Preliminary Actions for Companies Facing Securities Litigation

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In the past decade, approximately 6 percent of all S&P 500 companies and nearly 2.5 percent of all companies listed on a major exchange were named as defendants in securities fraud class actions.[1] In that same period, the average securities fraud class-action settlement increased from $11 million in 2000 to $42 million in 2009, for an average of $25 million per settled case during the decade.[2] In the past year, Securities Exchange Commission (SEC) formal orders of investigation, which often foreshadow shareholder claims, have more than doubled, increasing from an average of 246 formal orders issued annually from 2004 to 2008 to a high of 496 formal orders issued in 2009.[3] In short, while the likelihood of being sued in securities litigation may be statistically low, particularly for well-run companies, the potential damages remain unacceptably high. Given these risks, the increasing volatility of the financial markets, and the desire to minimize the negative publicity associated with securities litigation, companies would be well served by preparing a list of items to discuss with litigation counsel whenever they are sued by shareholders for securities fraud, breach of fiduciary duties, or other securities claims where damages are sought.[4]

The preliminary actions listed below are neither exhaustive nor absolute, but they summarize some of the important issues to be discussed by companies and their counsel at the outset of most corporate securities cases.

Preserve potentially relevant documents and electronically stored information. While most companies recognize they have a duty to preserve potentially relevant documents whenever litigation is reasonably anticipated, many lack established procedures to do so, and many more fail to document their efforts properly. As soon as securities litigation is filed or reasonably anticipated, in-house counsel should send written notice instructing employees with potentially responsive documents to preserve them and take appropriate steps to preserve electronically stored information (ESI). With minimal effort and expense, companies can create an effective record of their preservation efforts that can be used to defend against a future spoliation claim.

Identify key company personnel, determine whether they need counsel, and review indemnification agreements and bylaws. Securities and shareholder derivative cases frequently name C-level executives, certain directors, and even employees as defendants. In most cases, the same counsel will be able to represent the company and individual defendants, but some cases require separate counsel or shadow counsel for individual defendants. Director and officer (D&O) insurers will likely have their own views about when separate counsel is needed. In any event, companies and their counsel should review indemnification agreements and bylaws to determine whether indemnification is permissive or required, whether the company is required to advance defense costs, and under what circumstances defense costs must be repaid by individual defendants. Because public policy forbids companies from indemnifying for fraud, most companies should require their directors, officers, and employees who are indemnified to sign an agreement to repay expenses whenever fraud is alleged.

Notify insurers and make a preliminary coverage evaluation. Most companies have D&O liability policies with Side A, Side B, and/or Side C coverage that provides insurance against securities and shareholder derivative claims. Because D&O coverage is typically triggered when a claim is made, it's critical for companies to notify primary and secondary insurers promptly after litigation is filed. Because many insurers send a reservation of rights letter after being notified of claims, it's also important for companies and their counsel to review the policies and determine whether there will be serious coverage disputes.

Obtain a plaintiff-style damages estimate for the case. Securities fraud complaints rarely specify what damages they are claiming, but the damage models are fairly well established. An early estimate of how the plaintiff will likely view the case should be obtained at the outset of the litigation; it can be valuable for determining whether an early settlement might cost less than the defense.

Consider whether separate factual investigation is warranted, particularly in shareholder derivative cases. While much emphasis is placed on the sufficiency of pleadings in securities fraud cases and in shareholder derivative claims where demand futility is alleged, it may be expeditious to conduct a separate factual investigation, especially in shareholder derivative cases. If shareholders demand that the board investigate allegations of wrongdoing—or will inevitably do so—it may make sense at the outset to empower the audit committee, a committee of independent and disinterested directors, or even in-house counsel to investigate the allegations of wrongdoing first. To ensure the independence of an investigating committee and preserve privilege for its investigation, companies should consult with corporate counsel about the membership and appointment of the committee and make sure the committee has its own counsel to assist with the investigation.

Advise employees of the litigation and the need for confidentiality. Company employees will inevitably be concerned about the impact of potential litigation on them and their careers. Securities fraud actions and shareholder derivative disputes are increasingly publicized both by the media and by plaintiffs' law firms. To prevent the press or plaintiffs' counsel from learning more about the case than the company and its counsel do, current employees should be reminded early and often not to talk with others about the company's affairs.

Gather public filings and financial statements for the relevant period. When a company's stock price declines, plaintiffs frequently file a securities fraud class action and allege that the company intentionally misrepresented or omitted material facts. Defendants often get these cases dismissed by showing that the information was protected by the safe harbor for forward-looking statements, that plaintiff's allegations fail to raise a strong inference of scienter (intentional or reckless conduct), and/or that the allegedly omitted facts were actually disclosed. Although federal statutes prohibit parties from taking discovery in these cases while a motion to dismiss is pending, courts routinely examine a company's public statements to evaluate the legitimacy of the plaintiff's claims based on the information available to the market.[5] Collecting and reviewing these materials early provides a preliminary indication of the strength of the plaintiff's case.

Gather analyst statements on the company and the industry. While analyst statements may also be useful to support a motion to dismiss, it's important to collect them to evaluate a different issue—loss causation, i.e., whether the decline in a company's stock price was caused by the alleged fraud. In many cases, analysts comment upon stock price declines and identify industry factors that provide a reason for the decline other than fraud.[6]

Evaluate stock trading by insiders. Most securities fraud class actions allege that insiders were motivated to engage in fraud to sell their own securities at artificially inflated prices. Complaints typically include a table that lists insider trades by directors, officers, and key employees of the company and identifies only the total sales price (not the net profits realized). Careful analysis of insiders' trading histories can offset these allegations by showing that insiders actually made little or no profit, sold shares pursuant to 10b5-1 trading plans, or, in some cases, were also purchasing shares when the alleged fraud occurred.[7]

Identify former employees and potentially hostile witnesses who might be contacted. Because discovery is not typically allowed in a securities fraud class action or a shareholder derivative case until after a motion to dismiss or other preliminary motion is ruled upon, plaintiffs frequently contact former employees to obtain more information. Complaints typically use information from these confidential witnesses to allege that corporate officers and directors were aware of alleged wrongdoing and did not disclose it. While it's often difficult to obtain cooperation from former employees, some factual investigation, if properly handled, can be useful to evaluate the veracity of the plaintiff's allegations and the strength of potential evidence.

Evaluate the need for experts. Depending on the claims and the number of parties involved, it may be important to retain key experts early in a case before they are hired by others. The pool of potential experts may be particularly small when allegations involve arcane accounting rules or industry-specific requirements.[8]

Prepare a preliminary budget for the case and update it periodically.

Obtain a preliminary budget estimate for the litigation. Securities fraud litigation can be expensive, particularly when initial motions to dismiss are denied and extensive discovery is taken. Companies and their counsel should prepare a preliminary budget for the various phases of the case and update it periodically. It may also be useful when evaluating when and whether to settle.

Consider the likelihood of parallel SEC or other government investigations. Securities litigation is often filed on the heels of an SEC or other governmental investigation, but it sometimes arises before these investigations become public. In other situations, there may be an industry-wide investigation or even criminal proceedings that involve the client or its employees. These situations present particularly difficult timing issues because of the risk that evidence from one proceeding may be used in another proceeding. Companies and litigation counsel should consult with disclosure counsel and, if necessary, criminal defense counsel, to determine when and whether to make additional disclosures and whether litigation should be stayed or slowed until governmental proceedings are resolved.

Manage board and officer expectations for the litigation. Corporate managers should be apprised of the prospects for resolving securities litigation, the resources that will be required, and the likely timetable for resolution. Securities fraud class actions are particularly slow to get started as the parties often agree to stay proceedings until after a lead plaintiff is appointed and an amended complaint is filed.

Caution managers about their public responses to the litigation. Many executives, particularly those who have not previously been sued in securities litigation, want to go on

the offensive and make public statements denying the specific allegations of a complaint. While an immediate response by the company is often appropriate, it is rarely helpful to deny specific allegations before any factual investigation has been made. Indeed, a premature response could exacerbate the problem if the SEC decides to investigate the basis for the company's statement denying the allegations.

Consult with disclosure counsel about when and how to disclose the litigation in public filings. Depending on the nature and timing of the litigation and related investigations, it may be necessary or advisable to make public disclosures about litigation or an SEC investigation more quickly. Companies and their litigation counsel should work closely with disclosure counsel to ensure these matters are appropriately disclosed.

This checklist of preliminary actions is intended to help companies and their counsel avoid obvious mistakes and better evaluate costs and opportunities for resolving securities class actions and shareholder derivative claims. Because even the best-run companies are not immune to securities litigation, working closely with strong, experienced counsel is the best defense.

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Endnotes

1. *See* Stanford Law School and Cornerstone Research, Securities Class Action Clearinghouse: Litigation Activity Indices, http://securities.stanford.edu/litigation_activity.html (yearly averages from website used to calculate 2000–09 average) (last visited Apr. 8, 2010).

2. *See* Stephanie Plancich & Svetlana Starykh, NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2009 Year-End Update* 14 (Dec. 2009) (excluding settlements greater than $1 billion and 309 IPO Litigation cases).

3. Select SEC and Market Data for fiscal years 2004–09 (available at http://www.sec.gov/about.shtml); *see also* Robert Khuzami, Director Enforcement, U.S. Sec. & Exch. Comm'n, Speech to the Society of American Business Editors and Writers (Mar. 19, 2010) (transcript available at http://www.sec.gov/news/speech/2010/spch031910rsk.htm).

4. The actions listed above are most applicable to securities fraud and "clone" shareholder derivative claims that seek to recover damages when a company's stock price drops precipitously. While some of the actions are also applicable when shareholders bring claims challenging a merger or acquisition, those disputes often move at a faster pace and involve fundamentally different relief—e.g., injunctive relief to prevent a business combination from being completed absent a higher sales price or additional disclosures.

5. The Private Securities Litigation Reform Act of 1995 (PSLRA), 1934 Act § 21D(b)(3)(B), 15 U.S.C. § 78u-4(b)(3)(B) requires that "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." For motions to dismiss securities fraud claims, courts have routinely held that it is appropriate to consider SEC filings; press releases, transcripts of conference calls, and other documents referenced in the complaint; and stock prices. *See* 15 U.S.C. §§ 77z-2(e), 78u-5(e); Lone Star Fund V (U.S.) L.P. v. Barclays Bank PLC, 594 F.3d 383, 387 (5th Cir. 2010); Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 989 (9th Cir. 2009); Roth v. Jennings, 489 F.3d 499, 509 (2d Cir. 2007); Collins v. Morgan Stanley Dean Witter, 224 F.3d 496, 498–99 (5th Cir. 2000).

6. *See, e.g.,* Fener v. Operating Eng'rs Constr. Indus. & Miscellaneous Pension Fund, 579 F.3d 401, 408–09 (5th Cir. 2009) (affirming the district court's refusal to certify a securities fraud class action where the plaintiff's expert failed to isolate the impact of a corrective disclosure of alleged fraud compared to other negative information disclosed at the same time, such as changed economic circumstances, new industry-specific or firm-specific facts, conditions, or other factors independent of the alleged fraud).

7. *See* Metzler Inv. GMBH v. Corinthian Colleges, Inc., 540 F.3d 1049, 1067 & n.11 (9th Cir. 2008) (finding no inference of scienter where the defendants' trading was consistent with prior history and the bulk of trades were made pursuant to predetermined 10b5-1 trading plans); Southland Secs. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 367–69 & n.12 (5th Cir. 2004) (analyzing insider trading allegations and considering argument that purchases by defendants during the class period negated scienter); *In re* Gildan Activewear, Inc. Secs. Litig., 636 F. Supp. 2d 261 (S.D.N.Y. 2009) (finding no inference of scienter where only two insiders traded and did so pursuant to nondiscretionary Rule 10b5-1 trading plans).

8. *See* United States v. Reyes, 577 F.3d 1069, 1075–76 (9th Cir. 2009) (stock option backdating); AIG Global Sec. Lending Corp. v. Banc of Am. Secs. LLC, 646 F. Supp. 2d 385, 399 (S.D.N.Y. 2009) (loss causation related to asset-backed securities); *In re* Sunbeam Secs. Litig., 176 F. Supp. 2d 1323, 1331 (S.D. Fla. 2001) ("[P]roof of damages in a securities fraud case is always difficult and requires expert testimony.").