ROUNDTABLE

Securities Litigation

EXECUTIVE SUMMARY

Despite the drop in the number of securities cases, and some of the larger cases, such as *Enron* and *WorldCom* coming to a close, litigators remain busy: A good number are certainly involved in the flood of stock options cases that have been making headline news, and stock options task forces are now de rigueur at many firms.

Our panel of experts discuss the role of the institutional investor, whether big securities cases are winding down, the impact of the Delaware Court of Chancery's decision in stock options cases, and a case pending at the U.S. Supreme Court. They are Norm Blears and Michael Rugen of Heller Ehrman; Jeffrey Lawrence of Lerach Coughlin Stoia Geller Rudman & Robbins; Richard Heimann of Lieff, Cabraser, Heimann & Bernstein; Daniel Tyukody and Robert Varian of Orrick, Herrington & Sutcliffe; and James Meehan of PricewaterhouseCoopers. The roundtable was moderated by Custom Publishing Editor Chuleenan Svetvilas and reported for Barkley Court Reporters by Krishanna DeRita.

MODERATOR: How has the role of institutional investor changed?

RUGEN: The Private Securities Litigation Reform Act [PSLRA] was intended to encourage the involvement of institutional investors, and we've all seen that it has had a major effect over the last few years. We've seen a lot more institutions as lead plaintiffs in the class cases, and we are seeing institutions that are deciding to opt out of the megacase class actions and to file cases on their own, which has really changed the strategy of litigating these cases immensely. Just as a mark of how significant this change has been, there's one large institutional investor in California that's actually hired a retired judge to manage their caseload of securities cases. The interesting question is: is this just the phenomenon of the megacases that arose in 2001 and 2002, or is this something that's going to continue now that those megacases are starting to settle?

HEIMANN: It's impossible to tell. I think what's driving the opt outs in terms of institutional investors is primarily the recognition that they can get a better resolution for themselves financially by going out on their own. The more that is proven to be the case, the more likely it would be to happen again. On the other hand, at least the institutional investors, particularly public institutional investors, are somewhat sensitive to the possibility that opting out is seen as disloyal from the investor perspective because it mucks up class litigation and the ability to resolve class cases. But in the end, most financial institutions are going to be driven by their own self-interest, and if they think it's in their own self-interest to opt out, they are likely to do it.

LAWRENCE: Before the passage of the PSLRA, institutional investors were largely passive participants in the class action process. With the PSLRA and the recognition among institutions that they had a role to play and perhaps fiduciary responsibility, they became more involved, often serving as lead plaintiff. As a result of their participation and because they are sophisticated investors, they evaluate these cases just as Richard [Heimann] has said. If it is in the fund's interest to remain in the class case, then they will. If their individual damages are significantly high enough and the liability is such that they feel it makes sense to do it on their own, they'll do to on their own.

VARIAN: To what extent do you see the nonmonetary agenda factors playing a significant role these days? For example, CalPERS has had a lengthy corporate governance agenda that it has sought to advance via settlement terms in securities class actions. Other public employee pension funds and institutional investors have pushed similar agendas. Is that still a dynamic or a factor or do you think that's faded?

LAWRENCE: I don't know how prevalent it was as an overall philosophy and I'm not sure I'd characterize corporate reforms as an "agenda factor." But to the extent that institutions are participating in the system, then they are still asking for the reforms that they believe should be imposed.

VARIAN: I remember your firm had what Bill [Lerach] described as a nonnegotiable list of things that it needed—nonmonetary things for the most part and corporate governance reforms. When I would push back I would hear, you can't settle the case without at least a substantial number of these.

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RUGEN: In many of the megacases the company is either gone by the time the settlement comes around or the company has already settled with the SEC, in which case they've already agreed to a huge laundry list of reforms. So there's not that much left for the private plaintiffs to ask for in those cases. You can actually make a pretty strong argument that the opt-out cases are actually weaker from the plaintiff's perspective than class cases. There are many elements that are harder to prove in the opt-out cases. For example, actual reliance is an element in most of the opt-out cases, which isn't under rule 10b-5 for a class action, so it will be very interesting to see if some defendant is willing to push one of these cases to trial.

HEIMANN: It depends on the circumstances. If you are dealing with investments made on the basis of passive investing, you do have a reliance issue certainly, but if you've got an actively managed portfolio, it's relatively straightforward for reliance. You've got the analyst who did the work. You've got the portfolio manager who made the decision based largely on the analysts' work. In some cases, you have better claims under state law than you do under federal law—claims that cannot be pursued on a class case but can be on a individual basis. And those claims can be very powerful on behalf of the plaintiffs, either to settle or to go to trial.

RUGEN: In *AOL*, *WorldCom*, or *Enron*, it's easy to see the economics that would drive an institution to file its own case. Those institutions have hundreds of millions, sometimes even billions of dollars of their own losses. Is that same incentive going to be there in the more normal size case where the institution has lost, say, $10 million or $20 million?

BLEARS: My guess is it's more than $20 million, but it doesn't have to be $100 million. The plaintiffs lawyers are the ones who advise people about getting out on their own. I can't imagine you'd advise somebody to go out on their own against a solvent company and the accounting firms when the magnitude of loss is $10 million dollars.

HEIMANN: Well, it will depend. If you are talking about a standalone plaintiff in a situation like that, you are probably right. They wouldn't find it in their economic interest to do that even if they could recover an order of magnitude beyond what they get out of the class. But there might be circumstances where there are multiple opt outs in any given case, and where the institutional investor with a relatively small loss is willing to opt out because they can team up with others who have larger losses. And that has happened.

MODERATOR: Are big cases winding down?

MEEHAN: I'm not sure if the number of "big" cases is winding down, but the overall number of cases certainly appears to be. One simple reason for the decrease could be the performance of the stock market over the past couple of years. With positive stock market returns there are just not as many unhappy investors. I also don't think it can be ignored that in the post-Sarbanes world, there's more focus on corporate governance from management, boards of directors, and from auditors. While there has been an increase in the amount of enforcement activity from the SEC, many of the issues being investigated even today relate to actions from prior to 2002. I think that is a strong indication that Sarbanes is working.

TYUKODY: The number of cases is certainly down. As to whether the megacases are gone, only time will tell. We are past the frothy markets of '99, 2000, and not as much volatility is occurring in the markets. And Sarbanes-Oxley has had an effect of emboldening the accountants. The accountants are more active and more aggressive in raising issues with the companies they audit. With only four major accounting firms there's only a limited number of alternatives people have should they disagree with the positions taken by their outside accountants. That has also had an influence in the positions the accountants have staked out in some cases. Another result of SOX is that boards are much more serious about their responsibilities and their oversight role. They are aware that outside directors have had to pay money in settling these suits.

VARIAN: The section 404 internal control requirements probably have prevented a lot of errors, which is what most of these cases really stem from—a restatement or other substantial mistake that has an impact on the stock price. There has been fraud over the years, and that's never going to go away. We've all seen it, but that has been present in a relatively small percentage of the cases. What happened more often was there would be a serious screw up within the company and enough pieces lying around so good plaintiffs lawyers could

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pick them up and fashion them into something that might hang together well enough to get past a motion to dismiss. So I would say the 404 Internal Control changes probably are the biggest contributing factor to the number of cases decreasing.

BLEARS: My speculation is we haven't seen the last megacase. Look at *Parmalat*. It will be impossible to know who it's going to be, but there's going to be some massive implosions that will take place in the coming years. Perhaps the next megacase will be a foreign corporation whose shares are being traded on a U.S. exchange but isn't sufficiently familiar with the controls and rules that we've been discussing.

VARIAN: Foreign companies are absolutely more likely to find themselves in a situation where they can be sued in American courts, but it looks like there will be fewer of them to sue absent a roll back of Sarbanes-Oxley. The trend is not in favor of a big increase in foreign companies with securities trading in the U.S. So they may be better targets, but it will not be a target-rich environment.

LAWRENCE: When you talk about "megacases," you tend to refer to them as a unified group of cases, but they are not. They are cases defined by the particular people who are committing the particular fraud for a particular reason. So you take a *Parmalat*, or *HealthSouth*—where you have evidence at a trial that there was fraud going on for 15 years—or *Enron*, all of these cases had big dollar amounts, but they all had different contours that were defined by what the particular people involved in the companies needed or felt they needed at a particular time. You will see ebb and flow just like you see in every kind of case. You can't talk about a trend because these companies are committing acts for that particular company in that particular industry for their particular reasons.

TYUKODY: But there's another factor which is, in a lot of the cases like *Parmalat* or *WorldCom*, the fraud is pretty obvious as far as the issuer is concerned. The megacase aspect of many of these cases really concerns the banks and other potential third parties. If the Supreme Court accepts cert in *Charter Communications* or in *Homestore*, that would have a very big effect on whether there will be future megacases. Assuming cert is granted, the Court could provide some meaningful guidance to understanding the scope of primary liability for third parties in so-called scheme cases under Rule 10b-5 (a) and (c), and really give some meaning to what *Central Bank* holds in the context of situations like *WorldCom*.

MODERATOR: What's the impact of the recent Delaware Court of Chancery decisions on stock options [*Ryan v. Gifford*, 2007 Del. Ch. LEXIS 22 and *In re Tyson Foods, Inc. Consol. S'holder Litig.*, 2007 Del. Ch. LEXIS 10]?

TYUKODY: In the *Maxim Integrated Products* case [*Ryan v. Gifford*], Chancellor Chandler held first that Delaware would not stay its jurisdiction, despite the existence of prior filed cases in federal and state court in California alleging that a majority of the board "actively allowed" stock options backdating. Second, substantively on the question whether demand was excused in this derivative case, Chancellor Chandler held that particularized allegations of an intentional violation of a shareholder-approved stock plan, coupled with fraudulent disclosures regarding the directors' purported compliance with the plan, constituted conduct that is disloyal to the corporation and is therefore an act in bad faith. This was sufficient to excuse demand where three of the six directors allegedly engaged in such conduct.

If proven, the chancellor says these facts establish that the directors have violated their duties of loyalty, which has many implications. From the tone of the opinion, it is obvious that to Chancellor Chandler, it was a straightforward case.

The *Tyson Foods* case is a little more troubling analytically, in part because *Tyson Foods* seems to be a situation where bad facts made for arguably bad law. The defendants in that case allegedly engaged in numerous acts of self-dealing and had previously been before the court and had settled prior self-dealing allegations pursuant to a settlement agreement that called for independent oversight of transactions in which self-interest was potentially at issue.

However, that oversight allegedly was not being exercised effectively and the defendants allegedly were still engaging in inappropriate self-dealing transactions. It was in that context that Chancellor Chandler said that spring-loaded options were a violation of the director's duties. That is a conclusion that you could take serious issue with. Many people, including Commissioner Atkins at the SEC, have made a persuasive case that there's nothing inherently wrong with spring-loaded options.

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HEIMANN: As a plaintiffs lawyer, the first thing that jumps out at me, is this is the Court of Chancery in Delaware.

BLEARS: It's going to be very amusing if after 20 years of plaintiffs lawyers running away from Delaware law, everybody on the plaintiffs bar now starts running into court with the Delaware chancellor's opinions.

HEIMANN: I ran into court as fast as I could with this decision last week and I got a reply brief in the mail that took the position, "It's Delaware law. What does that have to do with a California case?"

LAWRENCE: The options backdating cases are making people seriously think about all the generalized rules that have developed over the years in derivative cases. When these rules are being applied to backdating cases, shareholders seem to be making gains in changing the balance and getting courts to critically analyze the rules. I think *Maxim* is a well-reasoned decision.

HEIMANN: The first issue we face in every one of these derivative actions is the demand-futility issue. California law is on all fours with Delaware law on the demand futility. As far as I can see, these cases, particularly the *Maxim* case, are very favorable to plaintiffs on that issue in California and in any jurisdiction where Delaware law is looked to, as is the case in many states.

BLEARS: That's probably the most significant thing about the *Maxim* case, that it could spell the end of the demand motions in these stock options cases, because it appears to impugn at least the comp committee and maybe the audit committee.

HEIMANN: I would not say maybe. The chancellor holds that the members of the comp committee cannot say they didn't know they were backdating options. Believe it or not, that's actually being argued, that the members of the compensation committee didn't really know what they were doing and that's being offered as a defense in at least one case that I have.

In a footnote, Chancellor Chandler says any member of the audit committee is potentially criminally liable, not just civilly liable, by having signed off on financial statements that were misleading because they failed to properly account for the options that were issued. That's very strong in terms of at least demand futility. It's a rare situation where you can't find a majority of the current board sat on either the audit committee or the comp committee during the relevant time period.

BLEARS: We haven't generally been making demand motions in stock options cases. We have formed SLCs [special litigation committees] on several occasions. But remember, before this decision, there were cases where courts came to the exact opposite conclusion on the demand issue. In *Brocade*, where there are now criminal charges, the first motion ever made was a demand motion, which was successful. So the recent Delaware rulings to some extent represent a departure, and I think that's one of the reasons Chancellor Chandler ignored the normal first-filed, hands-off approach.

I don't think this means that every late-filed derivative action in Delaware will trump you guys here in California. The court was out to make a point here; it hadn't ruled on any option cases yet, so here was a chance to give people Delaware's perspective, or at least Chancellor Chandler's, based on the facts alleged.

VARIAN: Once you form an SLC, the demand issue is gone anyway. Some things in these two decisions will make it difficult for an SLC to reach a conclusion that it should not pursue stock options claims. Some of the things Chancellor Chandler said about the duty of loyalty and good faith, and bad faith, make it appear that back dating and spring loading are per se breaches of the duty to act in good faith, and nonindemnifiable under 102(b)(7). If you are sitting on a special litigation committee with that law in front of you, you can still conclude that it's not in the best interest of the corporation to pursue the claims. But that may not be an easy thing to do.

HEIMANN: Is this the kind of language you're talking about? "I am convinced that the intentional violation of the shareholder approved stock options plan coupled with fraudulent disclosures regarding the director's purported compliance with that plan is disloyal to the corporation and therefore, an act of bad faith."

Unfortunately, there's more than that, but that's quite a little nugget.

BLEARS: This is a pleading motion, which assumes all the allegations to be true. The difference at the end of the day with an SLC is that you have had a

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chance to get people's recollections, you've had a chance to sort through millions of documents, and that evidence will often lead to the conclusion that the intentionality part that Richard [Heimann] just quoted doesn't exist. I would suggest that that's true in most cases with respect to compensation committee members.

In addition, many plans do not prohibit you from granting in-the-money options. More often than not, plans do permit you to do that. Besides that, problem grants often tend to be committee-of-one grants. In most companies, the comp committee grants do not have backdating problems.

MEEHAN: I agree. Regarding this issue of intentionality, I think this really needs to be considered on multiple levels. When you have a fact pattern where a comp committee was granting in-the-money options, maybe they understood what they were doing and maybe they did not. However, even if the comp committee were intentionally granting in-the-money options, that doesn't mean they would (or should) also understand whether there were accounting implications to the grant, and whether the company actually used the correct accounting. I'm not sure that just because it is concluded a comp committee "intentionally" authorized the grant of an in-the-money stock option, that it can also be concluded that comp committee understood all the potential ramifications of such a grant. Doesn't that confuse this whole issue of intentionality?

MODERATOR: What's at stake in this Supreme Court case, *Tellabs v. Makor Issues and Rights*?

LAWRENCE: Depending on the issue they reach it could be extremely significant. The issue that's on appeal is what you do on a motion to dismiss. Do they look at the Sixth and Ninth Circuit Courts, which suggest that you need to take into account inferences suggested by the moving party, or do you have to draw every reasonable inference in favor of the nonmoving party, as has been the law basically forever? On the other hand, if they follow their law, they really should just change the law in the Sixth and the Ninth Circuit and go back to the way the pleading rules have been, since the *Pawling* case in 1808, at least.

RUGEN: But there is that nice little wrinkle from the defense point of view and that troublesome little wrinkle from yours in the Reform Act that says you have to plead a strong inference of scienter. That's really what the case is about. There's been a lot of hyperbole about the SEC's brief in the *Tellabs* case. I don't understand why anybody is terribly upset about it. The Reform Act says you have to plead a strong inference of scienter, but the Seventh Circuit says that any set of facts from which a trier of fact could reasonably infer scienter, is a strong inference.

The facts from which a reasonable trier of fact could draw an inference of scienter is not a strong inference. It's a reasonable inference. So it seems like the Seventh Circuit was clearly wrong. For the SEC to weigh in and say, hey, Congress amended the law and said strong inference—something other than reasonable inference—doesn't seem to reflect some sea change at the SEC.

HEIMANN: The SEC's brief in *Tellabs* is defense-biased.

TYUKODY: I liked it as much as the plaintiffs liked the *Maxim* opinion. What is interesting about *Tellabs* is that it really gets to a problem the plaintiffs have with having been previously too successful with some kinds of cases. The category of case that gives many in the defense bar the most pause is that described in *Tellabs*, which is essentially a false projections case. Anyone reviewing the legislative history of the Reform Act can't fail to come away with the conclusion that the statute was intended to put a stake through these "false projections" cases. In *Tellabs* the bottom dropped out of the telecommunications market in late 2000 and early 2001, and the CEO continued to make optimistic statements about expected demand for his company's existing product and its anticipated next generation product that in retrospect proved to be overly optimistic.

While those statements proved to be wrong, in the *Tellabs* situation, the CEO did not sell a single share of stock during the class period, so it is unlikely that fraud was driving the company to make those statements. The SEC brief argues that in applying Congress's pleading standard, the test should be whether the alleged facts led to a "high likelihood" that the erroneous statements were made with scienter. The *Tellabs* situation is exactly the kind of case that Congress wanted a court to be able to dismiss at the pleading stage. The plaintiffs bar will likely have a hard time at the Supreme Court with this case. ■