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SECURITIES LITIGATION: MAPPING A STRATEGY FOR DEFENDING AGAINST FRAUD CLAIMS

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MINI-ROUNDTABLE

SECURITIES LITIGATION: MAPPING A STRATEGY FOR DEFENDING AGAINST FRAUD CLAIMS

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CD: What key trends do you believe are shaping the securities litigation landscape? To what extent has there been an uptick in the number of fraud-related cases?

Johnson: A significant trend currently shaping the securities litigation landscape is the rise of securities class actions filed in state courts. As a result of the US Supreme Court's decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, it is now settled law that state and federal courts have concurrent jurisdiction over claims brought under the Securities Act of 1933. The *Cyan* decision has led to an increase in the number of state court securities cases filed over the last year, although we are only now beginning to see how some of those cases are playing out. For example, in 2019, the Connecticut Superior Court in *Pitney Bowes* and the New York Supreme Court in *Everquote* held that the Private Securities Litigation Reform Act's (PSLRA's) mandatory discovery stay pending a motion to dismiss applied to the Section '33 claim filed in state court. These decisions are important victories for defendants who faced the threat of immediate, and costly, fact discovery before having the opportunity to test the allegations of the complaint through a motion to dismiss. It remains to be seen if other state courts will follow the reasoning of the Connecticut and New York courts but it seems likely that plaintiffs will continue to pursue state court actions as a means to pressure defendants for the early resolution of claims given the uncertainties of litigating these complex cases in state courts.

Reed: In the first half of 2019, almost 200 securities class actions were filed in federal court alone. As courts have become more sceptical of M&A litigation, we have seen some modest reductions in that type of litigation generally. At the same time, the remaining class actions, namely 10b-5 and Securities Act claims, are close to all-time highs. We do not expect this trend to change any time soon. We have also seen an increasing number of Securities Act class actions in state court. We expect this trend to accelerate, at least in the short term, until the state courts start to provide guidance on the pleadings standards for these cases. But securities plaintiffs generally think that there are strategic advantages to pursuing Securities Act class actions in state court.

Atkinson: Statistics show that fraud-related cases have been brought at very high levels over the past 12 months. Some of this is the result of an uptick in the number of filings in state court of claims under the Securities Act of 1933, a federal statute. This trend of plaintiffs pursuing federal securities actions in state court came after the Supreme Court's March 2018 decision in *Cyan*. In that case, Justice Kagan, writing for a unanimous

Court, held that claims under the 1933 Act may be brought in state court and are not removable to federal court. So-called event-driven securities cases have also become increasingly common. Event-driven securities litigation typically arises from the disclosure of an adverse corporate event, such as bad news. Bad news can often cause a company's stock to drop, and significant stock drops can lead to securities litigation. Government investigations, news reports, litigation against the company and so on, have become harbingers of securities litigation, even when those events have nothing to do with the securities laws. The plaintiff's theory in these cases is usually that the company misled investors by not sufficiently informing them sooner of the bad news, thereby supposedly committing securities fraud and harming shareholders who acquired the company's stock during the period when the bad news allegedly was not known to the public but was being withheld by the company.

CD: Could you outline the key issues involved in defending against a fraud-related claim? What guidance would you offer in terms of mapping an appropriate defensive strategy?

Reed: The overriding question is determining the catalyst for the lawsuit. If it appears to be based purely on a stock price drop and the company does not have a specific reason to believe that any misconduct occurred, then the company may follow a traditional defence, such as filing a motion to dismiss, opposing class certification and resisting merits discovery until these threshold issues are resolved. In other cases, however, the fraud claim may follow a major event, such as an industrial accident, the announcement of a government investigation, a whistleblower lawsuit or an admission that its prior disclosures were inaccurate. In these situations, the company may find itself fighting on multiple fronts, and the defence of the securities fraud litigation must be coordinated with the company's broader strategy. For instance, the company should consider whether parallel

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proceedings should be consolidated in a single court, whether to seek stays of some proceedings, pending resolution of others, and whether different defendant groups need separate counsel. These are highly specific judgment calls.

Atkinson: One of the key issues faced by companies defending against fraud-related claims is fighting the same allegations on more than one front. In addition to a securities action in one court, a company may also face a parallel securities class action in another federal or state court, a derivative action relating to the same issues, a government investigation, an action that is related to the securities case but is in a non-securities area, such as antitrust or products liability, and so on. It can sometimes be helpful to have one firm defend against all aspects of these matters, because doing so can lead to better communications and can facilitate a more streamlined and unified approach to the litigation. Either way, it is critical for defence counsel to be coordinated. Developing an overall litigation strategy is key to fighting these different battles, so as to avoid inconsistencies and knock-on effects from one forum to another, to ensure success on the issues that are critical across cases, and to create efficiencies that can be helpful for managing litigation costs. Considering the rise of event-driven securities litigation, it can also be helpful for companies to begin mapping out a strategy with defence counsel as soon as the company learns of bad news that could impact its stock price, even before litigation is filed. If or when litigation is filed, this early preparation can provide a foundation on which companies can rely to make informed tactical decisions from the start.

Johnson: In defending a securities fraud case, it is important to retain experienced counsel who understand the company's business and can undertake a careful and contextual analysis of the relevant disclosures at issue. Experienced counsel can also assist with the important step of preserving documents in the event the case proceeds into discovery. The next, and arguably most important, step for defending against a securities fraud-related action is the preparation of a motion to dismiss. Because of the high pleading bar established by the PSLRA, defendants have a real chance of getting claims dismissed or, at the very least, paired back. It may also make sense to engage an economic expert to assess the price impact of the alleged disclosures which can provide some insight into how plaintiffs may be valuing their cases. Establishing a good relationship with the directors & officers (D&Os) carriers is also a very important step in any defence strategy, particularly when a company is considering potential settlement of a claim.

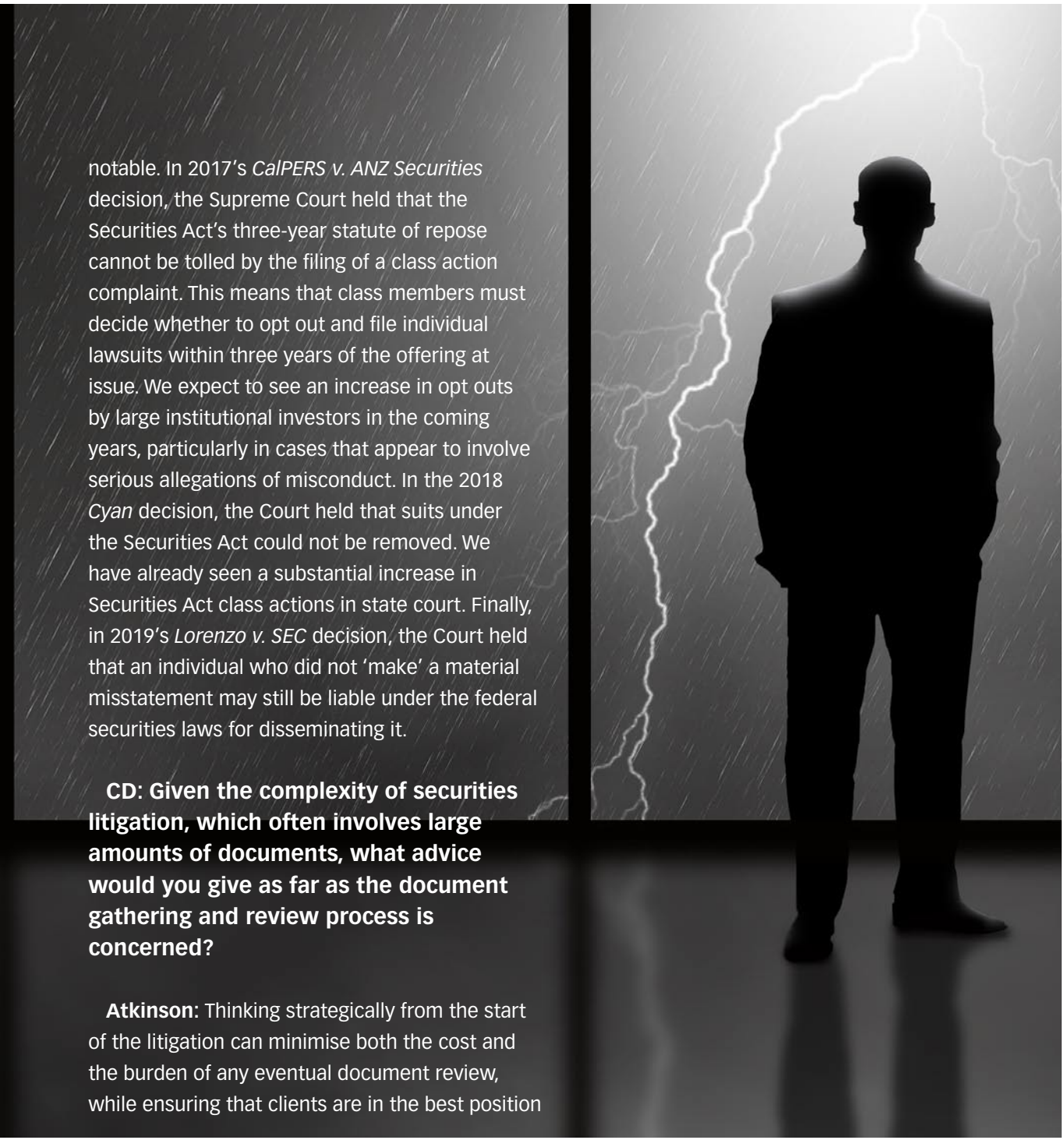
CD: Have any recent fraud-related securities litigation cases, including class actions and individual securities

cases, been particularly notable? What lessons can we learn from how they were conducted and resolved?

Johnson: This past year has seen several courts grappling to address the contours of the Supreme Court's Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund decision, in which the court addressed the scope of liability for statements of opinion. In *Omnicare*, the Court held that a statement of pure opinion does not constitute an "untrue statement of material fact" regardless of whether the belief is ultimately proven wrong. *Omnicare*, therefore, set a high bar to pleading the falsity of opinion statements. A number of recent decisions have reinforced the uphill battle that plaintiffs face in challenging statements of opinion. For example, in *Teamsters Local 210 Affiliated Pension Tr. Fund v. Neustar, Inc.*, the court dismissed a complaint in which plaintiffs alleged that the defendants' opinion that a certain transition "would occur" was false or misleading, even when defendants had a report warning that the transition might not occur by the specified date.

Atkinson: The Southern District of New York's decision in *Oklahoma Firefighters Pension & Retirement Systems v. Xerox Corp*., which the Second Circuit affirmed in June 2019, illustrates some of the intricacies involved in event-driven securities class actions. In *Xerox*, the plaintiff alleged that Xerox made more than 70 misstatements over a three-and-a-half-year period in connection with the company's implementation of a software product. The plaintiff argued that Xerox's share price was, as a result of those challenged statements, artificially inflated for that entire three-plus-year period before Xerox spun off the software product to a new company. Ultimately, the District Court granted Xerox's motion to dismiss, finding that none of the challenged statements were actionable or misleading. The court concluded that these statements and the allegedly omitted information were one or more of the following: immaterial, puffery, accurate statements of fact, forward-looking and accompanied by meaningful cautionary language, non-actionable opinion statements and conclusory pled. The problem with many event-driven actions is that, like *Xerox*, they are premised on unforeseen developments and events that plaintiffs' counsel then recasts as known all along and, therefore, is required to have been disclosed earlier. But fraud cannot be pled with the benefit of hindsight; it is what the issuer knew at the time it made the statements that matters. And, of course, most bad news is not securities fraud.

Reed: There have been three recent Supreme Court decisions which have been particularly



notable. In 2017's *CalPERS v. ANZ Securities* decision, the Supreme Court held that the Securities Act's three-year statute of repose cannot be tolled by the filing of a class action complaint. This means that class members must decide whether to opt out and file individual lawsuits within three years of the offering at issue. We expect to see an increase in opt outs by large institutional investors in the coming years, particularly in cases that appear to involve serious allegations of misconduct. In the 2018 *Cyan* decision, the Court held that suits under the Securities Act could not be removed. We have already seen a substantial increase in Securities Act class actions in state court. Finally, in 2019's *Lorenzo v. SEC* decision, the Court held that an individual who did not 'make' a material misstatement may still be liable under the federal securities laws for disseminating it.

CD: Given the complexity of securities litigation, which often involves large amounts of documents, what advice would you give as far as the document gathering and review process is concerned?

Atkinson: Thinking strategically from the start of the litigation can minimise both the cost and the burden of any eventual document review, while ensuring that clients are in the best position

to utilise key documents in their litigation decisions. As an initial matter, it is important for companies to have effective document retention policies in place. Companies should consider working with outside counsel to develop and update their policies for use both in anticipation of and during litigation. If the defendants plan to file a motion to dismiss, it might not make sense to spend too much time or money on document discovery prior to a ruling on that motion. Under the PSLRA, discovery will be stayed during the pendency of the motion to dismiss in federal court and, if argued correctly, in state court too. After the motion to dismiss is denied, early negotiation of discovery parameters can be useful in limiting the size and scope of the document review process. Negotiations concerning duplicative custodians, overbroad search terms and irrelevant time periods are an important part of managing the breadth of the review process. Additionally, we encourage parties to think critically about whether attorney review, both through contract-attorney review and outside counsel review, technology assisted review (TAR) or some combination of the two, makes the most sense, considering each specific case.

Reed: A company should, of course, act as promptly as reasonably possible to preserve documents that appear to relate to the subject matter of the lawsuit. Beyond that, the timing of a company's document collection and review strategy will often depend on the apparent merits of the lawsuit. If the lawsuit appears to be a meritless strike suit that is likely to be dismissed, companies may be best served by waiting to collect documents until the court resolves the motion to dismiss. This may avoid the collection and review process altogether if the motion is granted. In some cases, it may be wise to conduct preliminary due diligence on the merits of a securities litigation claim, using targeted collections and reviews that are designed to find core documents, to avoid inadvertently taking positions at the outset of a case that may later be different from what the documents reflect. Once motions are near resolution and merits discovery appears imminent, it is a good idea to begin the core document collection from key custodians to avoid a time crunch later in the process. Finally, the volume of discovery in these cases, particularly when individual officers and underwriting syndicates are involved, often warrants exploring TAR options or other discovery streamlining processes to manage the significant costs of a broad discovery process.

Johnson: If a securities case survives a motion to dismiss and the parties enter the fact discovery phase of the litigation, it is very important for the parties to engage in early discussions regarding electronic discovery. In federal court, the parties are obligated under Federal Rule of Civil Procedure 26(f) to address the scope of electronic discovery during the Rule 26(f) conference. It is very important

for counsel to have a fundamental understanding of the client's electronic infrastructure in order to be in the best position to negotiate a reasonable electronically stored information (ESI) protocol and ensure that document discovery proceeds as efficiently as possible. That likely means counsel will need to work closely with internal information technology (IT) personnel at the company to gain a clear understanding of the client's IT infrastructure. In addition, under Rule 26(b)(1), discovery must be proportional to the needs of the case, so counsel must keep that in mind when responding and objecting to discovery requests. Finally, because securities cases will often involve a large volume of documents, it may be beneficial to explore the use of computer assisted review (CAR) that can result in both a more efficient and cost-effective way of conducting large-scale document reviews and productions.

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Noelle M. Reed, Skadden, Arps, Slate, Meagher & Flom LLP

CD: Have any recent developments impacted securities legislation in your jurisdiction? If so, how are they affecting litigation in this space?

Reed: We have not seen major changes in the federal securities statutes recently. Many people believe the *Cyan* decision – which had to interpret admittedly confusing statutory language – reached a counterintuitive result in which many securities class actions arising under state law must proceed in federal court while class actions arising under the federal Securities Act can proceed in state court. However, given the gridlock in Washington, we do not think that Congress is likely to amend the Securities Act any time soon.

Johnson: The increase in the number of opt-out cases is a development worth watching. Cornerstone Research recently issued an interesting report entitled *Opt-Out Cases in Securities Class Action Settlements* in which it noted that between 2014 and 2018, 28 percent of cases with class action settlements over $20m involved opt-outs. In addition, for settlements over $500m, from 1996-2018, 65 percent of those had associated opt-out cases. Large institutional investors, as well as hedge funds,

appear to be driving the increase in the number of opt-outs. The existence of multiple opt-out cases can significantly complicate how the class action is managed and, potentially, the associated cost of settlement.

Atkinson: The Supreme Court's decision in *Cyan* has impacted securities litigation in several ways. In the aftermath of *Cyan*, New York state courts, for example, appear to have seen a significant increase in 1933 Act suits. State-court and federal-law securities actions like *Cyan* were almost unheard of in New York before 2018. *Cyan* also raised questions about whether all the protections guaranteed under the PSLRA in federal court would also apply in state court. For instance, *Cyan* did not address specifically whether defendants in state court would be entitled to the PSLRA's automatic discovery stay pending a motion to dismiss, though the court did say that certain provisions of the PSLRA that have the same explicit scope as the discovery stay apply "even when a 1933 Act suit was brought in state court". In *City of Livonia Retiree Health and Disability Benefits Plan v. Pitney Bowes Inc*, a Connecticut Superior Court in May 2019 concluded that the PSLRA's automatic discovery stay applied to a 1933 Act suit in state court. However, different New York Supreme Court justices reached different conclusions on that issue. We expect that state courts will continue to weigh in on this question.

CD: Given that securities litigation can become a protracted and frustrating process, what essential advice would you offer on defending a fraud-related claim?

Atkinson: According to experts, about one in 12 public companies will have been hit with a securities class action in 2019. In this landscape, there is no substitute for preparation. It is smart for companies to be proactive about securities risks and how to deal with them when running their businesses. Before a lawsuit is even filed, particularly if the company experiences bad news in some part of its business or suffers a significant stock drop for

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any reason, it can often be helpful for companies to work with securities lawyers. If a lawsuit is filed, companies should work promptly with counsel to assess the scope of the case, investigate the underlying facts, evaluate potential defences and begin formulating a case strategy. The better the early case assessment, the better the early strategic decisions and, hopefully, the better the ultimate result.

Johnson: There is no doubt that defending a securities litigation case can be both frustrating and time consuming. To combat this, it is critically important to engage experienced counsel who can mount the strongest and most aggressive defence to the claims. That means challenging the sufficiency of the allegations on a motion to dismiss but can also include probing the veracity of confidential witnesses identified in the complaint. In addition, in some cases, early settlement of a case may make sense and confidential mediation could provide a way to short-circuit an otherwise protracted litigation process.

Reed: Managing expectations is key. Parties' reactions can range from concern about the potential exposure to frustration at the inability to immediately rebut what they view as unfair and inaccurate accusations. And because the securities litigation process can seem arcane and counterintuitive, it is often helpful for parties to receive an early detailed download explaining the stages in the litigation process and the strategic alternatives that are available at each stage. For instance, parties understandably often want to tell their story to the court at the beginning of the litigation. In these situations, it is important to help them understand what information can properly be put before the court and why they typically benefit from the procedural rules that can postpone an exploration of the facts until preliminary legal issues like motions to dismiss and class certification can be decided.

CD: Do you anticipate an active securities litigation landscape in the months and years ahead? What key issues do you expect to dominate this space?

Johnson: We expect to see a significant number of new securities class action filings over the coming months and years. Given the level of market volatility, there is no question plaintiffs will continue to see economic value in filing stock-drop securities fraud cases. We also expect to continue to see an increase in the number of event-driven securities class actions, where plaintiffs file securities claims immediately after the announcement of an adverse event at a company, such as a cyber security breach, regulatory issue or product failure. Virtually any industry is susceptible to these kinds of event-driven cases, including most recently the e-cigarette

business. In late 2018 it was announced that at least two e-cigarette companies are facing securities class action claims alleging false and misleading statements regarding regulatory challenges resulting from the public backlash regarding e-cigarettes. We expect to have a better sense of how well plaintiffs will fare with these new event-driven securities class actions as more courts weigh in on pending motions to dismiss over the coming months.

Reed: Securities litigation is not going away any time soon. There are a number of key issues that will help define the next generation of litigation. First, state courts must decide what standards will govern Securities Act class actions. For example, there are already divisions developing over whether the PSLRA stay applies in state court. Second, courts will also continue to grapple with the extent to which foreign issuers and events occurring outside the US are subject to the federal securities laws. Third, defendants are actively pursuing new strategies for contesting class certification motions – for instance, by contending that the plaintiffs cannot prove damages on a class-wide basis. The courts' resolution of these issues could have a dramatic effect on the scale of securities litigation, as well as the timeline of individual lawsuits.

Atkinson: We see no sign of securities litigation slowing down. As for continuing issues, it appears that courts will continue to grapple with the *Cyan* decision, including an uptick in federal securities claims in state court and the sometimes-thorny issues that such claims can bring with them. We also expect social media to continue to play a big role in securities class actions, both in amplifying adverse corporate events and in disseminating statements that may later be claimed to be actionable. Additionally, if the markets are as volatile as some analysts predict they may be in 2020, then we expect to see an increasing number of stock-drop cases, including securities cases. CD