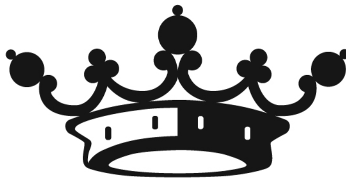
INSIDE THE MINDS

Securities Litigation and the Economic Crisis

Leading Lawyers on Understanding the Current Legal Environment, Developing Litigation Best Practices, and Helping Clients Respond to a Changing Marketplace



ASPATORE

©2009 Thomson Reuters/Aspatore
All rights reserved. Printed in the United States of America.

No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, except as permitted under Sections 107 or 108 of the U.S. Copyright Act, without prior written permission of the publisher. This book is printed on acid free paper.

Material in this book is for educational purposes only. This book is sold with the understanding that neither any of the authors or the publisher is engaged in rendering legal, accounting, investment, or any other professional service. Neither the publisher nor the authors assume any liability for any errors or omissions or for how this book or its contents are used or interpreted or for any consequences resulting directly or indirectly from the use of this book. For legal advice or any other, please consult your personal lawyer or the appropriate professional.

The views expressed by the individuals in this book (or the individuals on the cover) do not necessarily reflect the views shared by the companies they are employed by (or the companies mentioned in this book). The employment status and affiliations of authors with the companies referenced are subject to change.

Aspatore books may be purchased for educational, business, or sales promotional use. For information, please email West.customer.service@thomson.com.

For corrections, updates, comments or any other inquiries please email
TLR.AspatoreEditorial@thomson.com.

First Printing, 2009
10 9 8 7 6 5 4 3 2 1

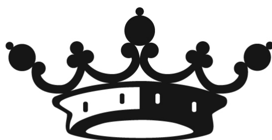
If you are interested in purchasing the book this chapter was originally included in, please visit www.west.thomson.com.

A Primer on Securities Litigation and Enforcement in an Economic Crisis

James C. Dugan

Partner

Willkie Farr & Gallagher LLP



ASPATORE

Introduction

My practice focuses on complex commercial litigation, federal securities litigation, Securities and Exchange Commission (SEC) enforcement, and internal investigations. I am a member of Willkie Farr & Gallagher LLP's Securities Litigation and Enforcement practice group, which has extensive experience in financial reporting fraud. Financial reporting fraud occurs when executives purposefully circumvent a company's internal accounting controls to manipulate its reported financial results. Financial reporting fraud can happen whenever management has extraordinary incentives to enhance reported financial results, such as a severe economic downturn in a business or industry.

Matters I have recently handled include representing an officer of a hedge fund that invested in Bernard Madoff's now-infamous Ponzi scheme in regulatory investigations and civil litigation; representing an insurance company in litigation against its former investment manager arising from failed investments in collateralized debt obligations (CDOs) backed by subprime mortgage securities; conducting, on behalf of the audit committee, an internal investigation of accounting irregularities at a Fortune 50 technology company; and representing the former chief financial officer (CFO) of a public company in an SEC investigation into stock option backdating.

The Evolving Nature of Securities Litigation

Prior to the enactment of the Private Securities Litigation Reform Act of 1995 (PSLRA),[1] federal securities class action litigation was dominated by "stock drop" cases, which were typically filed by securities class action plaintiffs whenever a public company's stock price experienced a sharp drop after bad news about the company was made public for the first time. Typically, these claims contrasted the newly announced bad news with positive public statements that the company's senior management had previously made about the company's business, and alleged that the company had defrauded investors by failing to disclose the bad news earlier. Many of these claims suffered from two primary defects: (i) they failed to allege precisely how the company's failure to disclose the bad news earlier

[1] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

than it did caused investment losses, and (ii) they tended to plead scienter—fraudulent intent—with a high degree of generality.

There emerged a common perception that many class action securities fraud cases bordered on being frivolous, in that every time a public company announced bad news, securities litigation would follow. Notwithstanding this perception, these cases had to be taken seriously because of the high cost of litigating any federal securities class action. In particular, the costs of discovery in such cases are extraordinarily high in terms of both dollars and business resources.

To counter this problem, Congress passed the PSLRA in 1995, which, among other things, enacted uniformly high pleading standards for federal securities fraud claims. Among other things, the PSLRA required a securities fraud complaint to specify "each statement alleged to have been misleading, the reason or reasons why the statement is misleading" and, if an allegation regarding the statement or omission is made on information and belief, to "state with particularity all facts on which that belief is formed" and to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[2] The PSLRA also imposed a mandatory stay of discovery during the pendency of a motion to dismiss the complaint. The practical effect of these provisions was that many cases that would have survived a motion to dismiss prior to the PSLRA were dismissed under the statute's more stringent pleading standards or were settled prior to the discovery phase.

Partly in reaction to the difficulty of pleading securities fraud subsequent to the PSLRA, and partly as a reflection of the times, securities fraud class actions in the later 1990s and the first years of this decade tended to focus specifically on allegations of accounting fraud, rather than on the failure to come clean about adverse business conditions. This trend became even more pronounced with the collapse earlier in this decade of Enron and WorldCom, which were brought down by giant accounting fraud schemes. The high-profile collapses of Enron and WorldCom, the significant accounting issues that contributed to those business failures, and the heightened pleading requirements under the PSLRA together spawned a

[2] 15 U.S.C. §§ 78u-4(b)(1), 78u-4(b)(2).

new wave of federal securities class action litigation featuring complaints that tended to be lengthy, complex, and focused on violations of rather technical accounting rules. In many cases, the company's independent auditor was alleged to have been in on the fraud and was named as a defendant. Many of these cases have since been dismissed or have settled, and by 2006 they had leveled off significantly.

Starting in late 2007 and continuing today (2009), many of the new securities litigation cases being filed have resulted from the financial turmoil associated with the credit crisis and financial institutions' exposure to investment vehicles linked to subprime mortgage-backed securities. Because of problems in the subprime mortgage market and corresponding uncertainty with respect to the valuation of mortgage-backed derivative investments, a number of financial institutions have written down the value of these investments and have recorded massive losses. This has led, in turn, to a significant rise in the number of filed securities class actions against a variety of participants in the market for subprime mortgage-backed securities and the complex derivative investments that sprung from that market. Those targeted include mortgage originators, financial institutions that originated or sold the investments, and banks that loaned money to subprime borrowers.

Much of this litigation has focused on the financial institutions that recorded write-downs on their investments, and the crux of these cases is the contention that write-downs should have been recorded earlier than they were. This turns on a question of valuation: Were these investments valued appropriately by the financial institutions that held them? The accounting standard governing this question is "Statement of Financial Accounting Standards No. 157" (FAS 157), which requires certain kinds of assets to be recorded at fair value.

Of course, there is plenty of room for second-guessing the values that financial institutions ascribed to these investments and, in the end, many of the subprime securities fraud cases will boil down to disputed judgment calls about valuation. Unlike the accounting scandals that dominated securities litigation earlier in this decade, however, the subprime crisis has not easily lent itself to allegations of fraud, mainly because the assets that are at the heart of these cases tend to be complex and difficult to value. In

addition, the unprecedented scale of the crisis, which so far has resulted in write-downs exceeding $135 billion across a range of financial institutions, and the uniformity of the decline in the value of subprime investments will make it difficult for plaintiffs to prove that their investment losses were caused by fraud, as opposed to general market conditions. As a result, many subprime mortgage-related securities class action cases may be dismissed for failure to allege facts sufficient to infer defendants' fraudulent intent or failure to allege causation pursuant to recent Supreme Court precedent, which is discussed below.

Securities Litigation Challenges in the Current Economic Environment

As I write this, we are in the midst of one of the most severe economic downturns in recent memory. In this environment, it is difficult to make predictions about the direction that securities litigation is likely to take. So far, litigation arising from the credit crisis and the deteriorating economic environment generally has taken a multitude of forms, including (i) cases against investment advisers, broker-dealers, and others generally alleging breaches of fiduciary duty, fraud, and violations of the Investment Advisers Act,[3] (ii) cases against pension fund managers based on the decline of the fund's investment portfolio generally arising under the Employee Retirement Income Security Act (ERISA)[4], and (iii) federal securities class actions brought by investors against financial institutions that have suffered losses on subprime investments alleging, among other things, fraud under Section 10(b) of the Securities Exchange Act and Rule 10b-5.[5]

[3] 15 U.S.C. § 80b-1 *et seq.* The Investment Advisers Act was enacted by Congress in 1940 to address abuses in the investment adviser industry and specifically prohibits registered investment advisers from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6(2).

[4] ERISA demands that a fiduciary discharge his duty "with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims." ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[5] Section 10(b) of the Securities Exchange Act makes it unlawful "to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15. U.S.C. § 78j(b).

Pursuant to this statutory mandate, the SEC promulgated Rule 10b-5, which contains three prohibitions. Under Rule 10b-5, it is "unlawful for any person, directly or

In addition, the economic downturn, and the collapse of value in the stock market in particular, have exposed a series of investment Ponzi schemes and are likely to continue to do so. The most significant of these is the Bernard Madoff scheme, in which investors have lost as much as $50 billion. The Madoff scheme alone has yielded more than 30 lawsuits against a variety of hedge funds, financial institutions, and accounting firms accused of helping Madoff perpetuate the scheme, either wittingly or unwittingly. More lawsuits will undoubtedly follow.

For the near future, securities litigation ancillary to bankruptcy proceedings is likely to be a growth area. As businesses struggle in the current economic downturn, the number of bankruptcies is likely to rise, and, as that happens, there will be an increase in federal securities litigation against third parties who, plaintiffs will allege, failed to warn investors about problems. Recent U.S. Supreme Court precedent (discussed below) will make these claims more challenging to pursue, but we can expect to see claims against accountants, lawyers, and other so-called gatekeepers rise, along with the increase in bankruptcies.

Although all of this suggests a time of great opportunity for litigators, the challenging economic environment also has a downside: litigation that is in any sense discretionary is less likely to be pursued by companies looking to keep legal costs down. Companies are also taking a hard look at litigation expenses and are pushing back on legal fees much more forcefully than they have in the past. In this environment, companies and their counsel should focus on keeping litigation cost-effective. This should include efforts to rationalize electronic document discovery, which is typically among the most expensive and time-consuming aspects of litigation.

---

indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

17 C.F.R. § 240.10b-5.

Recent U.S. Supreme Court Precedent Presents Significant Hurdles for Securities Class Action Plaintiffs

Because of three Supreme Court rulings favorable to defendants in recent years (one of them interpreting a key provision of the PSLRA), plaintiffs have found it more challenging to bring a viable securities fraud claim. The first of these was *Dura Pharmaceuticals Inc. v. Broudo*, 125 S. Ct. 1627 (2005). *Dura* answered in the affirmative the question of whether securities class action plaintiffs were required to plead loss causation.[6]

In *Dura*, investors claimed that the company had falsely disclosed that it was making progress on bringing an asthma medication delivery device to market. Ultimately, the Food and Drug Administration (FDA) did not approve the device. Critical here, plaintiffs failed to allege a drop in the price of Dura's stock subsequent to the disclosure that the FDA had not approved the device. Instead, plaintiffs merely alleged that the company's stock price had been artificially inflated at the time of purchase. The district court dismissed the complaint for failure to state a claim, holding that the plaintiffs had failed to plead "loss causation" because the complaint did not allege any relationship between the FDA's failure to approve the device and the drop in Dura's stock price.[7] The Ninth Circuit reversed, holding that it was sufficient simply to plead that "the price at the time of purchase was overstated" and that the price inflation was a result of the fraud.[8]

The Supreme Court reversed. The Court held that it was not sufficient simply to allege that the price of a security on the date of its purchase was inflated because of a false statement by the issuer. Instead, the Court held, the pleadings must provide "some indication of the loss and the causal connection the plaintiff has in mind." *Id.* at 1634. However, the Court stopped short of specifying precisely what allegations would suffice to

---

[6] The PSLRA added Section 21D(b)(4) to the Securities Exchange Act, which provides: "In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which plaintiff seeks to recover damages."

[7] "Loss causation," an element of a Rule 10b-5 cause of action, essentially means a causal link between the misrepresentation and the economic harm suffered by the plaintiff. *See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003).

[8] *Broudo v. Dura Pharm Inc.*, 339 F.3d 933, 938 (9th Cir. 2003).

establish loss causation. In practice, lower courts construing the loss causation pleading requirement have generally held that it is satisfied by an allegation that a corrective disclosure caused a drop in the price of a company's publicly traded stock.

In 2007, the Supreme Court, in *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007), interpreted the PSLRA's requirement that the complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." In an 8-1 decision, the Court, seeking to accommodate the PSLRA's "twin goals" of curbing frivolous litigation while protecting defrauded investors' right to seek recovery, concluded that a "strong inference" requires courts to weigh competing inferences of intent based on the facts alleged in the complaint. The Court held that "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Id.* at 2504-05. The Court's holding resolved a split among federal appellate courts regarding the interpretation and application of the PSLRA's stringent pleading standards and underscored the importance of the PSLRA as a "check against abusive litigation by private parties." *Id.* at 2504.

In general, *Tellabs* has been interpreted to mean that, when evaluating competing inferences of scienter or innocence that may be made from the alleged facts, a tie goes to the plaintiff.

Tellabs has had a profound impact on how courts evaluate a securities class action complaint on a motion to dismiss. Previously universal pleading devices, such as the use of anonymous "confidential informants" by plaintiffs, have been rejected by some courts as insufficient to meet the *Tellabs* pleading standard. Although by no means universal (for example, the *Tellabs* standard is actually more lenient than that which had prevailed in the Sixth Circuit), the consensus is that *Tellabs* has made the plaintiffs' job more difficult.

Finally, in 2008, the Court decided *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*, 128 S. Ct. 761 (2008). In *Stoneridge,* Scientific-Atlanta Inc. and Motorola Inc., two vendors of Charter Communications Inc., allegedly participated in a scheme by which Charter deliberately paid an additional $20 for each set-top cable box it purchased. The vendors then

paid the money back to Charter, enabling Charter falsely to record the vendors' payments as advertising revenue. The vendors allegedly agreed to help Charter conceal the true nature of the transactions by backdating sales contracts and falsifying documents, all for the purpose of convincing Charter's independent auditor that the transactions were real advertising purchases. Eventually, the scheme came to light, leading to criminal and civil fraud investigations and a restatement. The *Stoneridge* plaintiff, a Charter investor, later sued Scientific-Atlanta and Motorola alleging, among other things, that their conduct constituted a "device, scheme or artifice to defraud" in violation of Section 10(b) and Rule 10b-5(a) and (c).

The district court dismissed the claims against Scientific-Atlanta and Motorola, holding that the vendors—not having made a misstatement or omission on which plaintiff could rely—could be liable only as aiders and abettors, a cause of action rejected by the Supreme Court in *Cent. Bank of Denver v. First Interstate Bank of Denver N.A.*, 511 U.S. 164 (1994).[9] The Eighth Circuit affirmed[10] and the Supreme Court granted plaintiff's *certiorari* petition.[11] The issue before the Court was whether third parties could be liable to Charter's investors solely because they participated in a "scheme" to commit securities law violations.

The Supreme Court held that these third parties were not liable to Charter's investors. The Court explained that "[r]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the §10(b) private cause of action" and held that the third-party vendors "had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability."[12]

[9] *See In re Charter Communications Inc., Sec. Litig.*, No. 4:02-CV-1186 CAS, 2004 WL 3826761, at *5-8 (E.D. Mo. Oct. 12, 2004) (citing *Cent. Bank of Denver v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)).

[10] *See In re Charter Communications Inc., Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006).

[11] *See* Supreme Court of the United States Docket, http://www.supremecourtus.gov/docket/06-43.htm.

[12] *Stoneridge*, 128 S. Ct. at 769.

The Court's holding in *Stoneridge* seemed to put to rest the question of "scheme liability"—that is, whether securities fraud liability could be predicated solely on a third party's participation in a fraudulent scheme, a question that a number of lower courts had answered in the affirmative.

Congress has come under pressure from investor advocacy groups and even federal judges to enact legislation to overturn the Supreme Court's recent *Stoneridge* decision and its earlier *Central Bank* decision, which are viewed by some as too pro-defendant.[13] Legislation that overturns these decisions could make it easier to bring a securities fraud claim. Whether legislation on this topic is likely to be passed remains to be seen.

What to Expect if You Are a Securities Litigation Defendant

The good news for securities litigation defendants is that, based in part on the U.S. Supreme Court cases discussed above, it has become more difficult for plaintiffs successfully to litigate a securities fraud claim. However, if plaintiffs manage to get past the motion to dismiss stage, there has probably never been a worse time to be a securities fraud defendant facing a jury trial.

Given the negative economic news that has affected the public's perception of business generally—including billion dollar taxpayer-funded bailouts for financial institutions and others, and the hue and cry over perceived Wall Street greed—jurors are more inclined than ever to be highly skeptical of business defendants in a securities fraud claim. Litigation counsel in such cases will need a strategy to overcome potential juror bias and encourage the jury to see the "human" side of corporate defendants.

[13] Most recently, Judge Gerard Lynch of the U.S. District Court for the Southern District of New York, a well-respected jurist, former federal prosecutor, and Columbia Law School professor, amended his decision dismissing claims against the law firm Mayer Brown & Platt from a federal securities class action complaint over the collapse of brokerage firm Refco on *Stoneridge* grounds to express his concern that the court's decision in that case may permit culpable participants in securities fraud to escape civil liability: "It is perhaps dismaying that participants in a fraudulent scheme who may even have committed criminal acts are not answerable in damages to the victims of the fraud....This choice may be ripe for legislative examination." *In re Refco Inc. Securities Litigation*, 05 Civ. 9626 (GEL), at note 15 (S.D.N.Y. March 17, 2009).

Evolving Strategies and Tactics for Corporate Internal Investigations

Partly as a result of certain business excesses that are now being blamed for today's economic crisis, the financial markets' primary regulators and law enforcement agencies—the SEC, CFTC, FINRA[14] and federal law enforcement authorities—are taking increasingly aggressive action to investigate and address business misconduct. This comes on the heels of a change in leadership at the top levels of certain of those agencies (in particular the SEC) that is likely to bring a more regulatory and law enforcement-centered approach to how the government deals with business generally.

At the same time, the government is devoting greater resources to the SEC to investigate misconduct affecting the securities market. In short, business now faces an expansive regulatory and law enforcement-centered government agenda. In this environment, the consequences to a corporation of even one senior employee's wrongful conduct—which can be imputed to the corporation under current law—are severe.

In this environment, it is more important than ever to manage regulatory and compliance risk effectively and to have a proactive, rather than reactive, plan for getting out in front of any regulatory or criminal investigations. Typically, this means self-investigating allegations of potential wrongdoing and, in many cases, voluntarily disclosing what you learn to regulatory and criminal authorities. Increasingly, companies that wish to avoid the potentially draconian consequences of failing to detect and deter wrongful conduct by their employees are proactively implementing comprehensive compliance programs with a view toward dissuading regulators and prosecutors from imposing an outside compliance monitor. One component of any vigorous compliance program is regular forensic audits or spot checks of a company's internal controls. A rigorous compliance program should also provide for a reliable and whistle-blower protective process to permit employees to report suspected wrongdoing and should require company-initiated investigations of potential wrongdoing at an early stage.

[14] Respectively, the U.S. Securities and Exchange Commission, the U.S. Commodity Futures Trading Commission, and the Financial Industry Regulatory Authority.

Managing Internal Investigations and Regulatory/Law Enforcement Expectations

Let's say that you are the general counsel of a corporation and allegations of potential wrongdoing come to your attention. One of the first things you must decide is whether, and how, you intend to investigate the allegations. Here, the extent and form of the investigation will inevitably be driven by the potential materiality of the allegations to the company's business. For example, some allegations are appropriately handled by the company internally and may not need to involve legal counsel at all. But generally, where the allegations of potential wrongdoing could implicate violations of federal securities laws or criminal law, the investigation is best done by independent outside counsel for a variety of reasons, not the least valuable of which is to preserve the option of cloaking the results of the investigation in attorney-client privilege. Other important considerations include whether to have the investigation overseen by independent members of the company's board of directors (to avoid any charge that the investigation lacks independence from management), whether to memorialize the investigation's conclusions in writing, and how broadly to disseminate the investigative report.

Another important consideration is whether to report the results of the internal investigation to the regulatory and criminal authorities. Generally, if the internal investigation uncovers evidence of wrongdoing, companies are under an obligation to stop the conduct, but not necessarily to report it.

As with anything else, there are pros and cons to self-reporting. The main advantage to self-reporting is the prospect of receiving credit for cooperation in any SEC or U.S. Department of Justice (DOJ) investigation. The SEC, in a landmark policy statement referred to as the Seaboard Report outlined the parameters of cooperation, which, in that case, were deemed sufficient for the company to avoid being charged.[15] According to the Seaboard Report, the SEC will look to four factors in assessing the quality of a corporation's cooperation with an investigation: (i) self-policing prior to the discovery of the misconduct, (ii) self-reporting of the misconduct once it had been discovered, (iii)

[15] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969, Accounting and Auditing Enforcement Release No. 1470 (October 23, 2001).

remediation of any wrongful conduct, and (iv) cooperation with regulatory authorities and law enforcement. Although the Seaboard Report is a helpful guideline, following the steps outlined in the report does not guarantee a favorable result with the SEC. The main disadvantage of self-reporting is that it frequently ensures a potentially costly and distracting government investigation, the results of which will be difficult to predict.

The DOJ has also formally underscored the importance of self-reporting in a series of policy statements setting forth guidelines for prosecutors to consider in charging corporate entities. Beginning in 1999 with the "Holder Memorandum,"[16] which was revised and reissued in 2003 as the "Thompson Memorandum"[17] and further revised in several iterations of what became known as the "McNulty Memorandum,"[18] the DOJ's policy regarding corporate cooperation has evolved from one of encouraging corporate entities to self-report and even voluntarily to waive the attorney-client privilege to merely encouraging corporations to disclose relevant facts and evidence to assist the prosecutors in their investigation. Presently, the DOJ's official policy is *not* to consider, as part of deciding whether to charge the corporation with a crime, whether the corporation voluntarily waived the attorney-client privilege.[19] However, as a practical matter, the voluntary disclosure of otherwise privileged information undoubtedly will influence a prosecutor's assessment of a corporation's cooperation.

The takeaway from all of this is that corporations faced with allegations of serious wrongdoing need to weigh carefully the costs and benefits of self-reporting, keeping in mind that the benefits can be significant but so can the costs.

Best Practices for Securities Litigation Today

Getting the Facts and Coordinating Representation of Individuals and the Company

When advising a client facing a securities litigation claim, one of your earliest priorities should be to gather the facts. It is essential in assessing the

[16] Named for then-Deputy Attorney General Eric Holder.
[17] Named for then-Deputy Attorney General Larry D. Thompson.
[18] Named for then-Deputy Attorney General Paul J. McNulty.
[19] *See* Letter of Deputy Attorney General Mark Fillip to Hon. Patrick J. Leahy and Hon. Arlen Specter, dated July 8, 2008.

strengths and weaknesses of the claims and any potential defenses to gather as much information as possible as quickly as possible about the events underlying the claims. This typically entails (i) an effort to preserve, collect, and review relevant documents, including e-mails and other electronic documents, and (ii) where possible, interviews of key employees and others within the company's control. This will greatly assist counsel in formulating defense strategy and assessing next steps.

In many cases in which plaintiffs sue both the company and individual employees, it is not necessary for the employees to retain separate counsel. Things are not so simple, however, when the facts suggest that the company and its employees may have divergent interests or where employees have interests that diverge from one another. In these circumstances—which include situations where the company and its employees are subject to regulatory or criminal investigations and one may have an incentive to cooperate with the government investigation at another's expense—the interests of the parties may be in conflict, and separate counsel will be required for certain employees. As a general rule, if regulatory or law enforcement agencies are investigating the events at issue in the litigation, individual employees with potential exposure in those investigations should have their own counsel.

Assessing Risk

Once you have a handle on the facts, it is essential to take a hard look at the case and assess the risk to the client represented by the litigation. The level of risk (which can include risk of losing, risk of bad publicity or harm to business reputation, risk of regulatory or criminal investigation, and so on) will inform all tactical decisions and will shape litigation strategy. Here, it is important to note that not all risks can be treated equally, and that any assessment of the litigation risk presented by the facts will need to take into account a variety of factors that will be unique in every case.

Using Dispositive Motions Effectively

Time is usually a litigation defendant's friend: the more time that elapses between the underlying events at issue in the case and the eventual trial, the more recollections will fade, and the greater the likelihood that evidence will be lost or destroyed or that plaintiffs will lose interest in prosecuting the case.

Defendants may use a variety of tactics in a federal securities case to gain time, but by far the most common is the automatic stay on merits discovery imposed by the PSLRA during the pendency of a dispositive motion.

What this means from a practical perspective is that plaintiffs will often file a complaint and, anticipating motions to dismiss, will work with defense counsel to implement a litigation schedule that contemplates at least one amendment to the complaint (usually to supplement the factual allegations) and motion practice. Frequently, the first round of motions to dismiss is followed by additional amendments to the complaint, with the net result being that, by the time all of this is over (and assuming the case has not been dismissed with prejudice), months and even years can pass before discovery begins in earnest.

Perhaps one of the more significant developments in recent years in terms of formulating defense strategy has been the emergence of a growing body of case law construing the Supreme Court's holding in *Dura Pharmaceuticals* (referenced above) requiring plaintiffs to plead loss causation to survive a motion to dismiss. Lower courts have cited *Dura* in circumstances beyond those presented by a motion to dismiss to foreclose class action claims. Among the more noteworthy examples of this is the U.S. Court of Appeals for the Fifth Circuit's decision in *Oscar Private Equity Investments v. Allegiance Telecom Inc.*, 2007 WL 1430225 (5th Cir. May 18, 2007), which denied certification of a plaintiff class on the grounds that plaintiffs were unable to prove by a preponderance of the evidence that defendant's alleged misrepresentations had caused their loss. This ruling, which has not been universally followed by other federal circuit courts, incentivizes securities class action defendants to turn class certification motions into the equivalent of a trial on the merits and increases the already heavy burden on class action plaintiffs to get their claims to trial.

Emerging Issues in Securities Litigation

Aside from the litigation arising from the credit crisis, the most significant development likely to affect securities litigation in the near term is litigation related to investment scams and Ponzi schemes that are unraveling in the wake of the stock market meltdown, such as the Bernard Madoff scandal.
Looking forward, there likely will be increasing pressure on Congress to pass legislation overturning the Supreme Court's decision in *Stoneridge*. If that

happens, third parties—such as law firms, accountants, and banks—will need to be prepared for significant potential exposure from securities fraud claims.

James C. Dugan is a partner in the litigation department of Willkie Farr & Gallagher LLP in New York. Mr. Dugan specializes in complex commercial litigation, federal securities litigation, government compliance and enforcement, and corporate internal investigations.

Mr. Dugan is the author of numerous publications and presentations. He is a contributing author of "Civil Liability under the Securities Act of 1933" in Sommer, Federal Securities Act of 1933 *(Matthew Bender, 2008), the author of "Scheme Liability under Rule 10b-5: An Emerging Cause of Action," published in the December 2006 and January and February 2007 issues of* The Metropolitan Corporate Counsel, *"Whither Stoneridge Investment Partners v. Scientific-Atlanta? The Early Results,"* New York Law Journal *(July 8, 2008), and "The Future of Secondary Actor Liability under Rule 10b-5 After Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.,"* NYU Journal of Law & Business (*forthcoming Spring 2009). An interview with Mr. Dugan was published in the July 2007 issue of* The Metropolitan Corporate Counsel *entitled "Our Forbidding Litigation Environment Can Be Changed."*

Mr. Dugan is a member of the American Bar Association, the Federal Bar Council, and the City Bar Association. He also serves on the executive board of the Cornell Law Association.

In 1993, Mr. Dugan received a J.D., cum laude, from Cornell University Law School, where he served as articles editor of the Cornell Law Review. *He received a B.A. in 1990 with high distinction and honors in English from Pennsylvania State University, where he was elected to Phi Beta Kappa. After law school, Mr. Dugan served as a law clerk to the Honorable Charles H. Tenney, United States District Judge, Southern District of New York (1993-94).*

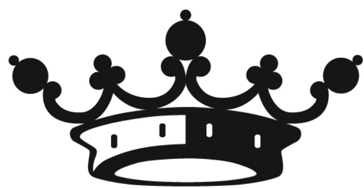
ASPATORE

www.Aspatore.com

Aspatore Books, a Thomson Reuters business, exclusively publishes C-Level executives (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. C-Level Business Intelligence™, as conceptualized and developed by Aspatore Books, provides professionals of all levels with proven business intelligence from industry insiders—direct and unfiltered insight from those who know it best—as opposed to third-party accounts offered by unknown authors and analysts. Aspatore Books is committed to publishing an innovative line of business and legal books, those which lay forth principles and offer insights that when employed, can have a direct financial impact on the reader's business objectives, whatever they may be. In essence, Aspatore publishes critical tools for all business professionals.

Inside the Minds

The *Inside the Minds* series provides readers of all levels with proven legal and business intelligence from C-Level executives and lawyers (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. Each chapter is comparable to a white paper or essay and is a future-oriented look at where an industry, profession, or topic is heading and the most important issues for future success. Each author has been selected based upon their experience and C-Level standing within the professional community. *Inside the Minds* was conceived in order to give readers actual insights into the leading minds of top lawyers and business executives worldwide, presenting an unprecedented look at various industries and professions.



ASPATORE