ROUNDTABLE

Securities Litigation

EXECUTIVE SUMMARY

Securities class action filings in the first six months of 2006 have dropped 45 percent compared to the same period last year, according to Cornerstone Research. And the reasons for the lower level of activity may be the same factors Cornerstone listed in its 2005 *Year in Review*—most of the lawsuits related to fraud during the dot-com boom and bust are over, corporate governance has improved, and the U.S. stock market is less volatile.

However, securities litigators remain busy. This month our panel of defense and plaintiffs experts discuss a recent Ninth Circuit decision, *Simpson v. AOL Times Warner, Inc.*, that may make third parties liable as primary violators under section 10(b) of the Securities Exchange Act; the effect of stock options-backdating investigations on securities litigation; and the rise in derivative suits.

The attorneys are Jay Pomerantz of Fenwick & West; Norm Blears and Sara Brody of Heller Ehrman; Jeffrey Lawrence of Lerach Coughlin Stoia Geller Rudman & Robbins; Tony Rodriguez of Morrison & Foerster; and Michael Torpey and Robert Varian of Orrick, Herrington & Sutcliffe. The roundtable was moderated by Custom Publishing Editor Chuleenan Svetvilas and reported for Barkley Court Reporters by Krishanna DeRita.

MODERATOR: What are the implications of the Ninth Circuit's recent decision in *Simpson v. AOL Time Warner Inc.*, [452 F.3d 1040 (2006)]?

LAWRENCE: Obviously, the case was dismissed on its facts with plaintiffs given leave to amend. But the Ninth Circuit's decision did many very helpful things in terms of clarifying what a primary violator can be.

One of the most important things in the opinion was not the ruling of the court but an understanding that ran through the opinion—the notion that auditors and people who review press releases, financial statements, and quarterly reports can be held liable under [the Securities Exchange Act section] 10(b) as primary violators even though they had not affirmatively made a statement themselves. That is something I have litigated in the Northern District quite a few times with varying degrees of success.

The court in *Simpson* now makes clear that you can recover for this kind of liability.

BRODY: Although it's a decision in favor of the defendants, it gives a lot of interesting ammunition to the plaintiffs. The court was certainly giving hope to plaintiffs that, if they could garner enough facts, they would be able, in some situations, to show that parties other than the primary actor are liable of a primary violation—but it would be pretty hard. It looks like one of those standards where you wouldn't be able to start showing until you got into discovery. So it suggests we will see amended complaints part way into discovery. Do you think it's going to happen earlier?

LAWRENCE: Obviously, garnering the facts to state a claim must be done before discovery; but that's just a function of the Reform Act [Private Securities Litigation Reform Act of 1995 (PSLRA)]. At our firm we do a lot of prefiling discovery and have been doing it for many years.

POMERANTZ: The standard that this court articulated includes an intent requirement. The court stated that a third party could be a primary violator if the principal purpose of that defendant's conduct was to create a false appearance of fact, i.e., false revenues, with the aim of deceiving investors. Given the holding of *Simpson*, the plaintiffs bar must allege particular facts establishing intent—that a third-party defendant was acting with the principal purpose of creating a false impression of fact to investors.

BRODY: Yes, the principal purpose being the hardest thing to show short of the plaintiffs getting some really substantial discovery. That's why I was thinking it would be the kind of situation where you see these third parties pulled in part way through a case.

VARIAN: I thought of it the other way. Maybe I should be more optimistic, but I assumed from the court's separation of scienter from this "principal purpose-and-effect" test that they were not the same concept—that you would not have to plead principal purpose and effect, with particularity that's required for pleading scienter and that maybe it would be easy for plaintiffs at the pleading stage to say enough on that subject and develop more information or evidence downstream. So it's an intent requirement, but it's not the kind of intent requirement that we are all used to dealing with in 10(b) cases.

BLEARS: Those are the key words that you seize upon as a defendant: Must "primary purpose" and "effect" be pled with 9(b) particularity? There will be judges who will take this and use it in a myriad of ways, but the people who may now find themselves in such cases are counterparties to fraudulent transactions—to the extent that that practice is still going on where two counterparties to business transactions engage in obvious sham transactions to increase revenues. In most cases, the standard should not give rise to liability for independent auditors.

TORPEY: My view of these cases is that there are not very many counterparties that anybody is going to sue. The factual situation in *Simpson* is at the edge of what was happening during the bubble and probably isn't happening very much anymore. All of the practitioners are looking at this decision and asking, "How does this affect the auditors, the lawyers, and the underwriters?" Those people are the repeat defendants who are most likely to be impacted by an expansion of the primary actor test.

BRODY: But those are like the line of cases from Massachusetts—*Lernout & Hauspie* and *Dexia*—where the banks were so involved in financing the sham transactions, that the courts kept them in as primary violators. The really interesting impact will be how this gets moved from the counterparty situation to the attorneys, banks, and accountants.

POMERANTZ: From the defense perspective, the argument will be that this decision does not apply to the "B" prong of Rule 10(b)5, which refers to "material misstatements and omissions." It only applies to the "A" and "C" prongs of the rule, which refer to "fraudulent schemes." As such, courts should not mistakenly apply *Simpson* in a case where a lawyer or an accounting firm was allegedly involved in, and therefore allegedly liable for, false or misleading statements.

Here's a related question: Is there currently a split in the circuits regarding what needs to be alleged to establish a primary violation of 10(b)? In *Charter Communications* [*In re Charter Communications, Inc.* 443 F.3d 987 (2006)], the Eighth Circuit held that a third party cannot engage in a primary violation based on a non-securities transaction. The plaintiff in *Charter Communications* has asked the Supreme Court to decide this apparent split in the circuits.

RODRIGUEZ: We'll have to see if the Supreme Court takes the case or waits to see how it plays out, but there is a clear break in the circuits on this point. If the Court passes for now, I wouldn't be surprised if we see attempts to sue counterparties who supposedly participated in a scheme. The bubble is over, as Mike [Torpey] said, but bubble or no bubble, it's inevitable that some company out there, through novel or familiar ways, is going to open itself up to a plaintiff who wants to try a counterparty theory.

VARIAN: To try to put this in a happier perspective from the defense side, *Central Bank* [*Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994)] did not go to the Supreme Court on the issue of whether there was aiding and abetting liability under 10(b), but rather on what the state of mind requirement was. The Supreme Court decided that case in a way that wiped out the law in every circuit, all of which had held that there was aiding and abetting liability. The Court's dangling statement in *Central Bank* left the door open for people to make creative arguments, which is what happened.

Now, under the Reform Act, to be a primary violator you still need to have acted with a state of mind that's pretty tough for plaintiffs to plead and prove, which is a good thing. You must have acted with a culpable state of mind apart from whatever else gets you in the gun sights as a primary violator.

RODRIGUEZ: I think Bob [Varian] is right, and courts should hold plaintiffs to these high standards. It'd also be good to see courts back away from any suggestion in the Ninth Circuit's opinion that a "scheme" was in connection with the sale of a security if the defendant issuer publicly reports its financials. There needs to be pleading and proof that the scheme was executed to affect publicly reported numbers, not just that it involved a company that publicly reports numbers.

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MODERATOR: What is the impact of options backdating on securities litigation?

VARIAN: The full impact is yet to be seen. We are at the front end of this process in terms of how some of these practices are going to translate, if they do at all, into securities class actions, and even how they are going to be framed in terms of derivative cases, although that's a little clearer at this point.

BRODY: Don't you think one of the biggest impacts is the fact that this is an area of securities litigation, which is being played out a lot more in the derivative case arena than in the class action arena?

TORPEY: Well, first of all, it is fundamentally changing the way in which companies are going to look at their conduct. People have been indicted in *Brocade* and Comverse for conduct that nobody would have believed was criminal 15 years ago. This is a massive step forward in the criminalization of the securities laws, which is also changing the way the defense bar has to handle these matters. The SEC and the DOJ are now quicker to act than the plaintiffs lawyers in the civil actions. In the old days, the plaintiffs bar was the first one out of the gate. Now the plaintiffs bar is the last one out of the gate. They just wait for the DOJ and the SEC to act, and the SEC and DOJ are much faster than they used to be.

BLEARS: The problem from a defense point of view is that companies are forced to, in the name of cooperation, lay open all of the facts, and in many cases, draw conclusions about the culpability of their own officers and directors and former officers and directors. But what's interesting is that to the extent there is an opportunity for the plaintiffs bar, it's going to depend upon their convincing committees, SLCs [special litigation committees], that if they are given the reins, they will act responsibly, efficiently, and exercise good judgment on the derivative side.

The derivative side will drive the stock option cases because the class action cases have huge damages and loss causation problems. I don't think that they typically will end up being a big deal. All of these new revelations about stock-option problems oftentimes create no market reaction whatsoever. But if people were self-dealing and making tens of millions of dollars in personal benefit, there's a lot to be recovered. You have the possibility of going way past the type of derivative case that settles for "corporate therapeutics" [non-monetary settlement] and six- or low seven-figure fee awards.

> **The single most interesting policy question about this stock option criminalization is, will like cases be treated in like manner?**

TORPEY: In *Brocade*, the case got settled for $525,000 and what looked like window-dressing corporate therapeutics.

BLEARS: That may be settlement one. We need to see what comes out of the next 20 or so settlements before we draw any conclusions about how big a deal the derivative cases end up being. I don't believe that most of them are going to resolve that way.

TORPEY: The initial criminal complaint, against [Brocade's former CEO] Greg Reyes had no allegation that he personally benefited from this conduct, and his lawyer is making a lot of hay out of that. I think the government was intentionally focused on the conduct without the gain, and the scary part of that is, the statute doesn't seem to require the gain as an element. What that means is, every garden-variety 10(b)5 case can be pled criminally and that part of what the government is asserting here is their ability to plead everything criminally if they want to.

Another interesting aspect of *Brocade* is that the SEC complaint has no allegations against the CFO that he participated in the conduct, only that he knew about it and didn't do anything about it. That's also a reach from what SEC complaints normally allege.

BRODY: But when you look at most 10(b)5 cases, you have a handful of ones that are extreme and very public. You have *Enron* and *Healthsouth* and those cases that everybody reads about in the newspaper. Those typically are the ones that at least get considered by the Justice Department. The interesting thing about the stock option cases is they are getting so much press. The *Wall Street Journal* has its own daily supplement on it. So there must be some pressure on the prosecutors.

RODRIGUEZ: Stock option cases, as typically reported, are very easy for people to understand and to present, whether in news articles, civil complaints, or even indictments. Did someone receive a gift already knowing what is in the box? Some fact patterns are more susceptible to screaming headlines, or court documents, than others. In any case, companies in just about every market sector are having to go through the X-ray machine to see if they've got a problem. This means companies that normally didn't think much about "securities litigation" now find themselves meeting a lot of securities litigators.

VARIAN: The big problem with these cases is that you can't tell whether they will be criminal or civil. The guidelines seem to have evaporated, at least in the Northern District. If you have somebody who is a former director or officer and a committee is doing an independent internal investigation and wants to interview him, do you let him talk to the committee? Not too long ago it wouldn't be such a big deal. But now you don't know who's behind the curtain—the Justice Department? Are you placing him at risk by even letting the committee interview him? You are four steps away from any kind of prosecution, but still you need to think about it from the outset.

BLEARS: The single most interesting policy question about this stock option criminalization is, will like cases be treated in like manner?

RODRIGUEZ: More people are going to get more attention. Many events are fueling the news about stock options, and plaintiffs and various government agencies are hurrying to take action. This compresses the time in which agencies and plaintiffs can get the experience necessary to feel comfortable dividing the ho-hum cases from the truly egregious cases. I think this is going to result in quite a few companies getting a lot more scrutiny—at least until agencies and plaintiffs firms max out on their resources—than is warranted.

TORPEY: They don't have the resources for it, and that's why I don't think it's going to end up like cases for like. If you can keep your head down for 18 months, you are going to be way better off.

POMERANTZ: As time goes on, the stock option cases will be divided into categories. On one side of the spectrum, you will have alleged intentional backdating. On the other, you will have companies that do detailed reviews and conclude there is neither improper conduct nor a need to restate the financials. Many derivative actions have been filed based solely on the initial announcement that a stock-option investigation had been commenced. Jeff [Lawrence], will the plaintiffs bar be mindful of the distinctions and dismiss pending derivative actions where, upon the conclusion of the investigation, the company does not restate and concludes there was no evidence of improper conduct?

LAWRENCE: Well, this notion of a monolithic plaintiffs bar is not exactly accurate. Our firm represents particular clients, prosecutes separate cases on behalf of particular classes, so I don't think that the plaintiffs bar being "mindful" is really a useful way to look at it. However, from our perspective, simply because a company has done an internal investigation and reports no fraud and the auditors have signed off on it, doesn't mean a fraud hasn't occurred. In many cases, which resulted in multiple millions in settlements, that is exactly what happened. Defense counsel represented that the investigation revealed no violation, and lo and behold, it turned out the investigation wasn't as complete as it might have been and yes, in fact, a securities fraud *was* committed.

On the other hand, if a company comes forward and says, "Here's the evidence—not just the cherry-picked documents—look at it, there's nothing there." Then, after we evaluate the evidence and we and our clients conclude there is, in fact, nothing there, it is very likely the case will go away. But that hasn't happened so much lately—the proffer hasn't happened and the results haven't happened.

BLEARS: That's coming around the bend. Many companies were forced to do investigations or at least inquiries in connection with getting their recent 10-Q out. Several companies have been mentioned in the papers as not being able to get their Qs out. But there will also be several who say

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they don't have any material problems. Maybe they take a small charge, but no restatement and no wrongdoing.

MODERATOR: Are derivative suits on the rise?

TORPEY: Absolutely, the question is whether there's going to be a payoff for the plaintiffs bar at the end of the day or not. What's causing the number of these suits to rise is the stock options investigation, which raises a few questions. Will the plaintiffs bar get past the demand motions? Will there be a payoff and will the companies let them keep it? And, most interesting of all, if there are derivative actions on the options stuff that go forward, who will be the plaintiffs lawyer? There's some chance that the traditional defense lawyers are going to end up doing that in certain circumstances, which will be interesting.

RODRIGUEZ: There are more derivative cases, but —putting aside the case that goes beyond low-grade accounting issues and instead involves slush funds and records falsification—derivative cases are going to be a high-volume, low-margin venture by plaintiffs firms. I think there will be many strong demand futility motions in response to these cases, particularly where there has been turnover on the board since the era when the alleged backdating occurred. I think we'll see plenty more class actions.

VARIAN: Derivative actions are definitely up, and they'll continue upward for a number of reasons, including the fact that the legal environment has gotten more friendly to plaintiffs and made it more difficult to make the demand futility or demand-required arguments that you have been able to make in the past, but it is a low-margin business. The engine that drives securities class actions is the damage theory, and the efficient market, and the ways plaintiffs have been able to calculate damages, which generate astronomical numbers in many cases. That's not true on the derivative side, and that's a really important difference.

BLEARS: Some stock option cases will survive demand motions. It will be interesting to see how often and how exactly the special litigation committee procedure is invoked. And as Mike [Torpey] mentioned, it will be very interesting to see which set of lawyers, and which set of plaintiffs bar lawyers, will earn the trust and confidence of some companies and their SLCs.

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LAWRENCE: One interesting trend about derivative cases is that for a long time they were often filed after a securities case was filed. The claim was often a breach of fiduciary duty related to the securities claim and the case was resolved in connection with the securities claim. Also, for the most part, derivative cases used to be filed in state courts. Now many of the options-backdating cases are starting off the process as derivative cases in federal court. As the cases go forward, there's going to be a body of law that starts to get developed more than in the past.

For example, for corporations doing business in California, it's not 100 percent clear whether Delaware law or California law applies in evaluating demand futility. With more extensive litigation, you're likely to get decisions that clarify the issue.

BRODY: One of the interesting issues is how the stock option derivative cases are going to get resolved. We've seen one resolution now with a corporate therapeutics settlement, in *Brocade*. But in a number of these cases, individuals are potentially going to be on the hook, and that will raise all sorts of questions about insurance. These are not indemnifiable claims, and they may be much harder for the plaintiffs to settle. I don't think the individuals will have the same incentive to just pay money and put it behind them the way a company settling a class action might feel, and so the insurance carriers are going to play a huge role in this.

POMERANTZ: The rise in derivative suits is a short-term phenomenon. Two or three years from now, it will return to the status quo—the plaintiffs bar will focus on securities class actions and derivative suits will be filed as "tag-a-long" actions. ■

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