307 - Securities Litigation & Derivative Actions: Trends & High Risk Activities

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Faculty Biographies

Elizabeth Edwards

Elizabeth F. Edwards is a partner with McGuireWoods LLP in Richmond, Virginia. She practices in the areas of complex commercial litigation including securities litigation, contract and other commercial claims, corporate governance, business torts, and trademark and trade dress infringement. Her practice encompasses litigation in federal and state courts, arbitration, mediation, and internal investigations. She has significant experience in discovery and document management in connection with litigation and governmental investigations, including electronic discovery, difficult discovery disputes, and the preparation and defense of privilege logs.

Ms. Edwards received her B.A. from Virginia Polytechnic Institute and State University and J.D. from the University of Richmond School of Law.

Mary Smith

Mary L. Smith currently serves as senior litigation counsel at Tyco International (US) Inc. in Princeton, New Jersey, where she manages the securities class action multi-district litigation relating to the Dennis Kozlowski era – one of the largest cases pending in the country. The settlement represents the single largest payment from any corporate defendant in the history of securities class action litigation. As part of her responsibilities, Ms. Smith manages a multi-million dollar budget, over 40 outside counsel, and over 60 contract attorneys.

Previously, she was an attorney at Skadden, Arps, Slate, Meagher & Flom LLP in Washington, DC. While at Skadden, Ms. Smith specialized in governmental investigations and securities class actions. Prior to her time at Skadden, Ms. Smith served in the Clinton White House as associate counsel to the President. Ms. Smith also served as a trial attorney for the United States Department of Justice Civil Division. Ms. Smith clerked for the Hon. R. Lanier Anderson III of the United States Court of Appeals for the Eleventh Circuit.

Ms. Smith is a co-editor of the ABA's section of litigation committee on corporate counsel journal. She is a member of the ABA's commission of women in the profession

Ms. Smith received a B.S., magna cum laude, from Loyola University of Chicago. She graduated from the University of Chicago School of Law, cum laude, where she was a member of the *Law Review.*

Edward Turan

Edward Turan is a senior deputy general counsel of the markets and banking of Citi in New York City, and head of the litigation department. Mr. Turan is responsible for the management of all aspects of litigation arising out of the businesses of Citi Capital Markets and Smith Barney. He also has responsibility for the employment and regulatory enforcement matters.

Previously, Mr. Turan was with the Fried Frank Harris Schriver and Jacobson law firm and specialized in corporate litigation and subsequently worked at Icahn Capital Corporation prior to joining Smith Barney's legal group. He also worked as a law clerk to the Honorable Inzer A. Wyatt in the United States District Court for the Southern District of New York.

He was a member of the national arbitration and mediation committee of the National Association of Securities Dealers, and is a member of the Securities Industry and Financial Markets Association (SIFMA) committee on litigation and arbitration, which he is the current chairman, and the SIFMA committee on amicus issues. He is also executive vice president and a member of the executive committee of the compliance and legal division of the SIFMA.

Mr. Turan has a B.A. from Harpur College, graduated from the Fordham Law School.

I. Supreme Court Developments

II. Circuit Court Developments

a. Scheme Liability

b. Class Certification

III. Options Backdating Cases

IV. State Court Securities Litigation

V. Pragmatic Effects and Practical Considerations for In-House Counsel

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I. Supreme Court Developments

Bell Atlantic Corp. v. Twombly

Pleading Standards Generally: *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955 (2007), held that a class consisting of local telephone service subscribers failed to plead a claim against telephone service providers for violation of the Sherman Act. In doing so, the Court expounded on the Fed. R. Civ. P. 8(a) pleading standards.

Bell Atlantic Corp. v. Twombly – con't

- A complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations.
- The Court, nevertheless, held that "a plaintiff's obligation to provide the 'grounds' of his 'entitle[ment] to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do."

Bell Atlantic Corp. v. Twombly – con't

- With regard to plaintiffs' claim, the Court found that, at a minimum, a plaintiff must allege "plausible" grounds to infer a violation of the Sherman Act. The Court reasoned that doing so "does not impose a probability requirement at the pleading stage; it simply calls for enough fact to raise a reasonable expectation that discovery will reveal evidence of illegal [conduct]."

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Bell Atlantic Corp. v. Twombly – con't

The Death of *Conley v. Gibson*?

- The Court also held that its oft-quoted statement from *Conley v. Gibson* that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove *no set of facts* in support of his claim which would entitle him to relief," should be "forgotten as an incomplete, negative gloss on an accepted pleading standard."

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Bell Atlantic Corp. v. Twombly – con't

The Death of *Conley v. Gibson*? (con't)

- The Court stated that "once a claim has been stated adequately, it may be supported by showing any set of facts consistent with the allegations in the complaint."

Tellabs, Inc. v. Makor Issues & Rights, Ltd.

Pleading Standard for Section 10(b): In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), the Court considered what Congress intended when it passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which requires, *inter alia*, that plaintiffs alleging violations of Section 10(b) of the Securities Exchange Act of 1934 establish a "strong inference" that defendants acted with an intent to deceive.

Tellabs, Inc. v. Makor Issues & Rights Ltd. – con't

- In an 8-1 decision authored by Justice Ginsburg, the Supreme Court held that "in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences."

Tellabs, Inc. v. Makor Issues & Rights Ltd. – con't

- Thus, a complaint will survive only if a reasonable person would deem the "inference of scienter . . . cogent and at least as compelling as any opposing inference of non-fraudulent intent."

Credit Suisse Securities (USA) LLC v. Billing

- **IPO Litigation is Immune from Antitrust Scrutiny:** In *Credit Suisse Securities (USA) LLC v. Billing*, 127 S. Ct. 2383 (2007), the Supreme Court held that certain long-standing securities industry practices in the issuances of IPOs are impliedly immune from antitrust challenges on the ground that the regulation of such conduct is within the sole jurisdiction of the SEC.

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Credit Suisse Securities (USA) LLC v. Billing – con't

- No antitrust liability can arise from:
  - "laddering"
  - "tying" arrangements
  - other allegedly excessive commissions

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II. Circuit Court Developments

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a. Scheme Liability

Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.

- **No Primary Liability for Third Parties:** In *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *petition for cert. filed*, (U.S. Apr. 5, 2007) (No. 06-1341), the Fifth Circuit held that the "district court's definition of 'deceptive acts' thus sweeps too broadly; the transactions in which the banks engaged were not encompassed within the proper meaning of that phrase." The Fifth Circuit further held that "Enron had a duty to its shareholders, but the banks did not," and "[t]he transactions in which the banks engaged at most aided and abetted Enron's deceit by making its misrepresentations more plausible." The Court concluded that "[t]he banks' participation in the transactions, regardless of the purpose or effect of those transactions, did not give rise to primary liability under § 10(b)."

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In re Charter Commc'ns, Inc., Sec. Litig.

- **No Scheme Liability for Third Parties:** In *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006), *cert. granted*, 127 S. Ct. 1873 (U.S. 2007), the Eighth Circuit held that any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not engage directly in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable for securities fraud under Section 10(b) of the Exchange Act or SEC Rule 10b-5 as a primary violator.

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In re Charter Commc'n, Inc., Sec. Litig. – con't

- **Facts:** Shareholders of Charter alleged that Charter had entered into sham transactions with two vendors, which had the effect of artificially inflating Charter's operating revenues, by purchasing cable equipment from the vendors at excess prices in exchange for the vendors returning the additional payments to Charter in the form of "advertising fees."

In re Charter Commc'n, Inc., Sec. Litig. – con't

- In holding that the vendors were liable only for aiding and abetting liability, the Court emphasized:
  - "[t]o impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings."

II. Circuit Court Developments

b. Class Certification

Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.

- **Class Certification Standard:** In *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *petition for cert. filed,* (U.S. Apr. 5, 2007) (No. 06-1341), the Fifth Circuit reversed a class certification decision involving the *Affiliated Ute* presumption and the fraud-on-the-market presumption.

Regents of the Univ. of Cal. v. Credit Suisse First Boston – con't

- The Fifth Circuit concluded that the district court's definition of "deceptive act" was integral to its conclusion that the class certification requirements were met. Without its broad conception of liability for "deceptive acts," that court could not have found that the entire class was entitled to rely on a fraud-on-the-market theory, as the market could not have been presumed to rely on an omission or misrepresentation in a disclosure to which it was not legally entitled.
- The Fifth Circuit also concluded that the *Affiliated Ute* presumption of classwide reliance did not apply; plaintiffs had no expectation that the banks would provide them with information, and there was no reason to expect that plaintiffs relied on their candor.

Regents of the Univ. of Cal. v. Credit Suisse First Boston – con't

- Likewise, the district court misapplied the fraud-on-the-market presumption; the facts alleged did not constitute misrepresentations on which an efficient market could be presumed to rely, as the banks did not act directly in the market for the securities.
- The transactions in which the banks engaged at most aided and abetted a corporation's deceit by making its misrepresentations more plausible. Their participation in the transactions did not give rise to primary liability under § 10(b).

- **Class Certification Standard:** In *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006), the Second Circuit held that district courts must weigh evidence on motions for class certification and cannot simply rely on the plaintiff's allegations to determine whether the requirements of Federal Rule of Civil Procedure 23 have been met.

Class Certification Standard and the Intersection of Dura

- In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), the Fifth Circuit held that, for purpose of resolving a motion for certification of a securities fraud class under Federal Rule of Civil Procedure 23, a court must assess whether plaintiffs have established loss causation in order to trigger the fraud-on-the-market presumption.

Oscar Private Equity Investments v. Allegiance Telecom, Inc.

- In *Oscar*, the Fifth Circuit overturned a class certification order brought under sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The court held that class certification should not have been granted because the plaintiffs failed to prove that a corrective disclosure (a restatement) contained in an earnings release caused a substantial amount of the decline in the stock price, where the release also disclosed other negative information that may have caused the decline, including that the company had missed analyst earnings per share estimates and that it might have trouble meeting its bank covenants going forward.

Oscar Private Equity Investments v. Allegiance Telecom, Inc. – con't

***In terrorem* effect of class certification:**

- In so holding, the court stated that it could not "ignore the *in terrorem* power of certification, continuing to abide the practice of withholding until 'trial' a merit inquiry central to the certification decision, and failing to insist upon a greater showing of loss causation to sustain certification, at least in the instance of simultaneous disclosure of multiple pieces of negative news."

Oscar Private Equity Investments v. Allegiance Telecom, Inc. – con't

***In terrorem* effect of class certification:**

- The court concluded as follows: "Given the lethal force certifying a class of purchasers of securities enabled by the fraud-on-the-market doctrine, we now in fairness insist that such a certification be supported by a showing of loss causation that targets the corrective disclosure appearing among other negative disclosures made at the same time."

III. Options Backdating Cases

- Options backdating has become the most widespread and highly publicized corporate fraud issue for the last year or so. Beginning with a series of *Wall Street Journal* articles in March 2006, virtually every week brought another headline on this topic.
  - According to one source, as of July 10, 2007, there were 31 securities fraud class actions filed and 160 shareholders derivative lawsuits. Moreover, by October 2006, approximately 40 executives, including at least 7 general counsels, had lost their jobs.

Source:

http://dandodiary.blogspot.com/2006/07/counting-options-backdating-lawsuits.html#links

http://dandodiary.blogspot.com/2006/10/latest-options-backdating-dispatches.html#links

Ashby Jones, Tough Times for In-House Lawyers – General Counsels Feel Heat as Backdating Scandal Claims Its Latest Casualty, Wall St. J., Oct. 16, 2006, at A12.

- As of November 2006, backdating has been identified at more than 130 companies, and led to the firing or resignation of more than 50 top executives and directors of those companies. Notable companies embroiled in the scandal include Broadcom Corp., UnitedHealth Group and Comverse Technology.

Source:

http://en.wikipedia.org/wiki/Options_backdating

- The class action suits have not materialized.
- Even when it is clear that options grant dates were manipulated, it is unclear how to calculate damages.
- Plaintiffs' lawyers have turned to derivative suits. Settlements in these cases usually consist of corporate governance changes and legal fees.

Not many cases have been decided.

- One recent case is *In re CNET Networks, Inc*., 483 F. Supp. 2d 947 (N.D. Cal. 2007), where the district court granted CNET's motion to dismiss. Because the action was brought as a derivative action, plaintiffs were required to make a demand on the board, or else plead with particularity that demand was futile. The court held that the plaintiffs had failed to plead with particularity that the demand on the board was excused as futile under FRCP 23.1, and, therefore, granted the nominal defendant's motion to dismiss.

IV. State Court Securities Litigation

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit

- **SLUSA Preemption Includes Holders Cases:** In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,* 547 U.S. 71 (2006), the Supreme Court held that SLUSA's "in connection with" requirement is satisfied when an alleged fraud "'coincide[s]' with a securities transaction," regardless of whether the plaintiff or someone else is a party to that transaction.

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Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit – con't

- SLUSA's phrase "in connection with the purchase or sale" was not to be read narrowly to encompass (and therefore pre-empt) only those actions that were brought by a purchaser or seller of securities to remedy fraud associated with her own sale or purchase of securities.

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Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit – con't

- For purposes of SLUSA pre-emption, the fact that the claim involved holders instead of purchasers or sellers was irrelevant.

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Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit – con't

Covered class actions under SLUSA:

- Any single lawsuit in which damages are sought on behalf of more than 50 persons and questions of law or fact predominate
- Any single lawsuit in which one or more named parties seek to recover on a representative basis and questions of law or fact predominate

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Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit – con't

Covered class actions under SLUSA:

- Any group of lawsuits filed in the same court and involving common questions of law or fact in which damages are sought on behalf of more than 50 persons and the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose

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So what does this mean?

- For instance, a plaintiff can't avoid SLUSA by bringing a class action that will include no more than 50 members

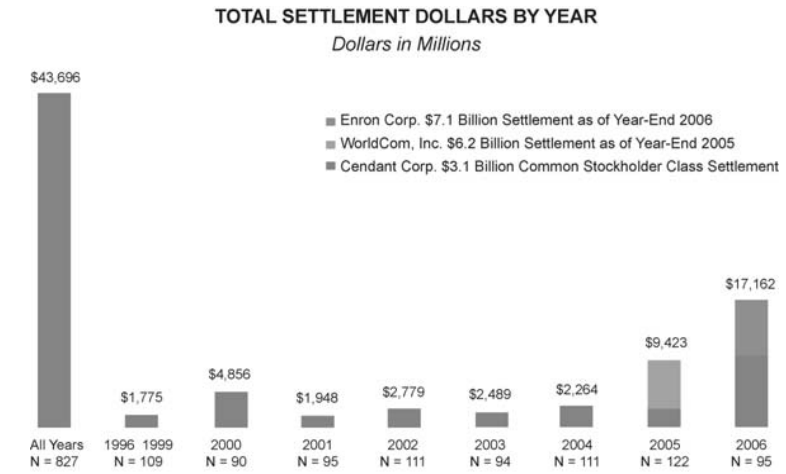
V. Pragmatic Effects and Practical Considerations for In-House Counsel

Is the era of the big securities class action settlement over?

- Impact of Supreme Court decisions – Is the pendulum swinging away from plaintiffs?
- View of settlement chart

Top 15 Securities Class Action Settlements As of July 2007

Rank	Company Name	Ticker	Settlement Date	Settlement Amount (In Millions)	Market Cap Loss (In Millions)	Settlement as % Market Cap Loss
1	Enron	ENRNQ	2005	$7,145	$61,024	11.7%
2	WorldCom	WCOEQ	2005	$6,156	$99,080	6.2%
3	Tyco International Ltd.	TYC	2007	$3,200	$35,156	9.1%
4	Cendant	CD	2000	$3,187	$18,824	16.9%
5	AOL Time Warner	TWX	2006	$2,650	$80,796	3.3%
6	Nortel	NT	2006	$2,450	$37,815	6.5%
7	Royal Ahold N.V.	AHO	2006	$1,110	$7,952	13.8%
8	McKesson HBOC	MCK	2006	$960	$8,800	10.9%
9	Lucent	LU	2003	$667	$61,535	1.1%
10	Dynegy	DYN	2005	$474	$10,382	4.6%
11	Adelphia Communications	ADELQ	2006	$460	$5,653	8.1%
12	Raytheon	RTN	2004	$460	$15,101	3.0%
13	Waste Management II	WMI	2001	$457	$12,143	3.8%
14	Freddie Mac	FRE	2006	$410	$7,382	5.6%
15	Quest	Q	2006	$400	$22,782	1.8%



See Laura E. Simmons and Ellen M. Ryan of Cornerstone Research, Securities Class Action Settlements: 2006 Review and Analysis at 1, available at http://www.cornerstone.com/Cornerstone_Research_Settlements_2006.pdf

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2006 Statistics

- During 2006, the total number of securities class actions fell to a record low of 106 since 1996, down from the 169 cases filed during 2005, representing a 37 percent decrease between years and a 43 percent drop from the ten-year average of 187.

See Grace Lamont and Patricia Etzold of PwC Advisory Crisis Management, 2006 Securities Litigation Study at 3, available at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2006_Final.pdf

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2006 Statistics – con't

- With respect to option backdating cases, 108 derivative cases were filed in state court, but only 20 cases were filed in federal court as private securities class actions.

See Grace Lamont and Patricia Etzold of PwC Advisory Crisis Management, 2006 Securities Litigation Study at 3, available at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2006_Final.pdf

2006 Statistics – con't

- While involved in only 35 percent of settlements in 2006, union pension funds and public pension funds as lead plaintiffs account for 81 percent of the total settlement dollars.

See Grace Lamont and Patricia Etzold of PwC Advisory Crisis Management, 2006 Securities Litigation Study at 3, available at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2006_Final.pdf

2006 Statistics – con't

- Though the number of federal securities class actions filed was down in 2006, the total volume of federal and state securities class actions, including options backdating cases, is in line with the average 218 cases filed per year since 2002, with 214 cases filed in 2006.

See Grace Lamont and Patricia Etzold of PwC Advisory Crisis Management, 2006 Securities Litigation Study at 3, available at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2006_Final.pdf

2006 Statistics – con't

- Understatement of liabilities and expenses was the most commonly alleged accounting violation in 2006 due to cases involving options backdating.

See Grace Lamont and Patricia Etzold of PwC Advisory Crisis Management, 2006 Securities Litigation Study at 3, available at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2006_Final.pdf

2007 Statistics

- The 59 filings recorded in the first half of 2007 (January through June 22, 2007) represent a 42 percent drop from the average semi-annual filing rate of 101 (mid-year periods July 1996 through June 2005).
- The number of filings in the first half of 2007 was slightly above the second half of 2006 total of 53.

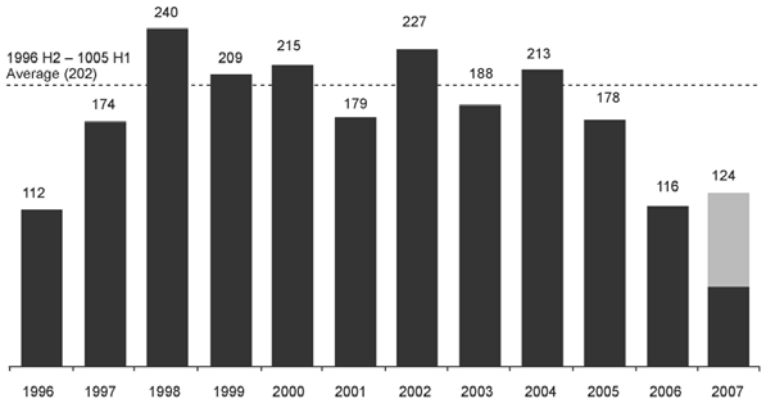
See Cornerstone Research, Securities Class Action Case Filings: 2007 Mid-Year Assessment at 2, available at http://securities.cornerstone.com/pdfs/2007%20Mid-Year%20Assessment.pdf

2007 Statistics – con't

- For the two-year period beginning the second half of 2005, the average semi-annual filing rate was 61 filings, 40 percent below the average observed over the preceding nine-year period.

See Cornerstone Research, Securities Class Action Case Filings: 2007 Mid-Year Assessment at 2, available at http://securities.cornerstone.com/pdfs/2007%20Mid-Year%20Assessment.pdf

CAF Index™ — Number of Class Action Filings
1996 - 2007 YTD



See Cornerstone Research, Securities Class Action Case Filings: 2007 Mid-Year Assessment at 5, available at http://securities.cornerstone.com/pdfs/2007%20Mid-Year%20Assessment.pdf

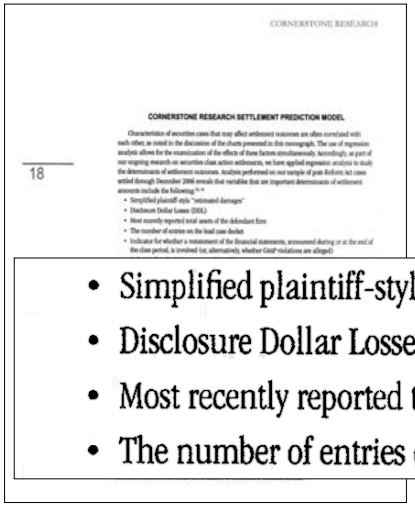
Pensions and Investments quotes Professor Joseph A. Grundfest on the nature of the drop in securities class actions that has been reported by Stanford Law School's Securities Class Action Clearinghouse:

- Increased enforcement activity by the SEC and the Department of Justice and "a heightened awareness among corporate insiders may have led to a shift in the incidence of securities fraud litigation," Joseph Grundfest, Stanford Law School professor and director of the clearinghouse, said in a statement about the report.
- "We've now had two years worth of extremely low filing activity," Mr. Grundfest said in the statement. **"This starting to look like a permanent shift, not a transitory phenomenon."**

See Press Release, Stanford Law School Securities Class Action Clearinghouse: In Cooperation with Cornerstone Research, Stanford Law School and Cornerstone Research Release Mid-Year Securities Fraud Class Action Filings Report (July 9, 2007), available at http://securities.cornerstone.com/pdfs/CSR%20Release%20MY1R%202007.pdf

Corporate Defendants' "Plan of Attack" Checklist

- ✓ Motion to dismiss
  - Impact of *Dura*
- ✓ Class Certification
  - Impact of *In re IPO* and *Dura* combined
- ✓ Summary Judgment
- ✓ Settlement
  - Impact of *Dura* on plaintiff-style damage methodologies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CORNERSTONE RESEARCH SETTLEMENT PREDICTION MODEL

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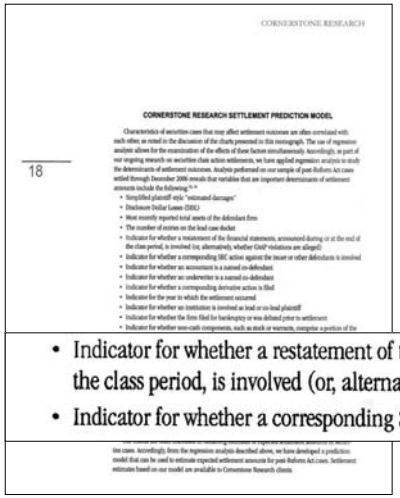
- Simplified plaintiff-style "estimated damages"
- Disclosure Dollar Losses (DDL)
- Most recently reported total assets of the defendant firm
- The number of entries on the lead case docket

See Laura E. Simmons and Ellen M. Ryan of Cornerstone Research, Securities Class Action Settlements: 2006 Review and Analysis at 18, available at http://www.cornerstone.com/Cornerstone_Research_Settlements_2006.pdf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CORNERSTONE RESEARCH SETTLEMENT PREDICTION MODEL

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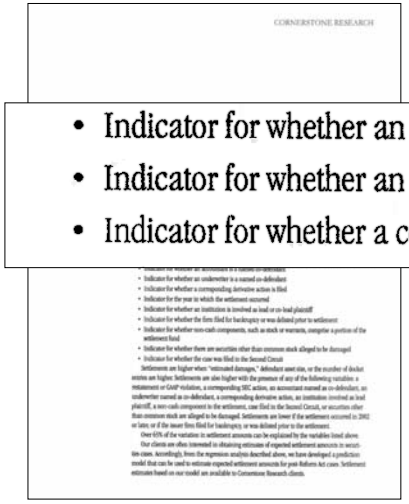
- Indicator for whether a restatement of the financial statements, announced during or at the end of the class period, is involved (or, alternatively, whether GAAP violations are alleged)
- Indicator for whether a corresponding SEC action against the issuer or other defendants is involved

See Laura E. Simmons and Ellen M. Ryan of Cornerstone Research, Securities Class Action Settlements: 2006 Review and Analysis at 18, available at http://www.cornerstone.com/cornerstone_research_settlements_2006.pdf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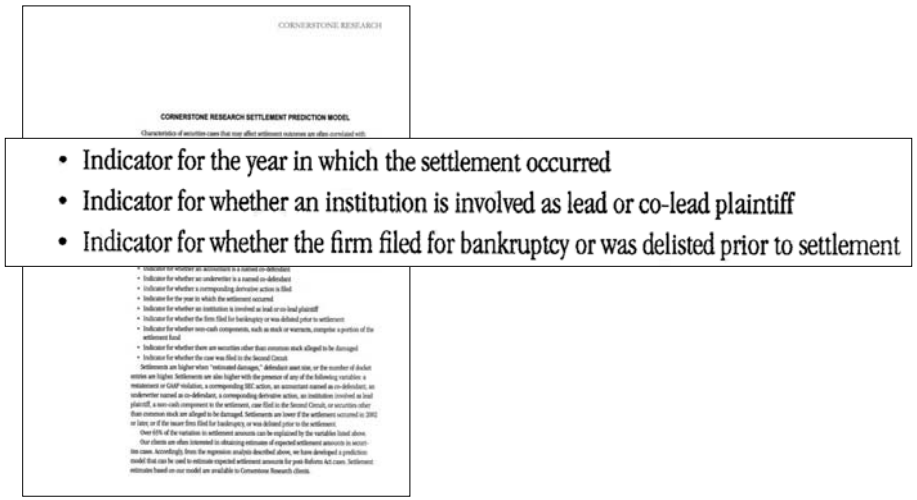
- Indicator for whether an accountant is a named co-defendant
- Indicator for whether an underwriter is a named co-defendant
- Indicator for whether a corresponding derivative action is filed

See Laura E. Simmons and Ellen M. Ryan of Cornerstone Research, Securities Class Action Settlements: 2006 Review and Analysis at 18, available at http://www.cornerstone.com/cornerstone_research_settlements_2006.pdf



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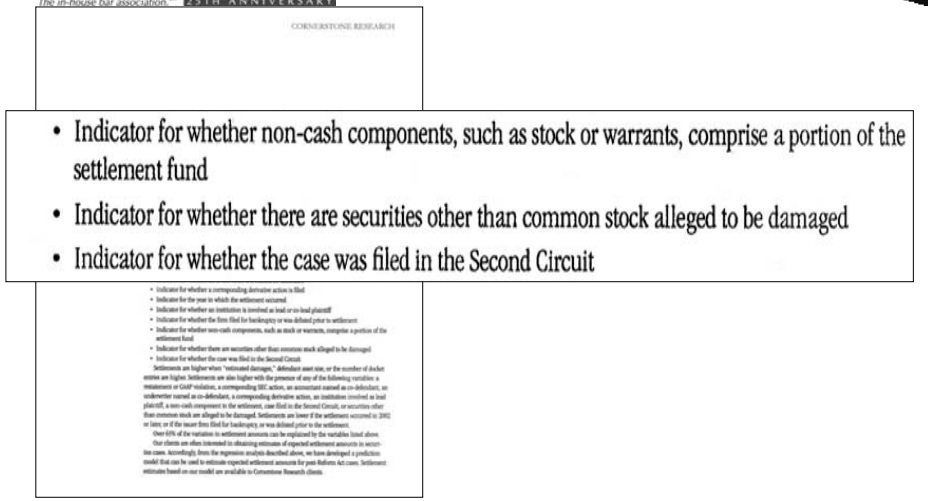

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