JONES DAY | One Firm Worldwide®

WHITE PAPER

March 2023

Your Company Has Been Sued for Securities Fraud—Now What?

According to the Stanford Law School/Cornerstone Research Securities Class Action Clearinghouse, each year since 2001, with just one exception (2006), investors have filed more than 150 securities fraud class actions in the federal courts.[1] More than 400 cases were filed each year between 2017 and 2019, and just shy of 200 were filed in 2022.[2] During that same time period, the median settlement of a securities fraud class action has ranged from $5.8 million to $12.1 million in 2018.[3]

Thus, while the likelihood of any particular public company being sued in securities-related litigation may be statistically low, the risk is not *de minimis*, and potential damages (or settlement amounts) are high. Given these risks, the volatility of financial markets, and most companies' desire to minimize the negative publicity associated with securities litigation, companies would be well served by having a list of action items in case they are sued.[4]

This *White Paper* identifies a nonexclusive list of some preliminary actions and highlights important issues that companies and counsel should consider at the outset of most securities cases.

PRESERVE POTENTIALLY RELEVANT DOCUMENTS AND DATA

While most companies recognize a duty to preserve potentially relevant documents and data whenever litigation is filed (or reasonably anticipated), some companies lack established procedures, and many fail to document their preservation and collection efforts appropriately. As soon as securities litigation is filed or reasonably anticipated, in-house counsel should send a written notice to employees with potentially responsive documents or data instructing them to take appropriate steps to preserve relevant information. By doing so, with minimal effort and expense, companies can create a record of preservation efforts that can help defend against a future spoliation claim. Indeed, the importance of reasonable preservation-related steps has grown, given the increasingly diverse ways in which employees may communicate, such as through personal devices, instant messaging (such as Teams or Slack), text messages, and WhatsApp, among others. Depending on the particular circumstances, preserving only corporate email may no longer be sufficient.

IDENTIFY KEY COMPANY PERSONNEL, DETERMINE WHETHER THEY NEED COUNSEL, AND REVIEW INDEMNIFICATION AGREEMENTS AND BYLAWS

Securities and shareholder derivative cases frequently name as defendants C-level executives and members of the board of directors. Oftentimes, the same counsel can represent the company and the individual defendants (particularly through the motion to dismiss stage), but some circumstances may require separate counsel for individual defendants. Thus, at the outset of a case, companies and their counsel should evaluate whether it is appropriate or necessary for individuals to engage separate counsel. Companies and their counsel also should review corporate bylaws and the certificate of incorporation, and any indemnification agreements, to determine whether indemnification is required, and/or whether the company must advance defense costs, and under what circumstances. Along those lines, the company may want to consider requiring (and some states' laws require) indemnified individuals to sign an agreement that obligates them to repay amounts advanced for defense costs if they are ultimately determined to be ineligible for indemnification.

NOTIFY INSURERS AND MAKE A PRELIMINARY COVERAGE EVALUATION

Most companies have D&O insurance policies to cover losses related to securities and shareholder derivative claims. Because D&O coverage usually is triggered when a written "claim" is made (e.g., when a lawsuit is filed), it is critical for companies to notify primary and secondary D&O insurers promptly upon receiving notice of any claim. Further, because many insurers send a reservation of rights letter after being notified of claims, companies and coverage counsel should review applicable insurance policies to evaluate the availability of coverage, potentially applicable exclusions, and/or likely coverage disputes.

OBTAIN A PLAINTIFF-STYLE DAMAGES ESTIMATE FOR THE CASE

Securities fraud complaints rarely quantify the damages plaintiffs are claiming, but damages models for securities cases are fairly well established. Obtaining an early estimate of how the plaintiffs may quantify damages can be a useful guide for estimating potential settlement value.

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 in which demand futility is alleged, it may be beneficial (or even necessary) for the company to conduct a separate factual investigation, especially in shareholder derivative cases. For example, if shareholders demand that the board investigate their allegations of wrongdoing—or will inevitably do so—it may be advisable to empower a board committee, such as the audit committee or a special committee of disinterested directors (or perhaps in-house counsel in certain circumstances) to investigate the allegations.

ADVISE EMPLOYEES OF THE LITIGATION AND THE NEED FOR CONFIDENTIALITY

Company employees may hear about the pending litigation, particularly given that securities fraud actions and shareholder derivative disputes are increasingly publicized by the media and by plaintiffs' law firms. Employees may become concerned about the impact of litigation on the company, or on them and their careers. Further, it is common for plaintiffs' firms to retain private investigators to contact former (and, sometimes, current) employees to obtain information that attempts to bolster the allegations in their complaint. To prevent the press or plaintiff's counsel from learning more about the case than the company and its counsel do, and to help calm any employee concerns, current employees should be informed of the litigation and reminded not to talk with unapproved outsiders about the company's affairs.

CAUTION MANAGERS ABOUT THEIR PUBLIC RESPONSES TO THE LITIGATION

Many executives, particularly those who have not been involved previously 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 may be appropriate, it is rarely helpful to deny specific allegations before a factual investigation has been made. Indeed, a premature response could exacerbate the problem if plaintiffs' counsel or the SEC later explores the basis for the company's denial of the allegations.

GATHER PUBLIC FILINGS AND FINANCIAL STATEMENTS FOR THE RELEVANT PERIOD

When a company's stock price declines sharply following disclosure of negative news, plaintiffs' law firms frequently file a securities fraud class action that alleges the company intentionally misrepresented or omitted material facts, the belated disclosure of which caused the stock price drop. Defendants often get these cases dismissed by showing that the information was protected by a statutory safe harbor for forward-looking statements, that the statements were non-actionable opinions or immaterial corporate "puffery," that plaintiffs' allegations fail to raise the required "strong inference" of scienter (i.e., intentional or extremely reckless conduct), and/or that the allegedly omitted facts were in fact disclosed. In deciding a motion to dismiss, courts routinely examine a company's public statements to evaluate the information available to the market. Therefore, collecting and reviewing these materials early can provide the company and its counsel with a preliminary indication of the strength of the plaintiff's case and the company's potential defenses.

GATHER ANALYST STATEMENTS ON THE COMPANY AND THE INDUSTRY

Analyst statements also may be useful to support a motion to dismiss, but it's also important to collect them to evaluate "loss causation," i.e., whether the alleged fraud caused the decline in the company's stock price (and therefore the alleged loss), or whether there was a different cause. Analysts often comment on significant stock price declines and identify industry factors that provide a reason for the decline, unrelated to the alleged fraud. Collecting these statements can help identify potential grounds to dismiss a complaint on loss causation grounds.

EVALUATE STOCK TRADING BY INSIDERS

When they have occurred, plaintiffs point to stock sales by company insiders before the company's disclosure of negative news as purported evidence that those individuals were motivated to engage in fraud so that they could sell their stock at artificially inflated prices. Complaints often include lists of stock trades by directors, officers, and key employees. Careful analysis of insiders' trading histories can help rebut these allegations by showing that insiders made little or no profit, sold shares pursuant to Rule 10b5-1 trading plans, were purchasing shares when the alleged fraud occurred, and/or that the sales were otherwise not suspicious in timing or amount.

IDENTIFY FORMER EMPLOYEES AND POTENTIALLY HOSTILE WITNESSES WHO MIGHT BE CONTACTED

Because plaintiffs face a heightened pleading burden in securities fraud class actions but usually cannot take discovery until a motion to dismiss is resolved, plaintiffs' law firms (or

their investigators) frequently contact former employees to gather additional information informally. Securities fraud complaints may include information learned from those individuals (often identified as "confidential witnesses") to support allegations that corporate officers and directors were aware of, or participated in, alleged wrongdoing. While it may be challenging for a company to obtain cooperation from former employees, some factual investigation, if properly handled, can help 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, and to do so before they are hired by others. The pool of potential experts may be particularly small when, for example, the allegations involve highly technical accounting rules, emerging technology, or industry-specific practices.

CONSIDER THE LIKELIHOOD OF PARALLEL SEC OR OTHER GOVERNMENT INVESTIGATIONS

Securities litigation is often filed concurrently with a pending SEC or other government investigation, and it can arise before these parallel investigations become public.[5] In other situations, there may be an industry-wide investigation or even criminal proceedings that involve the company or its employees. These types of situations can present particularly difficult strategic issues because of (among other things) the risk that evidence from one proceeding may be used in another. Companies should closely coordinate with their litigation, criminal, and/or disclosure counsel to reach informed judgments about, for example, when and whether to make additional disclosures, and whether litigation should be stayed or slowed until governmental proceedings are resolved.

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. Companies and their litigation counsel should work closely with disclosure counsel to ensure these matters are appropriately disclosed.

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 because the parties often agree to stay proceedings until after a lead plaintiff is appointed and an amended complaint is filed, and discovery typically is stayed until a motion to dismiss that complaint is resolved.

CONCLUSION

These recommended preliminary actions should help companies facing securities litigation to position themselves favorably, and to better evaluate risks 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 experienced litigation counsel is the best defense.

LAWYER CONTACTS

Henry Klehm III
New York
+1.212.326.3706
hklehm@jonesday.com

Walter W. Davis
Atlanta
+1.404.581.8517
wwdavis@jonesday.com

Marjorie P. Duffy
Columbus
+ 1.614.281.3655
mpduffy@jonesday.com

Ashley F. Heintz
Atlanta
+1.404.581.8978
aheintz@jonesday.com

Michael J. McConnell
Atlanta
+1.404.581.8526
mmconnell@jonesday.com

Robert C. Micheletto
New York
+1.212.326.3690
rmicheletto@jonesday.com

Adrienne Ferraro Mueller
Cleveland
+1.216.586.7370
afmueller@jonesday.com

Geoffrey J. Ritts
Cleveland
+1.216.586.7065
gjritts@jonesday.com

Evan P. Singer
Dallas
+1.214.969.5021
epsinger@jonesday.com

John C. Tang
San Francisco
+1.415.875.5892
jctang@jonesday.com

Nina Yadava
New York
+1.212.326.3746
nyadava@jonesday.com

ENDNOTES

1 *See* Cornerstone Research, Securities Class Action Filings, 2022 Year in Review.

2 *Id.*

3 *See* Cornerstone Research, Securities Class Action Settlements, 2021 Review and Analysis.

4 The actions listed above are most applicable to securities fraud and related shareholder derivative claims that seek to recover damages after a company's stock price drops. While some of the actions are also applicable when shareholders bring claims challenging a merger or acquisition, those disputes often move at an expedited 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 Historically, cases that involve a corresponding SEC investigation settle for higher amounts than cases without such a corresponding investigation. For instance, in 2021 the median settlement amount for cases that involve a corresponding SEC action was double the median for cases without a corresponding action. *See* Cornerstone Research, Securities Class Action Settlements, 2021 Review and Analysis, at 11.