSSER: The confidential witness issue does seem to be getting more and more attention. You have some judges who say, "It doesn't matter to me if the source is anonymous." And then you have others saying, "If the source is anonymous I will discount it," and then you have others saying, "You need to give me a certain level of specificity, not the names, but enough other facts so I can assess whether this is a relevant source."

KRAMER: That's the battleground. The most important thing the company should be thinking about if they do get hit with a securities case is how to appropriately rein in confidential witnesses.

ZELICHOV: The confidential witness point is interesting because if a company had a financial setback that resulted in a stock price drop and a securities class action, it probably had layoffs. You are therefore likely to have former employees whose view towards their former employer may not be positive and who may feel that they can exact revenge by cooperating as confidential witnesses with plaintiffs counsel.

PROSSER: It's risky to delve too far into the credibility of the confidential witnesses at the pleading stage. As defense counsel you may be able to identify the former employee by the dates of employment and position, and you may also know the employee was terminated because, for example, the person stole from the company. You could have all sorts of information that would undermine the credibility of this witness that the plaintiff is relying on to get past the motion to dismiss.

So on one hand you have the judge evaluating the credibility of the confidential witness described in the complaint, but the judge probably will refuse to consider the information that defendants have.

KRAMER: I've had situations where the other side relied on a confidential witness who was fired and I have called the lawyers on the other side and they have dropped reliance on that confidential witness because the plaintiffs lawyers didn't want to hurt their credibility with the court.

VANYO: If plaintiffs lawyers get ten minutes on the phone with a confidential witness, they feel lucky. That tends to be what appears in the complaint—little comments here and there that are pieced together.

KRUSE: We are conscientious in how we use confidential witnesses. The investigator we have is a former FBI agent, who is very skilled in assessing credibility. Confidential witnesses fall along a continuum from people who may have an ax to grind to people who believe a fraud is going on that they are not comfortable with.

Confidential witnesses can be part of the allegations you make in the complaint if the witnesses are identified as to the position they held in the company in the relevant time period, their background and professional expertise, and why they would be able to assess whatever the issue is. ■

PARTICIPANTS

ROBERT P. VARIAN is a partner in the San Francisco office of Orrick's Securities Litigation and Regulatory Enforcement Group. He is one of the few attorneys who have tried securities class actions to verdict. Mr. Varian represents issuers, officers, directors, underwriters, and accountants in securities and merger litigation throughout the U.S., and in internal investigations and investigations and proceedings by the SEC. He earned degrees from Lafayette College and the University of Maryland School of Law, where he was editor-in-chief of the *Maryland Law Review*.
rvarian@orrick.com

HON. DIANE WAYNE (Ret.) is a full-time mediator and arbitrator with JAMS in Southern California. She successfully resolves complex multi-party cases and class actions, including securities, business, entertainment, employment, intellectual property, environmental, insurance coverage, and bad faith matters. Judge Wayne has frequently been named to the *Daily Journal*'s list of Top Neutrals in California. She is highly respected and known for her ability to work closely with parties to employ innovative techniques to reach settlement. She is a retired judge of the Los Angeles Superior Court.
dwayne@jamsadr.com

"Securities" originally published in the October, 2008 issue of *California Lawyer.*
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