A SUMMARY GUIDE TO

SECURITIES CLASS ACTION LITIGATION

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I. OVERVIEW

Securities class actions are routinely filed against public companies following a decline in their stock price. Despite repeated attempts to reign them in, these actions are more prevalent than ever, annually yielding billions of dollars in settlements and costing companies hundreds of millions of dollars in insurance premiums and attorneys' fees.

In this guide, we describe the most common securities class actions: (1) those alleging fraud, which are brought under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and SEC Rule 10b-5; and (2) those alleging misrepresentations in registration statements and prospectuses, brought under Sections 11 and 12(2) of the Securities Act of 1933 (the "Securities Act"). We also identify the situations that give rise to the greatest risks of being sued, and suggest ways to mitigate those risks.

SECTION 10(B) OF THE EXCHANGE ACT AND SEC RULE 10B-5

Section 10(b) and SEC Rule 10b-5 prohibit fraud in connection with the purchase or sale of a security. Pursuant to a judicially "implied" private right of action, buyers and sellers of securities may recover investment losses caused by violations of Section 10(b) and Rule 10b-5.

The fraud allegations in securities class actions tend to follow the same story arc: senior executives of a public company made statements on investor calls, in press releases, and/or in SEC filings that they knew or "must have known" were false or misleading; these misrepresentations artificially inflated the stock price; the executives cashed in by selling stock (often in connection with exercising options) at the inflated price; and when investors finally learned the truth, the artificial inflation disappeared, thereby harming those class-period purchasers who held their stock (rather than selling at the inflated price) through the class period.

The elements of a Section 10(b) claim are borrowed from common-law fraud, with several important exceptions. First, the plaintiff need not have transacted—directly or indirectly—with the defendant. While common-law fraud typically involves a defendant enriching itself at the plaintiff's expense, in a typical securities class action the plaintiff did not buy from the executive who made the allegedly false statements. The seller (who received the inflated sale price) is usually not a party to the litigation.

Second, there is no traditional reliance requirement. In common law-fraud, plaintiffs must prove that they heard or read a misrepresentation from the defendant and then acted in reliance upon that misrepresentation to their detriment. In a securities class action, by contrast, reliance is "presumed." Investors need not prove that they were even aware of the misrepresentation; all they need to prove is that they bought in an "efficient market" (a market where stock prices react quickly to new information), the misrepresentation inflated the market price, and the market price declined as a result of the truth emerging. Typically, evidence regarding market efficiency and the reasons behind stock price movements is presented in the form of "opinions" by economists retained by plaintiffs' lawyers.

Third, there is no requirement that investors assume the burden of litigation. Through the class-action mechanism, absent class members—who typically represent the vast majority of potential damages—have no role in litigation being pursued on their behalf.

SECTIONS 11 AND 12 OF THE SECURITIES ACT

Sections 11 and 12(2) of the Securities Act provide an express private right of action to investors for misrepresentations made in securities registration statements and offering prospectuses, respectively. Section 11 and 12 claims differ from Section 10(b) claims in several important respects.

Section 11 is available only to investors who purchased securities offered pursuant to a false or misleading registration statement. Plaintiffs must prove that they purchased in the offering or "trace" the securities they purchased back to the offering. In most circumstances, tracing is impossible after a secondary offering has taken place. Section 12(2) has a strict privity requirement—in other words, it is available only to investors who purchased directly from the defendant in reliance on a false statement in a prospectus.

Where these Securities Act claims are available, they may offer plaintiffs significant advantages over Section 10(b) claims: plaintiffs need not prove fraud; the pleading standards may be less stringent; a wider range of defendants, including underwriters, attorneys, and auditors may face liability; the burden of proof on the issue of causation rests with the defendants rather than the plaintiffs; and damages may, in some circumstances, be easier to prove.

ACTIONS RELATED TO SECURITIES CLASS ACTIONS

Securities class actions are often accompanied by related but distinct lawsuits arising out of the same facts and circumstances. These related actions are addressed briefly below.

Shareholder derivative actions

Shareholder derivative actions are lawsuits brought by shareholders seeking to pursue litigation on the company's behalf, often

against the board of directors and top executives for breaching fiduciary duties owed to the company. Derivative actions contrast with securities class actions in that they are brought by shareholders—rather than by buyers or sellers of securities—seeking to remedy harm to the company rather than to investors. Also, in contrast to securities class actions, shareholder derivative actions generally arise under state law and are most often (although not always) litigated in state court.

The filing of a securities class action often triggers the filing of a related derivative action. When bad things happen to a corporation, plaintiffs' lawyers have multiple stories to tell: the securities fraud story is that senior management hid the bad things to inflate the stock price; and the derivative story is that the bad things happened in the first place as a result of misconduct by senior management and the board of directors. Among other claims, derivative plaintiffs often allege that the individual defendants in a securities class action harmed the company by subjecting it to potential respondeat superior liability in the securities class action. Few of the derivative actions that are filed on the heels of a securities class action proceed past the pleading stage. To litigate a derivative action on behalf of the corporation, a stockholder must plead facts showing that directors constituting a majority of the board are disqualified from exercising business judgment regarding the subject matter of the litigation, generally due to a conflict of interest arising out of a genuine threat of personal liability. Such showings are difficult to make, particularly in light of exculpatory clauses in most corporate charters. Derivative plaintiffs, therefore, will generally stay their actions in the hopes that the securities class action settles.

Often, it is in the interests of the corporation to agree to a stay in order to avoid incurring needless litigation expenses. This is particularly true for the reason that derivative claims are generally covered under the same insurance policy as the underlying securities class action, so that litigating the derivative action depletes the insurance funds otherwise available to fund the defense.

Derivative settlements, which must be approved by a court as fair to the corporation, often involve some or all of the following: (1) a release of the individual defendants; (2) the derivative plaintiffs' lawyers taking credit for the securities class action settlement being achieved solely (or primarily) with payments from directors and officers (D&O) insurance; (3) the corporation making changes in its board composition, corporate governance structure, or system of internal controls; and (4) the corporation paying a fee to the derivative plaintiffs' lawyers for the benefit of their services.

Shareholder class action disclosure claims

Shareholders may also have claims for violations of statutory and fiduciary duties of disclosure that arise under federal and state laws, typically in connection with a shareholder vote. These actions, which often arise in connection with a proposed merger, sale of the company, or other strategic transaction, may be brought as class actions. In contrast to securities

class actions, plaintiffs in these actions typically seek an injunction ordering additional disclosures before a shareholder vote, rather than damages. Unlike securities class actions, which may last years, these actions are typically resolved quickly, often before the shareholder vote.

SEC and DOJ investigations and litigation

Section 10(b) and Rule 10b-5 may be enforced not only in private actions, but also by the SEC, in civil enforcement actions, and by the Department of Justice (DOJ) in criminal actions. Parallel government proceedings may significantly complicate the defense of a securities class action. For example, executives facing potential criminal liability will almost always be separately represented; the scope and control over the attorney-client privilege will often be in dispute; communications with witnesses must be conducted in a manner that will not be viewed as obstructing justice; government settlement agreements should be negotiated with the private action in mind; and legal work should be structured to avoid duplication of efforts and maintain work product protection where possible. These are just examples of the many issues that can arise in parallel proceedings and that require careful attention from lawyers with experience in these areas.

II. SECURITIES CLASS ACTION RISK FACTORS

Pursuing a securities class action requires plaintiffs' lawyers to invest substantial resources. Plaintiffs' lawyers, therefore, base decisions regarding whom and when to sue on financial cost-benefit analyses. The more significant inputs in the analyses are addressed below:

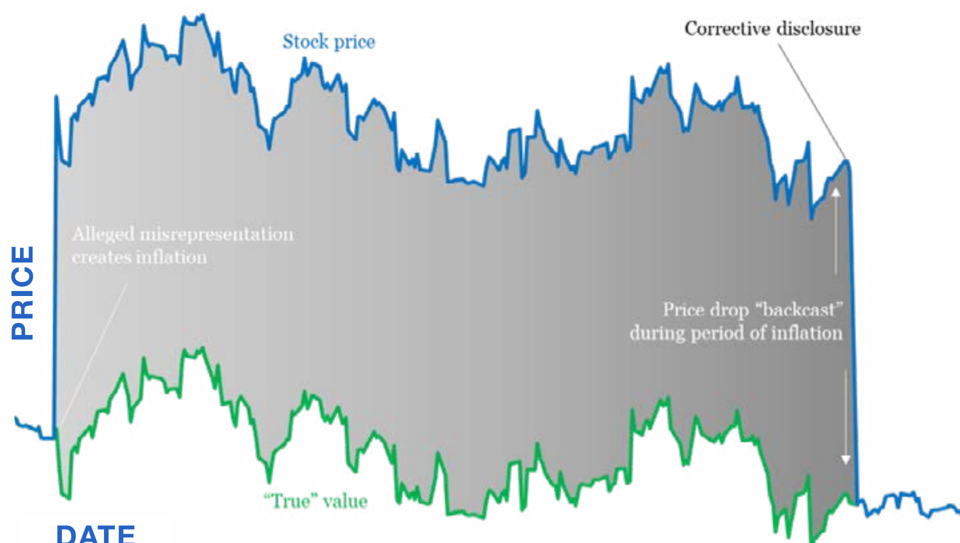
Stock Price Patterns

All else being equal, plaintiffs' lawyers will invest more in cases with larger potential damages. Obviously, a significant decline in market capitalization will attract attention; a large decline in market capitalization alone, however, does not always signify large potential damages.

Estimation of potential damages in securities class actions is complex and often speculative. Most commonly, plaintiffs estimate damages by (1) measuring the per-share price drop they attribute to a "corrective disclosure" and (2) multiplying the result by an estimate of the number of shares purchased during the period of price inflation (subtracting in-and-out traders). An example of this methodology, commonly called "backcasting," is illustrated in the chart below.

This initial damages figure must be adjusted to take account of the "90-day bounce back" provision included in the Private Securities

"BACKCASTING" DAMAGES



Litigation Act of 1995 (PSLRA), which caps recovery by each investor at the difference between the price that the investor paid for the stock on the one hand and the mean trading price during the 90 days following the corrective disclosure on the other hand.

The bounce-back provision has two important consequences. First, and most obviously, it reduces potential damages where the stock price recovers during the 90 days following the corrective disclosure. Second, it reduces potential damages in situations where a company's stock price has increased in the years and months preceding the corrective disclosure date. This point is illustrated in the following charts on page 10.

Company A and Company B both suffer a 10% stock price decline in a single day after which their stock prices remain steady for the 90-day bounce-back period. Company A is subject to suit from all persons who purchased during the two-year class period. As the chart shows, however, Company B is subject to suit only by those who purchased in the final six months of the class period.

Other Risk Factors

In addition to potential damages, plaintiffs' lawyers should consider the additional factors discussed below when deciding when and whom to sue:

1. RECENT IPO

The likelihood of a securities class action increases substantially when a company's stock price drops below the IPO price during the first three years following the IPO (before the Securities Act's statute of repose period ends). Under these circumstances, plaintiffs may pursue claims under the Securities Act, which offers significant advantages, including (1) relatively less stringent pleading standards; (2) no need to prove fraud; (3) the right to recover for misleading "omissions" (rather than affirmative misrepresentations); (4) the absence of a loss causation requirement; and (5) the right to recover from third parties involved in the offering, including underwriters and auditors. Furthermore, absent forum selection clauses in corporate charters, investors may pursue these claims in state courts, where claims are typically more likely to survive a motion to dismiss.

2. ACCOUNTING ISSUES

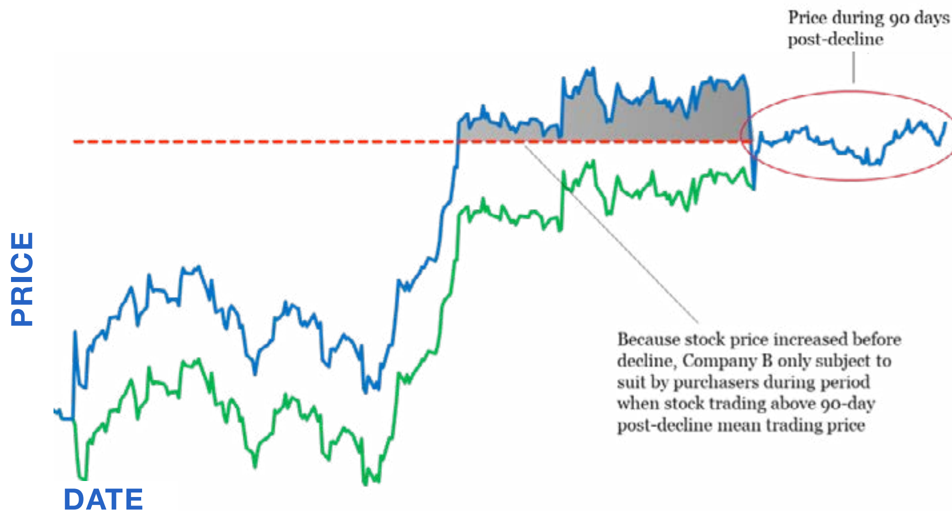
An announcement that a company's financial statements should no longer be relied upon followed by a stock price decline will likely lead to a securities class action. Such announcements are frequently harbingers of financial restatements, which may be regarded as admissions of material falsity. With falsity admitted, the remaining issues often concern the state of mind of the executives who presented the statements to investors.

In truth, many accounting adjustments or restatements turn on technical accounting concepts or actions by lower level employees, neither of which support claims of securities fraud. Still, courts are often reluctant to dismiss securities class actions based on alleged accounting improprieties. These cases can also be complicated to defend owing to the involvement of outside auditors, who may be placed in the difficult position of either acknowledging deficiencies

"BOUNCE BACK" PROVISION LIMITS DAMAGES

COMPANY A

COMPANY B



in the auditing process or claiming that they were deceived by the company.

3. GOVERNMENT INVESTIGATIONS

The announcement of a government investigation will often result in a securities class action being filed for several reasons. First, investigations significant enough to warrant public disclosure are likely to result in enforcement actions, findings of wrongdoing, and/or the payment of fines to the government. These results may lighten plaintiffs' burden of proof on some elements, or may even constitute admissions on the part of defendants.

Second, plaintiffs may be able to piggyback on the investigative work done by the government to obtain discovery relatively quickly and cheaply. For example, plaintiffs will generally demand immediate production of all documents produced in response to government subpoenas and all recordings of testimony taken by government agencies.

Third, public investigations may create a swirl of negative publicity, which may in turn encourage disgruntled former employees to cooperate against the company. eager to cooperate. Plaintiffs often quote the news media in complaints when seeking to meet their heightened pleading burdens.

Fourth, the existence of a government investigation may be conducive to the early settlement of securities class actions, before the plaintiffs have invested significant resources. This may occur in circumstances where the company replaces its senior management and/or where it enters into a settlement with the government and wishes to put an end to all litigation arising from the incident so that it can start afresh.

4. PUBLIC CRITICISM

Plaintiffs' lawyers review reports from securities analysts, the financial press, and social media to aid them in developing their story, frequently seeding their complaints with quotes from analysts expressing surprise or questioning the credibility of management. Depending on the source, such statements may significantly increase the likelihood of a securities class action being filed. Plaintiffs' lawyers may also actively work with the media, encouraging and cooperating with reporting and posting that supports a fraud narrative.

5. SHORT SELLERS AND ACTIVIST INVESTORS

Short sellers and activist investors may have an interest in presenting corporate management in a negative public light. Plaintiffs' lawyers may take advantage of that negative publicity to support securities class action claims. The danger is enhanced when activist investors have board seats with greater access to company information.

6. ADMISSIONS OR APOLOGIES

Plaintiffs' lawyers carefully review earnings call transcripts, looking for acknowledgments by executives that earlier communications were unclear, inaccurate, or incomplete. *Mea culpa* statements along the lines of "we should have been clearer about the risks in this area" may appear innocuous at the time they are made, but when woven together with other facts, such as insider stock sales, they can sometimes support a story that will survive a motion to dismiss.

7. GUIDANCE MISSES

Where a company's stock price declines following a guidance miss or the early withdrawal of guidance, plaintiffs will carefully comb through earlier statements seeking one not accompanied by a Safe Harbor warning or that they can characterize as historical, rather than forward-looking. A plaintiff favorite in this regard are statements to the effect that the company has achieved specific benchmarks along the way to a projected future result.

8. INSIDER SALES

One weakness plaintiffs often face is the absence of any apparent motive for executives to engage in fraud. Public company executives generally do not fit the profile of swindlers. Indeed, they often have invested much of their life building a strong reputation in the business community. Many founded or significantly contributed to the growth of the companies they lead. They tend to be financially secure and they generally do not have criminal records. Ultimately, it is a heavy burden for plaintiffs' lawyers to convince a judge or jury that the most compelling explanation for a misstatement is fraudulent intent, rather than simple human error.

This absence of motive may be fatal at the pleading stage, where plaintiffs must present a theory of scienter that is both cogent and at least as compelling as any alternative explanation. Insider stock sales often provide the only support upon which plaintiffs can construct a cogent fraud case.

Courts recognize, however, that boards of directors routinely award equity-based compensation to align the interests of executives with shareholders, and that executives routinely exercise options and sell shares to diversify their holdings. Only sales that are unusual in amount or timing, therefore, may be considered as evidence of scienter. Properly constructed Rule 10b51 trading plans may significantly reduce—although not eliminate—the risk that insider sales will trigger a securities class action.

9. BUSINESS SETBACKS

The federal securities laws were not intended to provide insurance against stock price declines caused by business setbacks, whether or not attributable to mismanagement. Nevertheless, plaintiffs' lawyers have spent decades recasting management missteps as securities fraud claims, with some success.

During the period following stock price declines, plaintiffs' lawyers comb through public statements for ones they can cast as misleading in light of a failure to disclose mismanagement or other business failures. Plaintiffs' lawyers present mismanagement as a "concealed risk" that caused the stock price to be artificially inflated until the risk materialized. They further allege that executives had a motive to cover up the risk in order to avoid exposing their own incompetence and losing their lucrative positions.

10. INDUSTRIES AT HEIGHTENED RISK

Securities class actions are more likely to be brought against companies in certain sectors, including technology, life sciences, and financial services. A combination of factors underlie this tendency, including the prevalence of rapid, disruptive shifts, relatively volatile stock prices, and accounting rules that apply in these industries.

Additionally, technology companies may be able to control the timing of their revenue recognition to a much greater degree than manufacturing companies. For this reason, technology companies are generally more likely to be accused of fraud through improper earnings management. Similarly, financial services companies are susceptible to allegations of earnings management through manipulation of underwriting standards or loan-loss reserves.

Companies that engage in highly regulated industries, such as healthcare, are also more susceptible to being sued. For example, allegations of off-label marketing are easily recast as allegations that executives improperly boosted earnings in order to inflate the stock price.

III. ACTION ITEMS

There are many actions companies can take to reduce the risk of a securities class action being filed against them and to strengthen their defense in the event that an action is filed. The most important of these actions are set out below.

THINGS TO DO NOW

Review Safe Harbor warnings.

One of the simplest and most important steps a company can take to protect against a securities class action is to avail itself of the Reform Act Safe Harbor for forward-looking statements. This provision protects corporations and executives from liability in the event that forward-looking statements do not ultimately materialize. The protection is absolute where the forward-looking statements are identified as such and accompanied by meaningful cautionary statements.

Both the language of the Safe Harbor warning and the process for generating it should be reviewed regularly. The process should be designed so that the greatest risks the company faces are identified, generally through a bottom-up process, and described in warnings accompanying public statements.

Executives communicating with investors may be tempted to skip the Reform Act's technical requirements—such as stating that investors should read the Risk Factors section of the Form 10-K. Companies should have measures in place to avoid this issue. It is also important to update cautionary language frequently as risks evolve.

Plaintiffs will often argue that cautionary language was not "meaningful" for the reason that it was accompanied by false statements of historical fact. Where possible, therefore, companies should avoid combining the presentation of current results and metrics with forward-looking estimates (e.g., justifying forward-looking financial guidance with concrete statements about current performance).

Develop procedures for executives to answer questions on investor calls and in other public settings.

Implementation of a rigorous, bottom-up process for preparing and reviewing public disclosures is critical to avoiding a securities class action. Obviously, where well-designed processes are followed, disclosures are more likely to be accurate and complete. Beyond that, such processes make it substantially more difficult for plaintiffs' lawyers to prove intent to defraud.

The Sarbanes-Oxley Act of 2002 imposed requirements that companies design and

implement a system of internal controls to ensure the accuracy of their reporting. SEC filings are generally prepared by teams of employees following established procedures and reviewed by trained professionals. Plaintiffs' lawyers know that the risk of materially false statements escaping internally controlled processes, controllers, internal auditors, external independent auditors, disclosure committees, and legal counsel is relatively low. For these reasons, plaintiffs' lawyers' first point of attack will typically be communications made outside these channels. Most prominent of these are statements made on quarterly calls with investors or in similar situations, such as question-and-answer sessions with the media.

One of the most important steps to protect against securities class actions, therefore, is to bring the same rigor applied to financial statements and SEC filings to investor calls. Participants should stick to a written script that has been reviewed and certified as accurate—in writing—by a disclosure committee. The script should include not only introductory remarks, but also answers to questions. All reasonable questions should be anticipated and executives counseled not to extemporize, but rather to answer only by quoting from the menu of prepared answers or by referring the questioner to the company's SEC filings. All assertions in the script should be tied out and supported by independent documents, which should be retained.

The Safe Harbor warning should be scripted out so as to conform to warnings that courts have found sufficient as a matter of law and should explicitly refer listeners to written cautionary language.

Executives should be counseled not to make sweeping assertions that have not been validated by controlled processes. For example, the statement "Customer feedback about our new product has been universally positive" can be proved false by a single email from a single customer expressing a different viewpoint.

Where executives chose to share their opinions—as opposed to certified metrics—these opinions should be clearly identified as such and qualified with words such as "In my opinion," "I believe," etc. Just as with statements of fact, statements of opinion should be supported by internal documents.

One of the greatest challenges plaintiffs' lawyers face is to establish scienter in the mind of the individual executive who "made" the materially misleading statement. The statement maker is defined as the person who has ultimate authority over the contents of the statement and the decision to disseminate it. To prove fraud, a plaintiff must establish that the person who "made" the statement knew it was false, or was deliberately reckless as to its truth or falsity, at the time they made it.

This task is difficult, if not impossible, where every statement made is supported by a certification, prepared through a bottom-up process by persons with personal knowledge, in writing, that is shown to the speaker.

Maintain relationships with analysts, investors, and the media.

Plaintiffs review analyst reports following significant stock price declines looking

for expressions of surprise or statements impugning management. Whether or not sell-side analysts have greater insight, or the ability to affect market prices, is open to debate. Regardless, a statement by a securities analyst affiliated with a well-known investment firm to the effect that "management's credibility is now in question" can make the difference between a securities class action that is dismissed and one that proceeds through years of discovery.

For this reason, companies should take reasonable measures—consistent with all SEC rules, including Regulation F-D—to avoid surprises and misunderstandings between management and analysts.

Implement and/or review Rule 10b5-1 trading plans.

Enacting a Rule 10b5-1 trading plan is one way to reduce the risk of a securities class action being filed and improve the outcome in the event an action is filed. Obviously, insiders have many valid reasons for selling stock, including diversification. Nevertheless, a plaintiff's story is far stronger where insiders sell millions of dollars of stock in the period before a sudden price decline.

The existence of a plan will not, in itself, absolve insiders of liability. The terms of the plan must comport with the SEC rule. Furthermore, plaintiffs have retained experts to offer opinions that plans with certain characteristics are actually indicia of fraud.

For this reason, it is critical to obtain professional advice from counsel familiar with the latest developments in this area before enacting a trading plan.

Review risk factors in SEC filings.

The risk factors and other discussions of risks appearing in the company's SEC filings, press releases, and other public disclosures should be prepared through controlled processes by which management at various levels reports up the risks it faces. These risk factors should be referenced in all public statements to investors. Executives making statements on the company's behalf should be advised—in writing—of the process through which the risk factors were prepared and that this process has been designed to reasonably ensure that all material risks are identified and disclosed.

Plaintiffs routinely argue that warning of risks is misleading where the risk has already materialized. This argument can be blunted with language clarifying that the identification of risks is not intended to imply that the risk has not already materialized in whole or in part.

Provide communication training to executives and staff.

Colorful emails or other forms of electronic communication are the fuel on which securities class actions run. This is true for several reasons. First, the real drivers of company stock prices are often complex and difficult for a judge or jury to fully understand. Emails about the corporate house being "on fire" or the CFO being "crooked," by contrast, are easy to understand.

Second, unlike human memory, these documents do not fade away with time. It is not uncommon for eight or nine years to elapse between the time period at issue in a securities class action and the trial date. In the meantime, witnesses may change jobs,

retire, or otherwise become unavailable to testify, leaving emails and other documents as principal trial evidence.

Third, jurors may place greater weight on extemporaneous email communications than on more formal internal reports, believing that formal reports may be sanitized by insiders loyal to management or by the legal department.

Fourth, the rules of evidence provide plaintiffs certain potential advantages with respect to internal company documents. Plaintiffs may avail themselves of the "admission of a party opponent," or "statement against interest" exceptions to the hearsay rule to present emails that are harmful to the company. Defendants, by contrast, may be limited in what documentary evidence they can present on the theory that they can tell their story through witnesses.

Finally, emails—unlike witness testimony—go to the jury room. There, they can play a pivotal role in deliberations.

Executives who have not gone through litigation often fail to appreciate the harm that can flow from even one ill-considered email with colorful language. One of the most effective measures in-house counsel can take to minimize the damage of a securities class action is to counsel executives to assume that anything they type in an email can and will be used against them in litigation someday.

Make it difficult.

Plaintiff lawyers look for soft targets—defendants from which they can expect to extract a settlement quickly, before incurring substantial risk and cost. All else being equal, plaintiff lawyers will be reluctant to sue a company with a reputation for fighting in court.

There are clear benefits to settling a securities class action early, including reducing the costs of defense and distraction to management. The near-term benefits of an early settlement, however, must be balanced against the potential that such a settlement will invite future litigation.

Review D&O insurance policies.

D&O liability insurance policies play a critical role in funding the defense and settlement of securities class actions. These policies should be carefully reviewed to ensure that the scope and limits of coverage, the amount of the retention (deductible), and the defendants' right to select counsel of their choosing are fully understood. Companies should also consult with their insurance broker to understand the approach their insurer takes to funding the defense and settlement of cases.

Review indemnification provisions and agreements.

Generally, companies wish to provide executives with the maximum protection from the threat of personal liability extending beyond insurance coverage. One important protection is the company's undertaking to indemnify its executives from personal liability and to pay the costs of their defense. Such protections free executives to make business decisions without regard to their personal finances and facilitate the defense of litigation by removing a potential source of conflict among defendants. Where individual

defendants are entitled to indemnification, the interests of the company and the individual defendants tend to align, even after executives leave the company, reducing the likelihood of finger-pointing and the need for separate representation.

Federal law may restrict indemnification in certain circumstances, such as where a company "claws back" compensation following a financial restatement. State laws generally restrict indemnification of executives found to have acted in bad faith. Outside the context of a criminal prosecution or bankruptcy, such findings are rare. And even in these contexts, the law generally requires companies to advance defense costs to their executives, provided that the executives undertake to repay these costs upon a finding that the executives acted in bad faith. Indemnification agreements can make advancement mandatory.

THINGS TO DO WHEN THE THREAT OF LITIGATION ARISES

Don't wait to be sued—preserve the record.

In days gone by, plaintiffs' lawyers would rush to the courthouse with boilerplate complaints within hours of a large stock price drop, seeking to be appointed lead counsel based on "first filed" rules. That practice ended in 1995 after Congress passed the PSLRA, which established a uniform procedure for the appointment of lead plaintiff and lead plaintiff's counsel based primarily on the amount of potential recoverable damages.

As a result, plaintiffs' lawyers often engage in efforts to recruit large investors or to assemble coalitions of investors. These efforts may include issuing press releases on investor websites or posting on social media that the firm is "investigating allegations of securities fraud against XYZ Corporation and its CEO," and requesting all persons who may have investment losses to contact the firm.

Plaintiffs' lawyers may enter into negotiations with large institutional investors, including union, pension, and retirement funds from around the world in an effort to represent the client with the largest potential recovery. These negotiations may last months and involve the formation of coalitions of investors and law firms. As a result, the delay between the stock price drop and a lawsuit being filed may last months and is constrained only by the statute of limitations (one year from discovery for Securities Act claims; two years for Exchange Act claims).

Plaintiffs' lawyers have also learned that the passage of time is often beneficial to their claims. Plaintiffs generally build their case on emails and paid expert testimony, neither of which are vulnerable to the passage of time. By contrast, defendants rely upon the testimony of corporate executives whose memories may fade and whose incentives to prepare for their testimony may be reduced if they leave the company.

It is, therefore, important for companies to preserve the record during the period between the price drop and the time a lawsuit is filed. Companies should do far more than preserve documents, as is required when litigation can be reasonably anticipated. When a securities class action

appears likely, counsel should ensure that key testimony is memorialized in the form of attorney-client privileged memoranda with documentary support. It is also important to meet with counsel to manage how any new documents relevant to the issues in the case are created; to ensure that the basic outlines of the defense are understood; and to maintain favorable relationships with potential witnesses, including former employees.

Notify your D&O insurance carriers.

Immediately upon the filing of a claim, insurers should be notified and the policy should be reviewed. The policy may include provisions regarding the selection of outside counsel.

Select counsel.

Most D&O policies provide that the insureds may select counsel of their choosing without affecting coverage. Some carriers, however, require or encourage retaining counsel from a list of approved "panel counsel." In any event, it is critical to retain counsel with specialized experience in securities class actions.

Whether or not to retain the firm that provides counseling on general corporate matters and SEC filings depends on individual facts and circumstances. It may be advisable to consider retaining separate counsel in circumstances where insiders relied upon review by their outside counsel when making the statements challenged in the action. It is generally, although not always, preferable for all defendants to be represented jointly, at least until a ruling on the motion to dismiss. Obviously, however, the issue of joint representation will depend on many factors, including the facts of the case and the nature of the relationships between the defendants.

Coordinate the defense with any internal investigation or parallel proceeding.

Facts giving rise to securities class actions may also precipitate governmental inquiries, whistleblower complaints, and internal investigations. Obviously, corporate directors and officers have fiduciary and other legal duties requiring that they cooperate with governmental investigations and otherwise take reasonable measures to address internal allegations of misconduct.

It is also important that investigations and responses to government inquiries be conducted in a manner that reduces the risk of prejudice to the company in a securities class action, whether or not one has been filed. The complexity and significance of these issues make it critical that experienced counsel be involved from the outset. Among other interrelated issues are the following: whether and when to publicly disclose a government investigation; the roles of board members and executives in connection with the investigation; the role of in-house counsel in the investigation; the extent to which the attorney-client privilege and the work-product doctrine protect the investigation from discovery in the securities class action; and whether and how the results of the investigation should be disclosed.

Notify current employees.

As noted above, plaintiffs' lawyers frequently publicize their allegations on investor websites and social media platforms in an

effort to solicit institutional investors to serve as a lead plaintiff or former employees to serve as "confidential witnesses."

Ethical rules generally bar plaintiffs' lawyers from communicating with current employees of a company they are suing. Nevertheless, whether through inadvertence or otherwise, such communications often occur. It is generally wise, therefore, to inform employees of the litigation and that they should direct any person inquiring about the subject matter to the legal department.

Consider contacting former employees.

In order to meet the stringent pleading requirements of the PSLRA, plaintiffs' lawyers are often aggressive in seeking inside information. Ethical rules generally prohibit plaintiffs from contacting current employees, who are considered to be represented persons, so plaintiffs' lawyers focus on former employees, often retaining investigators to locate and interview them.

These investigators may present themselves as former law enforcement agents seeking to uncover additional facts about a known fraud perpetrated by company insiders. Former employees often mistakenly believe that they can help the company by speaking with an investigator, or even that they are required to answer questions, particularly where the investigator describes himself or herself as a "former FBI special agent investigating fraud."

It is important, therefore, to consider reaching out to former employees as soon as securities litigation appears imminent. This task must be undertaken with care, particularly in circumstances where there is a parallel government investigation. Decisions regarding how to reach out, what to say, and how to record the communication all require careful judgment based on the particular circumstances.

In the event that plaintiffs' investigators obtain misleading statements from former employees, it may make sense to obtain sworn affidavits from the employees to that effect, and then send plaintiffs' counsel a letter demanding that they withdraw the misleading statements from the complaint or face sanctions under Rule 11 of the Federal Rules of Civil Procedure.

IV. FAQ

The filing of a securities class action, or the threat of such a filing, generally results in questions from corporate executives. Some of the most frequent are addressed below:

1 How worried should we be about this?

In most cases, not very. Most securities class actions are either dismissed or settle within insurance policy limits and while "plaintiff-style" damages may be large, they bear little relationship to real-world damage awards. Cases that proceed through class certification and past a motion to dismiss may require time and attention from senior executives, but the risk of a crippling judgment against the corporation or individual defendants is usually small.

Plaintiffs face heavy burdens and numerous obstacles before they can recover a judgment. They must certify a class and prevail on every element of their claims and they must overcome all affirmative defenses. Defendants have many opportunities to win or substantially reduce liability, including motions to dismiss, challenges to class certification, motions for summary judgment, motions to exclude critical expert witness testimony, trial, and appeal. In short, to prevail, plaintiffs must win on every element every time, while defendants need to win on only one element once.

2 What are the potential damages?

One of the most challenging aspects of securities class actions is estimating damages. Few securities class actions proceed to a judgment after trial, so there is little precedent. Paid experts are often given wide latitude to offer whatever opinion they wish, so long as it is presented as economic analysis. It is important to keep in mind that any initial damages estimate will almost invariably be many times greater than the settlement value of the case.

Roughly speaking, investors are entitled to damages for the amount they overpaid for the stock minus any windfall they recovered by selling during the class period at an inflated price. As discussed above, "plaintiff-style" damages are derived by multiplying the dollar drop on the disclosure date by an estimate of the number of damaged shares. The number of damaged shares is estimated based on assumptions regarding class-period trading behavior.

These estimates often substantially exaggerate actual damages that may be recovered for several reasons. First, plaintiffs routinely file complaints that extend the class period far beyond reasonable limits for the specific purpose of exaggerating potential damages. While the class period may be fairly clear

in some types of cases—where financial results are restated for a particular period, for example—it is highly subjective in others—such as where an executive is alleged to have concealed declining product demand.

Second, the dollar drop in stock price following a corrective disclosure is often not a proxy for the amount of inflation during the class period. Take, for example, a company that makes a false statement that it has strong cybersecurity measures in place and then, months later, suffers a security breach and a stock price decline. In this instance, plaintiffs would have a hard time persuading a jury that the entire amount of the stock price decline was attributable to exaggerations about security measures, rather than to the malicious actions of a third party.

Third, these estimates ignore the likelihood that not all class members will file claims in the event of a judgment. Of the few cases that have proceeded to judgment, claims rates have been below 50%.

Fourth, these estimates ignore the fact that, even when they rule in favor of plaintiffs, juries often award plaintiffs only a fraction of what they request. Jury decisions on damages may be based on idiosyncratic analyses not presented by either side.

Fifth, these estimates ignore the complex rules for allocating liability among multiple defendants. The PSLRA abolished joint-and-several liability in most circumstances and replaced it with a proportionate fault system. Thus, where a former employee with relatively modest personal wealth is judged to be 90% responsible for the harm, the effect may be to cap recoverable damages at a small fraction of the jury award.

3 Are individual defendants at risk of personal liability?

In most cases, individual defendants are protected from the expense of defending themselves and insulated from personal liability by D&O insurance and indemnification. As noted above, these protections are strong, provided they are appropriately managed.

The exceptions to this rule arise in extreme cases. D&O insurance policies typically include an exclusion where a court has found that the individual engaged in deliberate, knowing fraud. Similarly, the indemnification laws of the state of incorporation generally preclude indemnification, and require reimbursement of advanced defense costs, upon a determination of bad faith.

A second exception exists where a company faces insolvency and executives have substantial net worth. Under these circumstances, indemnification protections may fall away and insurance policy limits may be exhausted, leaving individuals as the only defendants worth pursuing.

4 When and how should I communicate internally about this?

Internal communications regarding the litigation should be explicitly designated attorney-client privileged and should include a reminder (1) to preserve existing documents; (2) not to communicate internally or externally regarding the litigation or create new discoverable documents concerning the subject matter of the action; and (3) to refer any inquiries regarding the litigation to the attorneys defending the case.

5 When and how should the company communicate externally about this?

There are often strong internal pressures to issue a public statement in response to the filing of a securities class action. These pressures arise from the fact that plaintiffs have attacked the integrity of the company and its leaders; the damages sought are often large; and plaintiffs' lawyers often seek to publicize their claims as widely as possible.

Plaintiffs' lawyers frequently publicize their cases for several reasons. They may hope to attract an investor or group of investors with the largest stake in the outcome, thereby securing their position as lead counsel; they may hope to reach former employees willing to provide them with information to support their allegations; or they may hope that they can obtain allies in the media to assist in the investigation and, potentially, pressure or prejudice decision-makers, including elected officials, regulators, judges, and jurors, against the company.

Many plaintiffs' lawyers are skilled at using the media to generate negative publicity. The narrative form of a complaint is similar to that of a media piece in significant respects: both seek to present complicated issues in a way that will interest an audience; both rely upon simple narrative forms with clearly defined good and bad actors; and both rely upon anecdotes, argumentative language, and selective use of statistics.

In most instances, the company's best response is to state that the claims are without merit, the defendants intend to contest the case in court, and the company will have no further comment in keeping with its general policy of not commenting on ongoing litigation. In any event, litigation counsel should be consulted regarding all such communications.

6 Do all defendants need their own lawyers?

Generally, no. There is no need for individuals to have separate representation at the early stages of a securities class action. Typically, all evidence is preserved under the control of the company and discovery is stayed while a motion to dismiss is filed on behalf of all defendants.

Joint representation is typical in the pre-trial stage, even after a motion to dismiss is denied for several reasons, including reducing the costs of defense, presenting a united front to the court and plaintiffs' counsel, and ensuring that the case is defended in a consistent manner.

While different individuals may have different arguments—for example, one defendant may argue that he did not make the statement while another may argue that she did not have scienter—it is rare that the arguments are inconsistent.

In some circumstances, it is advisable to retain "shadow counsel" for certain executives—lawyers who can advise the executive in the background without identifying themselves to the court or opposing counsel. In the event that the need arises, shadow counsel can emerge to advocate publicly on their clients' behalf.

7 Should the board be involved in managing the defense?

The filing of a securities class action, even with allegations of fraud against the CEO and CFO, does not, without more, require active involvement of the board of directors.

Typically, securities class actions should be reported to the board but managed under the direction of the general counsel or chief legal officer. In some cases, the facts giving rise to the litigation or presented in the complaint—as opposed to the initiation of litigation itself—may cause the board to initiate its own investigation.

Additionally, it may be advisable for the board to retain its own counsel, who does not report to the individual defendants, to provide advice on strategic decisions related to the litigation, including in the settlement process.

8 Should we expect more cases to be filed?

The facts underlying a securities class action may result in a constellation of litigation, including shareholder derivative actions discussed above. It is also increasingly common for large investors to "opt out" of securities class actions and file their own claims. Often, these "opt-out" plaintiffs will stay their actions while the securities class action progresses. In the event that the securities class action settles, opt-out plaintiffs generally try to negotiate a higher per-share payout. To comply with the statute of repose, opt-outs must be filed within five years of the alleged fraud.

9 Can we sue the plaintiffs for filing frivolous claims?

The PSLRA includes a provision requiring that, at the conclusion of every securities class action the district court must determine whether or not counsel should be sanctioned under Federal Rule of Civil Procedure11. Where plaintiffs' lawyers make allegations in a complaint that are not supported by facts, including where they mischaracterize statements by so-called "confidential witnesses," sanctions may be worth pursuing.

Sanctions have been imposed in only a few cases. The threat of sanctions, however, may result in plaintiffs electing not to proceed with certain claims or withdrawing unsupported allegations.

10 Can we convince the plaintiffs to drop the case?

Sometimes, yes. Plaintiffs' lawyers have no interest in pursuing futile claims. Where a defendant can present compelling evidence that allegations are false, it may be worthwhile to present this evidence to the plaintiffs' lawyers and request that they drop the case. It is critical, however, to review the insurance policy and possibly consult with counsel for the insurers before undertaking any such exercise. Most D&O policies require that the insured involve the insurers in any settlement discussions. D&O policies also typically include exclusions, referred to broadly as "insured vs. insured exclusions," that may be triggered in the event that a defendant "cooperates" with plaintiffs.

11 How are these cases typically resolved?

Most securities class actions end in either (1) dismissal at the pleading stage, without any

discovery taking place; or (2) a settlement funded primarily by insurance after some or all of discovery is completed. The relatively high rate of dismissal is due to a combination of factors, including that the pleading requirements securities class actions are more stringent than for most other categories of litigation.

The relatively high settlement rate is also due to a combination of factors, foremost among them being D&O insurance. State laws may require D&O insurers to pay up to the limits of their policies to fund any settlement negotiated by their insured in accordance with the policy, so long as the amount is reasonable. In the event that a reasonable settlement falls apart due to an insurer refusing to fund it, the insurer may be liable for any judgment rendered against the insured in the underlying litigation—without regard to policy limits.

Whether or not a settlement is "reasonable" requires applying professional judgment to all the facts and circumstances. In the event that the case does not settle, that determination is generally made only after a judgment against the defendants, in which case it is a daunting task for an insurer to prove that an earlier settlement offer, for a fraction of the ultimate damages, was not "reasonable."

Another factor favoring settlement is the fact that plaintiffs' counsel are typically compensated with a percentage of the settlement amount, out of which they pay expenses, including overhead and salaries to junior lawyers. For this reason, they have a strong financial incentive to settle early, while costs are low.

12 How long will the case take to resolve?

Securities class actions typically take years to resolve, although there is little activity during most of the time. The pace of litigation is generally directed by the courts, so there is little that defendants can do to speed things up.

There is a wide variation in the time to resolution depending on a multitude of factors. Courts typically grant plaintiffs leave to amend their complaint after it is dismissed, often several times. Settlement can occur at any stage of the proceedings. Typically, though, cases are not settled until after a motion to dismiss is denied at least in part.

13 Can liability arise simply for failing to disclose material information?

Sometimes. While a company may face sanctions from the SEC for failing to disclose information required to be disclosed by a rule or regulation, such as Item 303 of Regulation S-K, there is a split among the circuits regarding whether or not this regulatory requirement gives rise to a duty to disclose that is actionable under Section 10(b) and Rule 10b-5. In most circuits and under most circumstances, silence without more will not give rise to a securities class action.

There are important caveats, however. First, a company transacting in its own stock, through a follow-on or secondary offering, a stock-for-stock merger, a stock buy-back program, or otherwise, has a duty to disclose all material information to the counterparty to the transaction. A failure to disclose in this context

may give rise to claims under Sections 11 and 12 of the Securities Act or for insider trading under the Exchange Act.

Second, courts have generally held that companies have a "duty to correct" earlier false statements of historical fact upon learning that the statements were false when made. Whether and how this principle extends to statements that, while literally true, were misleading when made requires careful analysis.

Third, courts are split on the question of whether companies have a "duty to update" prior statements that, while not false or misleading when made, remain "alive" and have been rendered misleading as a result of subsequent undisclosed events.

Fourth, a statement may be actionable where the statement itself is rendered misleading by failure to disclose information. For example, a company may not have a duty to disclose that its largest customer has cancelled all future orders, but a statement such as, "We are thrilled to report that our largest customer continued its pattern of increasing orders last quarter," might arguably be rendered misleading by failing to disclose the cancellation.

Relatedly, by expressing an opinion, a defendant may undertake a duty to disclose facts tending seriously to undermine that opinion. For example, plaintiffs could argue that the statement "We believe our practices are in compliance with all applicable laws" would be rendered misleading by a failure to disclose a warning letter from a regulator claiming violations.

Plaintiffs also comb through "risk factors" for warnings of risks that may materialize in the future. They then argue that disclosing a risk of future harm creates a misleading impression that the harm has not yet come to pass.

Whenever a company elects not to disclose material negative information, therefore, it must exercise particular care when making affirmative statements, including disclosures of risks.

14 Are company counsel potential witnesses?

The statements giving rise to securities class actions are often vetted by professionals, including lawyers, before they are made. Among other things, lawyers review SEC filings for compliance with the disclosure requirements of the securities laws and SEC rules and regulations. Executives may believe that the statements they make cannot subject them to liability because they have been "approved by lawyers."

In some circumstances, current or former executives may wish to elicit evidence of communications with lawyers to prove that there was no intent to defraud. Doing so, however, may compromise the attorney-client privilege, which belongs to the corporate defendant. Where these issues arise, it is generally appropriate for individuals to obtain advice from counsel independent of the company.

Generally, the advice of counsel issue arises only after a case has survived a motion to dismiss. The issue should be identified early so that it can be addressed in a thoughtful way that serves the interests of all defendants.

V. MORRISON & FOERSTER'S SECURITIES LITIGATION PRACTICE

Morrison & Foerster's securities litigators across the United States have demonstrated the ability to win at every stage and in every type of case, most famously winning a jury verdict for JDS Uniphase and its former executives in a securities class action seeking $20 billion in damages—the largest securities class action in history. We are one of the only firms with an in-house forensic accounting group led by a Certified Public Accountant with decades of accounting experience and are home to numerous former SEC officials with extensive first-hand experience working in the SEC's Division of Enforcement. Clients facing high-risk, high-profile disputes turn to us to represent them in the full range of issues that arise in securities litigation, including securities class actions, derivative actions, M&A litigation, and SEC investigations and enforcement actions.

Judson Lobdell has extensive experience in the fields of securities litigation and criminal law, including securities class actions, shareholder derivative actions, SEC enforcement actions, criminal jury trials, DOJ and SEC investigations, as well as internal investigations. Judson is a former Assistant U.S. Attorney who has tried more than 30 cases to juries and argued cases in the U.S. Court of Appeals for the D.C. Circuit and the D.C. Court of Appeals.

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