Securities Roundtable

EXECUTIVE SUMMARY

Securities litigation has seen a number of notable developments, including significant decisions in *Stoneridge Investment Partners v. Scientific Atlanta* and *Ryan v. Gifford*, as well as two closely watched trials (*Apollo* and *JDS Uniphase*). Our panel of experts from Northern and Southern California discuss how these cases have affected their practice, as well as trends in securities class action cases. They are Susan Muck of Fenwick & West; Bruce G. Vanyo and Richard H. Zelichov of Katten Muchin Rosenman; Richard M. Heimann of Lieff Cabraser Heimann & Bernstein; Jordan Eth and Darryl P. Rains of Morrison & Foerster; and Daniel J. Tyukody and Robert Varian of Orrick Herrington & Sutcliffe. The roundtable was moderated by freelance writer Bernice Yeung and reported for Barkley Court Reporters by Krishanna DeRita.

MODERATOR: What are the potential impacts to internal investigations as a result of the Delaware Chancery Court's January decision in the options backdating case, *Ryan v. Gifford*?

RAINS: I didn't find the decision very surprising. I think Chancellor Chandler articulated a number of rules that most of us were already following. He brought some clarity to issues that people hadn't focused on completely, but I don't think his decision is going to cause a big change in the way people conduct investigations. More importantly, it doesn't change the fact that investigations will continue to be done and relied upon in derivative cases.

VARIAN: I found the decision troubling in a number of ways but at least, there are now some very clear guidelines that we can cite when we explain why a CEO shouldn't attend a meeting at which results of an investigation conducted by an independent committee are being reported.

ZELICHOV: Chancellor Chandler was very concerned about the fact that the directors were present with their personal attorneys in their capacity as potential defendants in this particular case. He also doesn't like options backdating, which had some bearing on how he came out in this case.

MUCK: *Ryan* brings up a question as to whether the decision is consistent with the board's fiduciary duties to exclude officers or directors of the corporation from a presentation by investigators. In the ordinary course of doing investigations, there isn't someone identified at the outset as the likely wrongdoer. It's an extreme position to think that counsel for the special committee is supposed to anticipate what may happen and decide that a CEO can't appear at that meeting because they might be named a defendant in a derivative suit.

HEIMANN: I don't do these investigations. Is it the special litigation committee or counsel that typically makes a presentation to the full board of directors before they come to any conclusions?

VANYO: There isn't a typical scenario. The special committees are not focused on trying to get rid of a derivative suit; they're concentrating on conducting an independent investigation. Afterwards, they'll go to the full board with their findings, and in many instances, full authority's given to the special committee to make the decisions.

The problem Susan [Muck] identified is a tricky one—the court has applied the common interest issue, but in a lot of cases, it's not very clear who has common interest throughout the litigation.

HEIMANN: But if you've appointed a special committee, whether they've been sued or not, you have reached the conclusion that they are sufficiently independent to serve on that committee. It would seem that the other board members are adverse.

TYUKODY: It depends on how you set up the special committee. Special committees, like special litigation committees (SLCs), have full authority to make a decision. There are also special committees that only do the investigation and then present the facts to the board; it does not identify a wrongdoer, if there is one. It's then up to the full board to determine, for example, whether the CEO knew that options backdating was taking place.

RAINS: There are some simple rules to follow after this case: (1) The special litigation committee will need full authority to direct the litigation and to make decisions resulting from the investigation, (2) the company will need to get separate counsel, and (3) the committee shouldn't divulge anything to the full board that the company hasn't divulged in its 8-K. These rules are clear and they won't be hard to follow. If there's anything I fault in the decision, it's the court's citation of *Garner* for the proposition that the attorney-client privilege doesn't apply because the plaintiffs couldn't get the information from other sources.

VARIAN: I was also troubled by the opinion's reliance on *Garner*, and the court's apparent

reliance on the fact that there was no paper trail or written report. If the absence of a written report is going to be a pivot point in an analysis of good cause under *Garner*, that's going to present the defense with some serious challenges.

ZELICHOV: Has anybody reconsidered the idea of not having a written report in light of this decision?

RAINS: I write written reports when an audience demands it, such as the SEC, a court, or the company's auditors. Directors sometimes want written reports because they realize their direct examination will be smoother if they have a written report. They also appreciate their cross-examination could be a little tougher if there's a written report. So that's a harder decision.

ETH: One of the lessons of this case is to assume that nothing is going to be protected. Forget about privilege; forget about privacy.

ZELICHOV: That's a difficult thing to get junior lawyers to understand. They've been told for years about attorney-client privilege and attorney work product. They think what they're writing will be kept secret from the rest of the world and not published on the front page of the *New York Times*.

VARIAN: However, I'd say that one of the positive things about Chandler's decision, at least for the defense bar, is that he was pretty clear in acknowledging that there is attorney-client privilege between special committees and their attorneys.

MODERATOR: What is the potential impact of the U.S. Supreme Court's ruling in *Stoneridge Investment Partners v. Scientific Atlanta*?

TYUKODY: *Stoneridge* is the most important case for defendants in a generation. *Stoneridge* involved alleged "round trip" transactions between a cable television company, Charter Communications, and its set-top box suppliers, where the suppliers allegedly agreed to charge Charter $20 more per set-top box, and to recycle that money back to Charter in the form of advertising revenue. Those maneuvers, which lacked economic substance, allowed Charter to satisfy analysts' expectations regarding its revenue. The case concerned whether Charter shareholders had a claim against the set-top box manufacturers for participating in a "scheme" to defraud or engaging in an "act or practice" that was deceptive under subparts (a) and (c) of Rule 10b-5 of the Securities Exchange Act. What the court held was that there wasn't a sufficient basis for concluding that the plaintiff shareholders had relied upon the acts of Charter's counterparties. The court basically said that the claim was just too attenuated and that there was no direct reliance by Charter's shareholders on transactions that they knew nothing about.

The Court's approach was different than the main argument offered by the defendants who argued that the word "deceptive" in section 10b was a limited term of art. *Stoneridge* is important in the mega-cases like *Enron*, where the plaintiffs have recovered $7 billion in damages from the investment banks. Given the decision in *Stoneridge*, perhaps that $7 billion didn't have to be paid.

VANYO: *Stoneridge* takes a dramatically different approach to who can be sued than the Court had previously taken under *Central Bank*. It allowed for a more expansive view of what can be defined as a deceptive act, and it took a different approach to who can be sued by saying, "If you can satisfy these basic elements of 10b-5, which includes reliance, then you can sue people," even though the deceptive act did not consist of making a statement or assisting in making a statement.

RAINS: *Stoneridge* says that a non-verbal act can be deceptive, and that a publicly-disclosed non-verbal act can be relied upon. That runs you right into *Basic v. Levinson* and the presumption of reliance. Under this approach, non-speakers are opened up to liability.

VANYO: I think it presents that possibility. The court went on to say that this proximate approach was ultimately the decision of the company as to how to book these transactions, and therefore, any participation by these third parties was too remote.

TYUKODY: "Deceptive" has a fairly broad meaning. Deceptive can mean fraudulent schemes and acts in the absence of a statement. If Scientific-Atlanta and Motorola had done a joint press release with Charter Communications and said, "We've entered into a long-term contract where we will buy and sell set-top boxes for $120 versus a $100," things would have been different.

ZELICHOV: In *Santa Fe Industries, Inc. v. Green*, the Court decided that "manipulative" was a term

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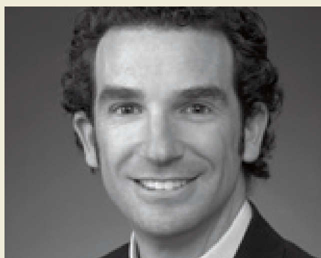

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of art and it was very narrowly construed. Although it may not have been enough for the majority to cite *Central Bank*, if it had cited *Central Bank* and *Santa Fe*, perhaps it could have decided that manipulative is a term of art that does not apply here.

TYUKODY: That's true about the word "manipulative." But it appears that in *Stoneridge* the defendants asked the Court to interpret "deceptive" similarly, as a limited term of art.

VARIAN: We can all agree that the facts in *Stoneridge* were compelling because it was alleged that the counterparties knew that the transactions would be misreported. It's not that much of a stretch to say that the deception was foreseeable; indeed, that was the alleged purpose of their conduct. So why shouldn't they be held responsible? Investors relied on what they reported. Just because there's an interim step of another issuer with financial statements, should that really make a difference? Arguably not, but the Court rejected that argument.

ETH: The court is saying that whether or not the conduct was despicable and fraudulent, 10b does not cover it—maybe the wrongdoing is covered by the SEC or state law. What is interesting about this case is that you can say that there was a form of reliance here, but it was too attenuated, and that's the whole basis of the decision. How can anyone determine, in a doctrinally pristine way, where to draw that line? The Court drew the line by saying that since 10b is an implied right of action, it was going to draw the line as narrowly as it could.

HEIMANN: From a plaintiffs' perspective, the Court in effect held that the alleged conduct of these defendants violated section 10b. But according to the majority, individual investors can't pursue claims under 10b against them; only the SEC can. Furthermore, claims for fraud and the like can be pursued in state court by defrauded investors, but not as a class action. So the defendants are immune from a class action, which is the most effective means of obtaining redress for individuals who face losses as a result of fraud.

VARIAN: That's exactly right and the Court's decision is exactly right for the reasons Jordan [Eth] stated. The fear I have going forward is that it's now clear that the SEC has to pick up the slack, and it has said that it will try.

HEIMANN: Another aspect of this decision from the plaintiffs' perspective is that in a case like this, where the liability is strong against the primary wrongdoer, *Stoneridge* only matters if the primary wrongdoer is incapable of satisfying the judgment that one will obtain against him.

TYUKODY: The real concern is that every lawsuit is going to be a lawsuit not only against the issuer, but also the entities with which the issuer did business.

MUCK: There's an economic impact of the expansion of liability that would occur—the impact on the insurance coverage. The notion that public companies will have to insure against the possibility that their third parties will also be defendants, and the notion that insurance companies will provide that kind of insurance, is not realistic.

ETH: If you take the doctrine seriously from this decision, it's going to turn on venue. If you are in front of this U.S. Supreme Court, I think the answer would be: Too attenuated. But if you're in district court, we will see a lot of ambiguities that get wrestled out over time.

MODERATOR: What can we learn from the jury trials in *Apollo* and *JDS Uniphase*?

ETH: One lesson from *JDS Uniphase* is that the merits do matter in securities cases, and they matter at trial sometimes more than in any other place. Some lawyers are enamored with the view that juries hate companies and people who have made money, and as a result, juries will compensate victims. We were able to overcome that in two days of deliberation in a unanimous verdict. You really have to look at the witnesses, the documents and what the themes are in the case. These cases can be defended, even if they might look bad based on superficial factors.

MUCK: What struck me about some of the press on *JDS Uniphase* was the role that the institutional investor had in driving the case to trial—specifically the lead plaintiff's role when it is also a fiduciary institution. How do you think this has affected the likelihood that securities cases will go to trial?

ETH: Putting aside the *JDS Uniphase* case in particular, it has changed the dynamic. In many cases, a lead plaintiff is also a political entity,

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and these plaintiffs may have different incentives, such as holding companies, accountable on general principle.

VARIAN: Sometimes, institutional investors with corporate governance agendas demand things in the settlement that are not monetary recoveries, and that would be beyond anything that could have been recovered in the lawsuit. For the institution, particularly a political one or a labor union, that's an important objective, but it's an objective not necessarily shared by the other people in the class, who usually just want to recover as much money as they can. That's an important difference.

MUCK: The plaintiffs with a fiduciary duty to the class and their institutional holders are pressing for larger average settlements. Are you finding that, Richard [Heimann], on your end as well?

HEIMANN: It depends. Public pension funds choose their cases and for the most part, they are interested in pursuing only those cases that have strong liability facts and significant losses with defendants who have a significant capacity to pay. From my experience, once the decision is made to get involved, they are pushing for larger settlements. They believe it's their responsibility to drive the cases on behalf of shareholders, and lawyers shouldn't be in charge. Today, pension funds take the position that they will not settle for the figures that lawyer-driven cases would have been settled for in the past.

MUCK: Do you think *JDS Uniphase* will make more defendants want to go to trial?

ETH: Going to trial took an incredible toll on the individuals and on the company. We've all received calls from clients where they say, "We just got sued. Is there a way we can sue them? If we lose, can we get our money back? Our reputation? Our time?" And the answer is almost always, "No."

ZELICHOV: We recently did a survey of public company directors. One question was, "Would you prefer complete victory after trial or a reasonable settlement long beforehand?" And a reasonable settlement before trial trumped, by a large margin, a complete victory after trial. Although *JDS Uniphase* was a win for the defense and *Apollo* a loss, it's not going to change the way directors view these cases. As litigators, we may want to try every single case, but our clients do not.

MUCK: Outside directors who sit on multiple boards have enough experience to view litigation and settlement as a business decision, but for management, particularly newer public companies, there is an initial impulse to want vindication. As counsel, it is important for public company management to understand that winning a trial is not necessarily a "vindication."

ETH: Looking back at some of the other developments from *Apollo*, one is that loss causation may not be the best jury issue.

TYUKODY: The defense bar will need to take a look at technical issues such as loss causation and corrective disclosure, and ask, "What do those words really mean to non-lawyers?" It's as if we are giving jury instructions in a foreign language.

HEIMANN: Our firm has a fair amount of jury experience and it's clear to us that jurors take their roles seriously and struggle to follow, to the letter, the instructions. If those instructions are not clear and understandable, they have terrible problems. When they are clear, they will do everything they can to come out with the right result based on their appreciation of the facts.

RAINS: Juries do try hard, but some jury instructions in securities cases are inherently difficult. The research we do shows that jurors have a difficult time distinguishing between "knew," "must have known," "consciously disregarded for the obvious," and "should have known." They tend to feel it was the defendant's job to know—that's why they make the big bucks. The distinctions matter, but jurors sometimes can't draw those distinctions.

VARIAN: The broader lesson that we see in *JDS Uniphase*, and most of the other securities class actions that have been tried, is that plaintiffs in most cases will lose at trial. And the *Apollo* case notwithstanding, That's still the message. I think that will make a difference when you get down to the hard negotiations—either accept the settlement or be prepared to go to trial. Going to trial is not something defendants would ever desire, although it's not something the plaintiffs really want either.

VANYO: Most of the cases settle because neither

side wants the trouble and expense of a trial. I don't think that dynamic is going to change. I don't think we are going to see a rash of cases going to trial. It's too painful.

MODERATOR: What are some class-action trends?

VANYO: It's interesting how the class-action filings were up significantly last year from prior years, particularly at the end of 2007. To one extent or another, it was the mortgage crisis that caused it. But it was not just the subprime companies or the subprime industry that were getting sued. The market had been pretty nonvolatile for a long period of time and suddenly, we had a volatile market where any kind of negative exposure was causing large drops. I found the number of IPO cases that were filed interesting.

MUCK: I did, as well. There have been more IPO cases because of the number of IPO's in the last several months. I also think there have been more biotech and life science companies getting sued because that industry itself has grown. There's also a lot of ambiguity in the law around what kinds of disclosures biotech companies have to make about Federal Drug Administration (FDA) communications and the status of its products.

TYUKODY: FDA cases are tailor made for securities class actions. I've found FDA cases challenging because incredibly important decisions lie in the hands of a third party. The signals from the FDA can be positive, and then at the last minute, the agency throws a curve ball. And because the product is so important to the company's health, it has a huge impact on its expected growth of revenues, and the fall of the stock price can be dramatic.

RAINS: Patent infringement issues can be challenging, too. Representations about the quality of a company's intellectual property, possible infringement claims by the company's competitors, and so forth, are being based on judgments being made by scientists and patent lawyers.

ETH: Some people say the uptick in filings at the end of 2007 was a result of the subprime mortgage crisis. Others say that whenever the market goes down, there are more cases filed. What are your views?

VANYO: People are blaming the drought over the last year and a half on a lot of things, but it's really based on the volatility and the sensitivity of the market. I think we are back to an era where it's not predominantly institutional investors bringing cases; it's now largely individuals.

VARIAN: I think we're going to see more cases filed, and it's not just a reflection of subprime problems. Where there are stock drops, there are securities class actions, and we've seen a lot of pretty significant stock drops recently.

MUCK: I think that with the uptick, there's a degree to which there's a bit of a competition among the plaintiffs' law firms now that Bill Lerach isn't in the picture. Some cases that I think would not have been filed a year ago are being filed now because of a more competitive interest within the plaintiffs' bar.

ZELICHOV: In the last six months, it seems as if Coughlin Stoia has been filing cases every week. In January of this year, I read somewhere there were 23 or 24 securities class actions filed, and about half of them were Coughlin Stoia cases. But that was just not happening six or eight months ago.

HEIMANN: I have to say I don't see what all of you are seeing. I see every securities class action case that's filed in this country—every single one—and the number of filings have been fairly consistent, to my memory. There's been an uptick in the number of cases in the last six months overall, but I think that's primarily attributable to what Bruce [Vanyo] has talked about in the terms of the market and the mortgage crisis. Some of those cases are potentially huge cases, and there are a bunch of small-issue cases that have been filed in the mix, too. But I just haven't seen a kind of sea change in the kinds and in the volume of securities class action cases that have been filed. ■

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