Securities Litigation

EXECUTIVE SUMMARY

In this month's discussion, our panel of experts discuss the implications of the Seventh Circuit Court's decision on the safe harbor provision of the Private Securities Litigation Reform Act; the role of the auditor in securities litigation; and the trend of increasing globalization in securities markets regulation and litigation.

Our panelists are Dale Barnes and Jordan Hershman of Bingham McCutchen; Susan Muck of Fenwick & West; Jeffrey Lawrence of Lerach Coughlin Stoia Geller Rudman & Robbins; Michael Torpey and Robert Varian of Orrick, Herrington & Sutcliffe; James Meehan of PricewaterhouseCoopers; and Jahan Raissi of Shartsis Friese. The roundtable was moderated by Chuleenan Svetvilas and reported for Barkley Court Reporters by Krishanna DeRita.

MODERATOR: What's the impact of the Seventh Circuit Court's decision in *Asher v. Baxter*, which created a Circuit split regarding the "safe harbor" provision of the PSLRA?

BARNES: The *Baxter* case caused us concern from the defense viewpoint. The whole point of the safe harbor was to protect defendants from the costs and the burden of discovery in situations where they had made adequate disclosure of the known risks. But the *Baxter* case said, well, we have to have discovery to figure out what was known.

LAWRENCE: The *Baxter* case dealt with a problem in the way the statute could be interpreted. The way the statute was written, one could argue that if you knowingly lied to the marketplace but somehow were able to come up with a risk disclosure, you could say, "While I did, in fact, lie and I knew I was lying at the time. I'm not culpable for that lie, because I've come up with a risk disclosure that I think is sufficient to protect me under the safe harbor."

But a knowing and intentional lie seems to be something that Congress legislated against, and the *Baxter* case says in those circumstances that we are not going to let risk disclosures necessarily preclude liability as a matter of law. It may, after you find out more information, but not on a motion to dismiss. The Seventh Circuit's *Baxter* decision made some sense out of what was at least an ambiguity in the law. It makes it clear that you won't be able to say, "I knowingly and intentionally lied to the market, and by the way, I am going to be able to escape any liability."

The District Court's decision on the *Baxter* case is also interesting in its safe harbor analysis because it deals with the standards needed to establish actual knowledge. There were two prongs to safe harbor—one is the cautionary language and the other is the actual knowledge on the part of the defendant. When they brought the motion to dismiss in *Baxter*, the defendants argued both prongs.

The District Court ruled on the cautionary language portion, and the Seventh Circuit wrote its opinion on that issue. On remand, the defendants came back and raised the actual knowledge prong. The district court analyzed a half dozen cases and distilled out what was needed. It then denied the motion to dismiss, finding that the plaintiffs had sufficiently alleged defendants' actual knowledge of the false statements.

VARIAN: I don't think that's what it says exactly. All of us on the defense side believe that there are two branches of the safe harbor—one is actual knowledge and one is cautionary language—and you don't have to win on both. At least theoretically and conceptually, it is a license to lie. We don't know anybody who's ever done that, of course, but that's the way the statute was written. Perhaps Judge Easterbrook was trying to reconcile the anomaly that you've identified, but I don't think that the decision changes the fact that there are two prongs and you can win on either one of them.

HERSHMAN: The safe harbor provision was designed to encourage companies to make forward-looking statements, which is something that they were previously more reluctant to do because of fears that they would get second guessed and sued if their guidance to the Street regarding their expected financial performance and other matters ultimately didn't materialize. In the vast majority of instances when those sorts of predictions about the future don't materialize, it's got nothing to do with fraud. Sometimes expectations aren't met, and so that is why Congress enacted a provision that was designed to be a safe harbor, to encourage companies to make the sort of forward-looking statements that the market wants.

Baxter eviscerates the safe harbor provision. In one recent case, *In re Gilat Satellite Networks*, the Eastern District of New York distanced itself from *Baxter*, stressing: "Such a reading of the statute would render the safe harbor meaningless." And that's exactly right. If courts could not rule, as a matter of law, on the safe harbor's application, then safe harbor would provide no support for the grant of a motion to dismiss fraud claims based on forward-looking statements. The safe harbor would thus be essentially useless, as most securities class actions that survive a motion to dismiss end up settling.

TORPEY: I think *Gilat* had it slightly wrong, because if *Baxter* is right, the discovery survives. It's the discovery stay that is eliminated.

Xing Xiang Zhou

It seems to me like this is a terrific boon for the plaintiffs bar in that now they always allege a forward-looking statement. We bring a motion to dismiss saying either that there was meaningful cautionary language or no actual knowledge. Plaintiffs will then say, "Time out. I get discovery and we'll come back to this motion to dismiss on the safe harbor after I get to look at all of your documents showing the intent of all of the officers of the company." That is a disaster for defendants and contrary to plaintiffs' prior pleading tendencies.

HERSHMAN: That approach would be flawed, however, because, were safe harbor issues to be resolved on the basis of this discovery, they would almost never be resolved on summary judgment. In most cases, a court would most likely conclude that a genuine issue of material fact exists as to whether the cautionary language at issue was "meaningful," given the competing arguments that each side would make about what the defendants allegedly knew at the relevant time.

VARIAN: Yeah, but when Jeff is finished taking the discovery that he would be able to get under the *Baxter* decision, he's going to turn over a whole bunch of new things and be able to construct a great complaint. At least in the Seventh Circuit, it might be a really bad idea to file a motion to dismiss that invokes the safe harbor because you are inviting in a Trojan horse. You are going to be subject to a lot of discovery, which as Jordan correctly pointed out, was not intended by the Reform Act. Its primary purpose was to prevent that from happening.

TORPEY: The irony of this is the plaintiffs bar, for the last three or four years, has been running away from the forward-looking statements. They have been trying to figure out any way they can to make forward-looking statements sound historical, because they didn't want to deal with the safe harbor. Now, if you are a plaintiffs lawyer, you want to run to it, because all of a sudden, it's going to open up discovery at a much earlier state, theoretically, if *Baxter* has legs or not.

HERSHMAN: I definitely think that the plaintiffs bar will seek to get courts in other jurisdictions to follow *Baxter*, and some mistakenly might. That said, the vast, vast majority of safe harbor rulings since *Baxter* have not mentioned or followed *Baxter*.

MODERATOR: Investigations are a critical part of securities litigation. What is the role of the auditor in an investigation?

TORPEY: The auditors have a role that they didn't used to have in all of this. They are often an obstacle in the lawyer's path to figuring out how to get through the end of this. The relationship between companies and the auditors has become much more adversarial.

MEEHAN: It is an enormous challenge when your client is going through a 10A situation. It is very different from when clients have faced private securities class actions in the past. There is a myriad of risks and consequences of how the auditor needs to deal with the investigative team and the company. This all impacts the timing and appropriateness of press releases and public filings. I believe all the audit firms are refining how they deal with these situations.

BARNES: We represent both issuers and auditors. It's important for a company to focus on the relationship with its auditor in these circumstances. Although the auditor has an independent duty to understand the facts and circumstances as they may pertain to the financial statements, I don't think a company should view its auditor as an adversary. We have seen investigations from the auditor's perspective and in which our auditor clients have resigned when they did not feel the company was being sufficiently cooperative. Having your auditor resign in the midst of your investigation with the SEC breathing down your neck is not what you want. When we represent issuers in an investigation, we make sure that we are working productively with the auditor.

RAISSI: Auditors are in a difficult position because they have a public company client who needs their services in a crisis situation. But they are also correctly thinking about their own liability, vis-à-vis the SEC, because the SEC is quite aggressive now in pursuing accountants for audit failures.

BARNES: Arthur Andersen was a wake up call for everyone.

MUCK: That's true. What I find really unfortunate is a situation where the auditors, because of their own risk profile, feel that they want to resign or consider resignation where there hasn't been actual wrongdoing, but the anxiety level is high. You've got a public company with public shareholders that may not have done anything intentionally wrong and maybe not even anything negligent, and yet you are going to have a press release announcing the resignation of an auditor.

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ROUNDTABLE

BARNES: It's important to keep your auditors happy if you possibly can. Keep the lines of communication open and try to avoid ultimatums on both sides.

LAWRENCE: This situation was a little bit foreshadowed by the PSLRA. When the statute got passed, there were provisions in it for the auditors to take particular action in order to avoid their own liability that almost necessarily put them adverse to the company. I've personally seen situations after the PSLRA where you had an 8-K filed by an auditor that said, "We are resigning, and this is why." The company has filed it, which they are required to do, and the company files a response and says, "This is why this happened," and the auditor, in turn, files another response, and essentially, you've got the entire dispute laid out in front of SEC.

MEEHAN: The time line for this whole process has changed. Whereas in the past most of the new facts would come out during the discovery phase of a private securities class action, now all the work is done up front in the investigation. To best deal with this all parties need to, as best they can, stay on the same page. This means outside counsel that performs the investigation, the forensic accountants, the audit committee, corporate counsel, management, and the outside auditors. This can be further complicated when individual members of management get their own counsel.

However, these communication issues have to be actively managed or indeed the company may wind up having surprises when their outside auditors do not appear to be reaching the same conclusions as all the other parties.

BARNES: To complicate matters further, the SEC has indicated that an attorney conducting the investigation may face some of the same issues. In late 2004, the SEC reportedly notified the attorney who conducted the Endocare investigation that he might face civil sanctions for his role in the investigation. Without any precise definition of just what does constitute an adequate and thorough investigation, these kinds of warning shots make the playing field a bit more uncertain for audit committees and their counsel.

HERSHMAN: It's just become so much more complicated in this environment to make these determinations because of many of the competing factors that are at play. It used to be that, in most instances, as securities lawyers on the civil side, we would do everything we could with our clients to seek to cooperate with the SEC investigation. But now, it's become a whole lot harder in the early stages to determine whether or not you are going to allow a client to testify, even when you really don't think that there was any wrongdoing, the risks associated with testifying are so high.

Oftentimes, when the audit committee conducts its investigation when new management is in place, it appears that new management is doing everything it can to protect the company, and the investigation seems to be geared towards essentially hanging old management out to dry. You have new independent counsel coming in, working for the audit committee, and doing an investigation. If you represent some member of the former management team, it becomes harder to determine whether you are going to agree to put your client forward to participate in that type of investigation.

MUCK: It's one of the most difficult questions raised by these internal investigations. If counsel who represents the audit committee conducts an investigation, then presumably, you help give assurance to the outside auditors that the audit committee has conducted an independent investigation. You can also provide some assurance to the government, in the event that you have to self-disclose something, that the investigation is independent. But at the same time, you don't necessarily insulate your clients, the audit committee, from all exposures or liability.

They are going to be sued in class actions if the stock price drops. They are going to be sued in derivative actions if there's any kind of announcement about management errors or potential breaches of fiduciary duty, and depending on the type of claim, you may still have your own clients, the audit committee, being exposed. At the same time, you may have documents, memos, and any number of materials that may or may not have to be provided to the SEC. You are going to be asked to waive the attorney-client privilege. It's an extraordinarily complicated mess because of the fragmentation of representation.

LAWRENCE: I'm not so sure things are geared to "hang old management out to dry." Rather, you have the new management looking out for the company and making an independent assessment about what has happened and what is in the best interests of the entity. Before you had all the people, including those who were alleged to have committed fraud, standing together shoulder to shoulder, CEOs and CFOs, and basically making it very difficult to figure out that there was a problem and who caused it.

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VARIAN: But when you have somebody who's still a manager or executive in the company and there's an internal investigation going on and maybe it's not as clear whether that person did very much wrong, there's still a terrible risk out there if that person does not fully cooperate in the investigation.

RAISSI: How could you have a CEO of a public company not cooperate in an investigation and remain the CEO? That just can't happen. The real difficulty is that you have in the neighborhood of 24 or 48 hours to make a decision to cooperate, you don't have a lot of information and you are forced to make the call almost on the fly. In probably nine out of ten situations, you are going to go ahead and make the decision to talk and not take the Fifth, but that decision is very difficult. Once you talk, you can't take it back, and you must assume that the company will provide notes of the interview to the SEC.

TORPEY: And you haven't reviewed your own e-mail. As an individual CEO or CFO, you could be saying lot of things that might at the end of the day come back to bite you that you don't think are unlawful and were in the normal course of what you were doing. You are almost always working with, at best, partial information.

MUCK: The other problem with former employees coming in and not cooperating is, I think irrespective of what impression the lawyers will get—and hopefully lawyers will know that there are all sorts of reasons why this former employee may be unwilling to talk—if there's an independent investigation, the outside auditors or the forensic auditors or both are clearly going to draw a conclusion adverse to that employee or former employee, and that's something over which the lawyers will oftentimes have little or no control, but will have a lot of impact on how the investigation proceeds.

MEEHAN: I don't know that simply because a former employee is unwilling to talk that the outside auditors will draw a negative conclusion. Before doing that they will certainly first look to the other evidence that comes out of the investigation and listen to the conclusions drawn from that evidence by the investigators and the audit committee.

MODERATOR: What are the implications of the trend towards increasing globalization in securities markets regulation and litigation?

TORPEY: A new statute was passed in Germany that has created a class action mechanism for the first time, and it was passed in response to the *Deutsch Telecom* case where Deutsch Telecom restated its financial statements, got sued in New York in a U.S. securities class action, and then got sued in 20,000 individual actions in Germany, which overwhelmed the court in Frankfurt. The court was motivated to get the legislature in Germany to create a mechanism for them to be able to handle it.

Contingency fees for lawyers are not allowed there but now financiers in Germany will look at your case and advance the money in order to pay the lawyers to bring the action against the company. Not surprisingly, those financiers have relationships with various lawyers, and they are communicating with one another and finding ways in which to work around the no-contingency-fee mechanism in Germany.

VARIAN: There's a push in Europe to enact legislation like there is in Germany, and it's pretty unclear how far they are willing to go. They don't like class actions. They don't like plaintiff class action lawyers. They don't like contingency fees.

RAISSI: The Dutch have also moved in the direction the Germans have. The impetus was the *Royal Ahold* case, where you had a slew of Dutch who had no means of effective recovery in their home court. But you make a good point that a lot of mechanisms used here, contingency fees, class certification, the fraud on the market doctrine, don't yet exist there.

TORPEY: The other problem is that it's not at all clear that a class settlement in the U.S. can be binding on a foreign shareholder. In a couple of cases, *Royal Ahold* and *Parmalat,* for example, there has been thinking about settling the U.S. case, bringing all the foreign investors into it, paying them, and getting rid of the case. The problem is that you can't get a release from a class that is clearly binding on any of the foreign shareholders because there's no mechanism for class actions in some of those countries. As a consequence, you don't have a release that is going to bind a nonparty the way the releases bind class members here in the U.S. It will be years before all of this is sorted out.

RAISSI: Many European countries don't yet embrace the concept of damages in securities

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cases. Usually rescission is the only remedy. So in that case they may recover damages in the United States, but do they still have a rescission right in Europe? These are issues that will eventually be harmonized because the markets are converging globally.

For example, the EU is moving toward common listing standards for all 25 countries in order to try and create one common market, and competing with the United States to be the premiere listing spot for public companies. As that happens, it's inevitable that they will develop mechanisms to protect shareholders as we have here.

The regulators and the governments are already working together quite closely, and they have been for years. The SEC's Office of International Affairs has been making informal and formal agreements with European and other countries for 15 years now. It takes a little bit longer for the SEC to investigate foreign companies, but they can get almost everything they can get here in most European countries now.

MUCK: Another fascinating global issue is Asia and how much the growth of Asian companies with U.S. investors will impact securities litigation and SEC enforcement activity. U.S. companies, including many Bay Area companies, are at the forefront of expanding operations dramatically in Asia. Regulators or outside counsel conducting investigations or defending class actions involving Asian employees or offices have to deal with some legal issues specific to those countries, which is often difficult. It's very, very different from Western or European notions of how you conduct an investigation or how litigation will go forward.

MEEHAN: Another facet of this issue is the Foreign Corrupt Practices Act (FCPA). The SEC and the DOJ are focusing more attention on FCPA matters over the past couple of years. This trend will likely continue. On investigations we have done in China, it seems you can't turn around without dealing with a government official. The FCPA's anti-bribery provisions are front and center whenever a company makes payments to a government official. In addition, companies' internal controls can be less robust when you go into their Asian subsidiaries. That puts them right in the crosshairs of the books-and-records provision of the FCPA.

RAISSI: The SEC is getting close to accepting international accounting standards for foreign companies listing here, which means companies will not have to follow U.S. GAAP [Generally Accepted Accounting Principles] to have their securities traded here. Once that barrier is down, you are going to see the number of foreign issuers grow dramatically, which means the number of SEC and private cases involving those companies is going to grow.

MUCK: I don't think businesspeople here are prepared for differences in business practices outside the U.S. that could trigger FCPA violations. For example, commercial bribes are not prohibited in all countries, and what is appropriate documentation of expenses varies in different countries. You may see a payment, X amount of dollars, to a government official or a potential customer who also happens to be a government official. It's not described correctly in the local office books and records. You haven't violated the law in that country, and perhaps may not have violated GAAP, but you may have violated the Foreign Corrupt Practices Act. So you are looking at securities law violations as a result. It's going to require enormous changes to the way U.S. companies oversee their foreign operations.

MEEHAN: What I've found is that companies thus far are struggling to grasp how the FCPA might eventually impact them. What they seem to be thinking is, "Our total spend in South America is only a small percentage of our business. It can't be that big of a problem." Yet what they are gradually learning is it's the $1,000 bribe that generated a $2 billion dollar contract that's going to cause you the problem. The expenditure for the bribe may be quite small, but the windfall can be huge. That's what's going to run companies afoul of FCPA. ■