



SCALE LLP

U.S. Securities Fraud Class Actions

What to Expect. How to Prepare.

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GOAL OF THE U.S. SECURITIES LAWS: FULL DISCLOSURE OF MATERIAL FACTS

“Underlying the adoption of extensive disclosure requirements was a legislative philosophy: There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. This Court repeatedly has described the fundamental purpose' of the Act as implementing a philosophy of full disclosure.”

Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988)



U.S. Securities Anti-Fraud Statutory Framework

Securities Act of
1933

Focuses On Initial and
Secondary Public
Offerings

Liability for Any
Material Misstatement
or Omission,
Regardless of Intent

Security Must Be
Purchased In Or
Traceable To
Materially Misleading
Prospectus

Securities
Exchange Act of
1934

Focuses On
"Aftermarket"
Transactions

Liability for Any
Intentional Material
Misstatement or
Omission

Misstatement Must Be
"In Connection With"
Purchase or Sale



Section 11 of the Securities Act of 1933

In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

- (1) every person who signed the registration statement;
- (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
- (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
- (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement, in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
- (5) every underwriter with respect to such security.

Section 11 of the Securities Act of 1933: Elements and Defenses



Elements of Claim

- Material Misstatement or Omission
- Damages = Difference Between Price and Value

Statutory Defendants

- Issuer Is Absolutely Liable
- All Others Have Affirmative Due Diligence Defense - Not Dismissible

The Good News

- Misstatement Must Be Contained In “Section 10” Prospectus
- Security Must Be Purchased In Or Be “Traceable” To Misleading Prospectus
- Claim Must Be Brought Within 1 Year Of Offering
 - Otherwise, Reliance Upon Misstatement Required

Section 10(b) of the Securities Act of 1934



It shall be unlawful for any person, directly or 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 . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement[,] 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

Rule 10b-5

It shall be unlawful for any person, directly or 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

Elements of Section 10(b)/Rule 10b-5 Claim



Material False Statement or Omission In Connection With Purchase Or Sale

- ❖ *Material means “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.”*

Rebuttable Presumption of Reliance Based Upon “Fraud on the Market”

- ❖ *“[I]n an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.”*

Misstatement or Omission Must Be Intentional (Scienter)

- ❖ *“Recklessness” generally not sufficient*
- ❖ *Plaintiffs must plead “strong inference” of fraudulent intent*
 - *Must be at least as compelling as alternative non-fraudulent intent*

Loss Causation and Damages

- ❖ *Causal link must exist between the misstatement or omission and the inflated price of the security at the time of the transaction.*



What Triggers The Filing Of A Class Action: The Economics of the Plaintiffs' Class Action Bar

- ❖ Virtually All Securities Fraud Class Actions Are Handled On A Contingency Basis
 - *Fees will generally be less than 25%, plus expenses*
 - *Fee awards are always subject to court approval after notice*
 - *Cases are risky, have long timelines, and require extensive labor/monetary commitment*
- ❖ Strong Plaintiffs' Firms Generally Look For Strong Cases
 - *Big Stock Drops/Big Volume*
 - *Long Class Periods*
 - *Indicia of Intentional Misconduct*
 - *Accounting Restatements (Irregularities v. Errors)*
 - *Revenue Recognition*
 - *Inventory Valuation*
 - *Percentage of Completion*
 - *Right of Return*
 - *SEC Investigations/Cease and Desist Orders/Internal Investigations*
 - *Auditor Resignations/Change in Management*
 - *Insider Transactions Immediately Prior to Significant Stock Movement*
 - *Large Restructuring Charges*

Timeline of Typical Securities Fraud Class Action



1. FILING OF INITIAL COMPLAINT/PUBLICATION OF NOTICE (D-DAY)
2. FILING OF LEAD PLAINTIFF MOTIONS (D-DAY +60)
3. APPOINTMENT OF LEAD PLAINTIFF/LEAD COUNSEL (D-DAY +>90)
4. FILING OF CONSOLIDATED AMENDED COMPLAINT (D-DAY +>120)
5. RESOLUTION OF MOTION TO DISMISS (D-DAY +>270)
6. COMMENCEMENT OF DISCOVERY (D-DAY +>300)
7. MOTION FOR CLASS CERTIFICATION
8. RESOLUTION OF MOTION FOR SUMMARY JUDGMENT (D-DAY +>570)
9. COMMENCEMENT OF TRIAL (D-DAY +>630)

Ways To Limit Your Exposure



- ❖ PICK YOUR AUDITORS CAREFULLY AND HELP THEM DO THEIR JOB
- ❖ PICK YOUR BOARD MEMBERS AND COMMITTEE MEMBERS CAREFULLY
 - MEET QUARTERLY AND KEEP APPROPRIATE MINUTES
- ❖ DOCUMENT AND FOLLOW INTERNAL CORPORATE POLICIES
 - BOARD COMMITTEE CHARTERS (COMPENSATION, AUDIT, NOMINATING)
 - INSIDER TRADING POLICIES
 - APPROVAL PROCEDURES
 - BLACKOUT DATES
 - 10B-5 TRADING PLANS
 - ETHICS/CONFLICT OF INTEREST POLICIES
 - COMPENSATION POLICIES/EQUITY INCENTIVE PLANS
 - ENSURE MANAGERIAL INTEREST ALIGNED WITH SHAREHOLDERS
- ❖ MAKE DISCLOSURES PROMPTLY - RESIST HIDING THE BAD NEWS
- ❖ SECURE D&O INSURANCE COVERAGE

D&O Insurance Considerations



❖ TYPES OF COVERAGE

- Side A = Directors and Officers (Pure Asset Protection)
- Side B = Corporate Indemnification Obligations
- Side C = Entity Coverage

❖ AMOUNT OF COVERAGE

- Depends on Market Cap, Size of Outside Investment, Trading Volume
- Balance Between Protecting Assets and Creating “Pot of Gold”

❖ TYPICAL PROVISIONS

- Claims-Made Policies = Covers Period In Which Claims Are Made
- Wasting Asset = Defense Costs Deducted from Total Policy Coverage
- Retention = Deductible Applicable To Policy
- Restrictions On Selection of Counsel
 - Panel Counsel Restrictions v. Incentives

❖ USE YOUR GC AND A KNOWLEDGEABLE INDEPENDENT BROKER/SPECIALIST

- Many Varieties of D&O Insurance Available
- Lower Risk Profile = Lower Rates!

Things To Do If You Are Sued



- ❖ PRESERVE ALL DOCUMENTS – DO NOT DESTROY ANYTHING
- ❖ MAINTAIN STATUS QUO PENDING LEGAL ADVICE
- ❖ CONTACT YOUR D&O CARRIER AND RETAIN COUNSEL ASAP
 - FIND COUNSEL YOU'RE COMFORTABLE WITH, EVEN IF NOT ON PANEL
 - REPUTABLE CARRIERS WILL APPROVE YOUR CHOICE
 - ULTIMATE GOAL = LIMIT DISTRACTION TO YOUR BUSINESS
- ❖ MAKE CORRECTIVE DISCLOSURES AS QUICKLY AND COMPLETELY AS POSSIBLE
 - AVOID “WATER TORTURE” PRESS RELEASES
 - AVOID SPECULATION OR UNNECESSARY PROMISES/ASSURANCES
- ❖ USE THE DISCOVERY STAY/INFORMATION ADVANTAGE TO YOUR BENEFIT
 - EVALUATE YOUR EXPOSURE REALISTICALLY AND CONSIDER EARLY OPTIONS
 - CONSIDER WHETHER PLAINTIFFS WILL EVER GET THEIR COMPLAINT SUSTAINED
 - BUT REMEMBER: RISK INCREASES DRAMATICALLY IF MTD IS DENIED



QUESTIONS/DISCUSSION

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