INSIDE THE MINDS

New Developments in Securities Litigation

Leading Lawyers on Adapting to Trends in Securities Litigation and Regulatory Enforcement

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Challenges and Concerns for Securities Law Defense Attorneys

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Introduction[1]

One thing is constant in securities litigation…that is, constant change. As securities cases arising out of the financial crises wind down, new developments, such as cybersecurity issues, begin to fuel a new generation of cases. Meanwhile, corporations, boards, and stockholders respond to developments in merger and derivative litigation with new tactical approaches that continuously invigorate the field of corporate governance litigation. Similarly, when the SEC begins to lose cases in federal court, rather than scale back its enforcement initiatives, the SEC shifts emphasis to a more friendly forum—the administrative proceeding where the deck is stacked favorably to the SEC. The challenge for legal counsel on both sides of the bar is to keep abreast of the constant ebb and flow to deliver the highest quality of legal services to clients caught in the securities litigation mine field.

Recent Trends in Securities Litigation

Several areas stand out in the sea of trends and developments in securities litigation, including shifts in the landscape of merger litigation, continuous advertising for representative plaintiffs, cybersecurity breaches as a driver of new case filings, and revitalization of derivative litigation.

Merger Litigation Trends

Among recent trends in securities litigation, one of the most significant has been the huge increase in shareholder litigation challenging public company mergers and acquisitions. A leading research firm reports that more than 90 percent of M&A transactions involving public companies end up in litigation—a pace that has remained roughly constant since 2010.[2] So-called "merger objection" lawsuits typically are filed by stockholders of a selling company claiming that the directors and officers breached their fiduciary

[1] The authors wish to thank Min Choi, an Associate in the Washington, D.C. office of Pepper Hamilton LLP, for his contributions to this article.

[2] CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING ACQUISITIONS OF PUBLIC COMPANIES, REVIEW OF 2014 M&A LITIGATION 1, *available at* https://www.cornerstone.com/GetAttachment/897c61ef-bfde-46e6-a2b8-5f94906c6ee2/Shareholder-Litigation-Involving-Acquisitions-2014-Review.pdf [hereinafter 2014 M&A LITIGATION].

duties in negotiating the merger price and terms, that the price is too low, and that disclosures to stockholders regarding acceptance or approval of the proposed merger are deficient. The law of the state of incorporation governs whether, in the context of a sale, directors owe their fiduciary duties to the company itself or to its stockholders. Accordingly, M&A lawsuits are filed as either direct stockholder class actions or as derivative suits in the name of the selling company.[3]

Historically, most M&A cases have been resolved by settlement before the close of the merger based on the defendants' agreement to make additional disclosures, or modest adjustments in the deal terms, and pay a negotiated attorney's fee to the plaintiffs. Recently, more M&A cases are being litigated as traditional class actions for money damages after the merger closes.[4] There has also been a recent rise in post-merger appraisal actions by individual investors who exercise their statutory right to decline the merger consideration and seek a judicial appraisal of the stock in the hope of significantly beating the merger consideration price.[5]

M&A actions have often been marked at the outset by a rush of plaintiffs competing to file lawsuits quickly to jockey for control of the litigation, resulting in multiple, duplicative suits filed in different forums asserting the same claims. For example, if a California-based company incorporated in Delaware announces a potential sale, merger lawsuits likely would be filed in state and federal courts in both Delaware and California, and possibly

[3] For example, because the duties of directors in the sale of a Delaware corporation run directly to the stockholders, merger cases typically are filed as class actions. *Revlon v. McAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). In contrast, the duties of directors in the sale of a Pennsylvania corporations run to the company and merger cases typically are filed as derivative suits. *In re Heinz Company Deriv. & Class Action Litig.*, No. G.D. 13-0003108, 2013 WL 1905075 (Pa. Ct. Com. Pl. Apr. 29, 2013).

[4] 2014 M&A LITIGATION, *supra* note 2, at 4.

[5] In two recent cases encouraging this trend, *Merion Capital LP v. BMC Software, Inc.*, No. 8900-VCG, 2015 WL 67586 (Del. Ch. Jan. 5, 2015), and *In re Appraisal of Ancestry.com, Inc.*, No. 8173-VCG, 2015 WL 66825 (Del. Ch. Jan. 5, 2015), the Chancery Court ruled that Delaware's appraisal statute did not impose a "share-tracing" requirement on an appraisal petitioner's right to demand an appraisal of shares acquired after the record date for determining the stockholders entitled to vote on a merger. In so holding, the Court rejected a potential obstacle to the so-called practice of "appraisal arbitrage" that seeks to use Delaware's appraisal process to capitalize on perceived undervalued transactions by purchasing shares of the target company's stock immediately after announcement of a merger.

other jurisdictions. These "fast filer" dynamics leading to multi-forum litigation often have dominated the early phases of merger litigation as parties scramble to funnel litigation into one forum.[6]

This trend has begun to reverse, however, following an important June 2013 ruling by the Delaware Court of Chancery in *Boilermakers Local 154 Retirement Fund v. Chevron,*[7] which held that forum selection bylaws are statutorily enforceable. Since *Chevron*, hundreds of companies have adopted bylaws requiring that stockholder disputes be filed in a pre-selected forum, which has reduced the number of multi-forum filings in M&A cases.[8] While companies typically select the state of incorporation (most often Delaware), which also supplies the law governing intra-corporate rights and duties of directors, officers, and stockholders,[9] companies are free to choose other forums. In one recent case, the Delaware Court of Chancery upheld a bylaw adopted by a Delaware corporation headquartered in North Carolina which selected North Carolina as the required forum for shareholder litigation.[10]

Advertising to Solicit Plaintiffs

Another important development impacting the pace and initiation of securities class actions and derivatives suits has evolved over the years into an established practice of the plaintiffs' bar. This is the phenomenon of Internet "advertising" by plaintiffs' firms seeking stockholder clients to serve as representative plaintiffs. Following news of a potential merger, or adverse corporate event and decline in a company's stock price, plaintiffs' firms publish notices stating that they are "investigating" potential

[6] LEO E. STRINE, JR. ET AL., PUTTING STOCKHOLDERS FIRST, NOT THE FIRST-FILED COMPLAINT 43 n.118, 49-50 (2013), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Strine_740.pdf.

[7] *Boilermakers Local 154 Retirement Fund v. Chevron*, 73 A.3d 934 (Del. Ch. 2013).

[8] 2014 M&A LITIGATION, *supra* note 2, at 2.

[9] The internal affairs doctrine recognizes that only one state's law should control the internal duties among directors, officers, and shareholders who otherwise would be subject to potentially conflicting duties. *Edgar v. MITE,* 457 U.S. 624 (1982).

[10] *City of Providence v. First Citizens Bancshares, Inc.*, 99 A.3d 229 (Del. Ch. 2014). The Delaware Bar's Corporation Law Council has approved proposed amendments to the Delaware General Corporation Law that would preclude bylaws that provide for an exclusive forum for intracorporate disputes outside of Delaware. The current proposal, however, would permit bylaws that provide for alternative forum choices, *i.e.*, forums *in addition* to Delaware.

breaches of fiduciary duty or securities law violations by the directors and officers, and post a link for interested stockholders to learn more. The historical roots of this practice developed out of a requirement established by Congress in the 1995 Private Securities Litigation Reform Act that a plaintiff who files a securities fraud class action must publish notice of the action to give other potential plaintiffs an opportunity to compete for the role of "lead" plaintiff with the right to appoint "lead" counsel.[11] Perhaps exemplifying the law of unintended consequences, "advertising" for stockholder plaintiffs via the Internet has fueled the steady flow of class and derivative litigation involving public companies, officers, and directors ever since.

Cyber Security Breaches

One of the newest trends likely to accelerate the filing of new securities and derivative litigation arises out of cybersecurity data breaches. Companies and their professional advisors are bombarded daily with articles, proposed standards, and advice on what companies should be doing to protect their own informational assets and their customers' personal data. Meanwhile, hackers and thieves are breaching corporate security barriers leading to crisis headline stories involving household names like Target, Home Depot, Wyndham, Anthem, and Sony. This corporate crisis *de jure* – much like the widespread stock options backdating scandal of a decade ago – has led to the filing of securities class actions and derivative suits following the announcement of a breach. Plaintiffs claim that the companies misrepresented or underreported the existence of security breaches or weaknesses in internal controls, and allege mismanagement by the directors and officers charged with data security and oversight.

In one of the few cyber breach cases to have judicial review to date, a federal district court in New Jersey dismissed a derivative suit filed against directors and officers of Wyndham based on their alleged failure to prevent data breaches and protect private customer information. The suit was triggered by Wyndham's report that the FTC had brought an action against the company based on previously undisclosed data breaches.[12] Stockholders made multiple demands on the Wyndham board to sue the directors and

[11] 15 U.S.C. § 78 u-4(3).
[12] *Palkon v. Holmes*, No. 2:14-cv-01234, 2014 WL 5341880 (D.N.J. Oct. 14, 2014).

officers allegedly responsible for failing to prevent the breaches. The board considered the demands, with the advice of independent counsel, and declined to file corporate litigation (citing, among other things, ongoing defense of the FTC action). In an October 2014 decision, the court dismissed the ensuing derivative suit, with prejudice, in deference to the Wyndham board's business judgment to refuse the demands. The court reviewed evidence that the board was actively engaged in overseeing remedial data security measures, had a firm grasp on the issues in the stockholder demands, and had made a good faith business judgment in refusing to pursue the alleged claims. The Wyndham case illustrates effective management of crisis-driven derivative litigation involving a cybersecurity breach.

Rise of Derivative Suits

Derivative suits against corporate officers and directors are on the rise and, in recent cases, have led to substantial monetary recoveries and fee awards to plaintiffs' attorneys.[13] Historically, derivative suits often were filed in the wake of securities class actions and settled for minor prophylactic measures, such as corporate governance improvements, and a relatively small attorney's fee award. Recently, derivative suits have gained traction with the plaintiffs' bar after high profile cases resulted in large settlements, including $275 million for Activision Blizzard (2014), $139 million for News Corp. (2013), $137.5 million for Freeport-McMoRan (2015), and $62.5 million for Bank of America Merrill Lynch (2012), among others.[14]

Fueling the revived interest in derivative actions, the Delaware Court of Chancery has issued several important decisions enforcing pre-suit discovery demands for stockholder access to corporate books and records enabling plaintiffs to plead more fact filled complaints.[15] Although Delaware courts have long encouraged stockholders to use Section 220 of

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[13] *See* Kevin LaCroix, *Largets Derivative Lawsuit Settlements,* D&O DIARY (Dec. 5, 2014), http://www.dandodiary.com/2014/12/articles/shareholders-derivative-litigation/largest-derivative-lawsuit-settlements.

[14] *Id.*

[15] For example, the court in *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140 (Del. 2011), enforced a stockholder inspection demand under Section 220 to file a better derivative complaint after the first complaint was dismissed for failure to plead that a pre-suit demand on the board would have been futile.

the Delaware General Corporate Law to obtain pre-suit books and records discovery before bringing a derivative action,[16] recent decisions enforcing Section 220 demands have demonstrated surprising generosity to stockholders. For example, the Delaware Supreme Court recently upheld a Court of Chancery decision enforcing a demand by Walmart stockholders to take extensive discovery under Section 220 into an internal corporate investigation of alleged bribery in violation of the Foreign Corrupt Practices Act, including requiring Walmart to search back-up tapes, and to produce lower level officer documents and certain attorney-client privileged communications.[17] The Delaware Supreme Court found no abuse of discretion in the Court of Chancery's finding that this discovery was "necessary and essential" to the stockholders, and was sought for a "proper purpose" of investigating management wrongdoing. Armed with factual details through pre-suit "books and records" discovery, plaintiffs firms are better able to craft derivative complaints that survive rigorous pleading requirements.

Impacts of the Financial Crisis of 2008

There has been a sharp decline in securities litigation filings driven by the credit crisis from the peak years of 2008 and 2009, which began to taper in 2010.[18] Most recently, a few cases have been filed by federal agencies seeking to use the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA), which has an extended ten-year statute of limitations, to seek recovery of credit crisis losses.[19] Private sector litigation, however, clearly is winding down.

Similarly, fiduciary duty litigation against bank directors and officers is winding down. From January 2009 through February 2015, the FDIC, acting as the receiver of failed banks, filed more than one hundred suits

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[16] *Id.* at 1150 n.64 (citing cases).
[17] *Walmart v. IEBW,* 95 A.3d 1264 (Del. 2014).
[18] CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS–2014 YEAR IN REVIEW 4, *available at* https://www.cornerstone.com/GetAttachment/52bfaa16-ff84-43b9-b7e7-8b2c7ab6df43/Securities-Class-Action-Filings-2014-Year-in-Review.pdf [hereinafter 2014 TRENDS].
[19] 12 U.S.C. § 1833(h) (ten year statute of limitations for certain claims). For example, in 2013, the Department of Justice brought an action under FIRREA against Standard & Poor's seeking civil penalties of $5 billion for allegedly defrauding investors with respect to mortgage backed securities. *United States v. McGraw-Hill Companies, Inc.*, No. Civ. 2:13-00779 (C.D. Cal. 2013).

seeking recovery from individual directors and officers for alleged breaches of fiduciary duty in the management and oversight of failed banks. Much like derivative suits and M&A actions, the legal claims and defenses in these cases focus on state law business judgment principles and D&O fiduciary duty and liability standards. With the economic recovery, bank failures have slowed dramatically while the FDIC works through a backlog of D&O claims arising out of the 2008 and 2009 bank failures.[20] The FDIC's statistics reflect a winding down of its salvage operations: The FDIC was authorized to bring suit against 369 bank professionals in 2012, declining to 316 in 2013, and further declining to 123 in 2014.[21]

Economic and Political Factors Impacting Securities Litigation Trends

Given the current Republican-controlled House and Senate, there has been speculation that Congress will attempt to roll back parts of Dodd-Frank, although the President has said that he would veto any such efforts. On the flip side, with a presidential election year coming up in 2016, efforts could be made on the Democratic Party side to increase regulation of Wall Street. Such efforts could potentially result in making Wall Street financial firms and public companies more vulnerable to securities litigation by, for example, conferring more enforcement power to the Securities and Exchange Commission.

Federal Class Action Filings in Securities Litigation

Consulting and research firms track statistical information regarding federal securities class action filings by number, jurisdiction, industry, and other variables.[22] The filing statistics show a steady number of new securities class actions each year for the last six years, with most new

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[20] *See* CORNERSTONE RESEARCH, CHARACTERISTICS OF FDIC ACTIONS AGAINST DIRECTORS AND OFFICERS OF FAILED FINANCIAL INSTITUTIONS 16 (2014), *available at* https://www.cornerstone.com/GetAttachment/ab8af5e2-c9f5-4317-86aa-f7dd49be9b36/Characteristics-of-FDIC-Lawsuits-Feb-2014.pdf.

[21] *Professional Liability Lawsuits*, FDIC, https://www.fdic.gov/bank/individual/failed/pls (last updated Mar. 24, 2015).

[22] *See, e.g.*, 2014 TRENDS, *supra* note 18; Dr. Renzo Comolli & Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2014 Full Year Review*, NERA (Jan. 20, 2015), http://www.nera.com/publications/archive/2015/recent-trends-in-securities-class-action-litigation--2014-full-y.html [hereinafter *2014 Review*].

filings in the Ninth and Second Circuits. The decline in filings involving financial services companies that were hit hard in the credit crisis is being replaced by an increase in filings involving companies in the technology and health care industries.

Improvement of the financial markets has brought a sharp increase in the number of Initial Public Offerings (IPOs). For at least two reasons, newly public companies are statistically more likely to become targeted in securities class actions based on allegedly defective disclosures. First, investors who can trace their stock to newly registered offerings may sue under Section 11 of the 1933 Securities Act, which effectively imposes strict liability on issuers for material misstatements or omissions, and puts the burden on other participants in the offering process to prove their own diligence.[23] Second, new companies that are still ironing out routines for controls over public disclosures, including verbal earnings reports, are more prone to disclosure missteps.

On the other hand, there has been a marked reduction in new securities case filings against foreign issuers whose stock is traded in the United States. The Supreme Court's 2010 decision in *Morrison* limited the reach of Section 10(b) to domestic transactions and securities traded on domestic exchanges.[24] *Morrison* all but eliminated the extraterritorial application of the federal securities laws against foreign issuers. In the few cases filed since *Morrison*, courts have further considered the characteristics of domestic securities transactions in foreign stock still subject to regulation under Section 10(b).[25]

Similarly, the crush of lawsuits filed in 2010 through 2012 against companies headquartered in China whose stock trades on U.S. exchanges has fallen to a trickle.[26] Many of these companies became public overnight through a so-called "reverse merger" process in which a Chinese operating

[23] 15 U.S.C. § 77k. Statistics show a 2014 increase in section 11 claims. 2014 TRENDS, *supra* note 18, at 8.
[24] *Morrison v. Nat'l Australia Bank, Ltd.*, 561 U.S. 247 (2010).
[25] For example, in *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173 (2d Cir. 2014), the Second Circuit held that even when a foreign security is cross-listed on a domestic exchange, the purchase of that security on a foreign exchange is not a domestic transaction. This was true despite some plaintiffs having executed their purchases by submitting buy orders in the United States because the submission of buy orders did not itself establish irrevocable liability.
[26] 2014 TRENDS, *supra* note, 18 at 5.

company merged into a U.S. public shell. The shell company's stock trades on a U.S. exchange while all revenue generating operations are located in China, beyond the reach of investors and U.S. regulators. Heavy SEC regulatory enforcement and investigation activity against Chinese reverse merger companies fueled an explosion of private investor suits. As SEC regulatory attention has turned elsewhere, private class actions against Chinese reverse merger companies also has subsided.

Impacts of Recent Supreme Court Decisions

Two recent, important Supreme Court decisions are sure to have significant impact on securities litigation for years to come. In *Halliburton II*, decided June 23, 2014, the Court declined to reverse its twenty-five-year-old decision in *Basic v. Levinson* which established the fraud-on-the-market presumption of investor reliance as a substitute for actual reliance on allegedly misleading public disclosures.[27] This presumption has enabled securities claims to proceed as class actions based on a class-wide presumption that investors rely on the integrity of a stock's trading price on a public exchange as reflecting all generally known material information—including a defendant's allegedly false statements and omissions.[28] Absent this presumption, individual issues of reliance could overwhelm the case and potentially put an end to securities class action litigation.

The Court left *Basic* intact, but held that defendants may seek to rebut the presumption of reliance at the class certification stage by presenting evidence that an allegedly false statement did not impact the stock price. This decision creates an additional hurdle for class action plaintiffs at the class certification stage, but the height of the hurdle remains to be seen. On remand in *Halliburton II*, the federal district court presided over a one-day class certification evidentiary hearing consisting of a battle of experts. It will take time for courts to sort out how much evidence will be admitted at the class certification stage and the extent to which challenges to the admissibility of expert opinions will be allowed under the so-called *Daubert*

[27] *Halliburton Co. v. Erica P. John Fund,* 134 S. Ct. 2398 (2014) (*Halliburton II*). *Halliburton I* involved a separate but related decision in the same case in which the Supreme Court held that securities class plaintiffs need not prove materiality at the class certification stage. *Halliburton Co. v. Erica P. John Fund*, 131 S. Ct. 2179 (2011).
[28] *Basic v. Levinson*, 485 U.S. 224 (1988).

factors.[29] One thing is certain; *Halliburton II* paves the way for many future battles that will develop the contours of this new defense side tactical tool.

In another landmark decision, *Omnicare*, decided March 24, 2015, the Court opined on the standards for pleading a claim under Section 11 of the 1933 Securities Act based on an allegedly false opinion in a stock registration statement.[30] Omnicare included an opinion in a registration statement for a public offering that its contractual arrangements with healthcare providers, pharmaceutical companies and suppliers were "in compliance with federal and state laws." Omnicare later paid $150 million to settle a federal regulatory action alleging that the company was paying and receiving illegal kickbacks. In ruling on the adequacy of allegations in a follow-on securities class action under Section 10(b), the Sixth Circuit held that the plaintiff adequately pled an actionably false opinion by alleging that the opinion turned out to be objectively incorrect. The Sixth Circuit's ruling established a split with the Second, Third, and Ninth Circuits that have required a plaintiff to allege subjective falsity—*i.e.*, that the speaker did not actually believe, or have a reasonable basis to believe, that the opinion was true when made.

The Supreme Court vacated the Sixth Circuit's decision and set out a complex analytical framework with two separate standards for pleading an actionably false opinion: (1) a subjective falsity standard for a "pure" opinion containing no "embedded statements of [untrue] fact," and (2) a "reasonable investor" standard for opinions that omit material facts. To plead an actionably false "pure opinion," a plaintiff must allege facts demonstrating that the speaker did not "honestly" hold the opinion. To plead that an opinion is actionably false due to omitted facts, a plaintiff must plead facts allegedly known to the speaker that would make the opinion misleading to a "reasonable investor." These standards are sure to result in extensive lower court interpretive rulings and likely will have

[29] The Supreme Court in *Daubert v. Merrell Dow Pharm.*, 509 U.S. 579 (1993), established standards for the admissibility of expert testimony which are invoked to exclude so-called "junk science" that might confuse or unduly influence a trier of fact.
[30] *Omnicare v. Laborer Dist. Council Constr. Indus. Pension Fund,* 135 S. Ct. 1318 (2015), available at *http://* www.supremecourt.gov/opinions/14pdf/13-435_8o6b.pdf, on appeal from the Sixth Circuit decision of the same name, 719 F.3d 498 (6th Cir. 2013).

implications beyond Section 11 claims to litigation of claims under Section 10(b) and other securities laws involving allegedly false opinions or beliefs.

Helping Clients Prevent Securities Fraud Charges

Companies can mitigate both the risk and consequences of securities fraud claims by maintaining strong and sensible controls over disclosure. Good disclosure control starts with a clear tone of integrity and disclosure compliance at the top levels of the organization. Companies should establish and review the effectiveness of disclosure committees to make sure that material developments are known and vetted in a timely manner.

Further, disclosure in times of corporate crisis—such as a restatement, a data security theft, an adverse government action, or a surprising public exposé—is especially sensitive. Companies should strive to avoid sugar coating or cabining the magnitude of a problem when the facts are not fully known. The better path is almost always to disclose the problem without downplaying it, notwithstanding some risk of public speculation that the problem is bigger than it turns out to be.

When a negative corporate event is severe enough to trigger an investigation by the SEC, companies may be called upon to consider whether to seek leniency under the agency's new Cooperation Program. The SEC announced the Cooperation Program in 2010 in response to public criticism that the agency could have done more to prevent the financial crisis by incentivizing companies to self-report securities law violations. In theory, self-reporting is designed to help the SEC make the most of its relatively limited resources and help companies manage the risks of adverse enforcement action.[31]

The Cooperation Program is a revitalization of cooperation guidelines published a decade prior in 2001, known as the Seaboard Guidelines.[32]

[31] The Cooperation Program is discussed at *Enforcement Cooperation Program*, U.S. SEC, http://www.sec.gov/spotlight/enfcoopinitiative.shtml (last updated Jan. 26, 2015).
[32] *See* Exchange Act Release No. 44969 (Oct. 23, 2001) (Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on

According to public statements, the SEC considers a number of factors in determining whether to show leniency to companies that self-report, including whether:

1. the company had self-policing mechanisms, including effective compliance procedures and a proper tone at the top;
2. the company timely responded to the misconduct once discovered, and the extent to which it vetted and ultimately reported the underlying facts and circumstances;
3. the company took remedial measures, including dismissing or disciplining wrongdoers, modifying and improving internal controls, and, when applicable, appropriately compensating those adversely affected; and
4. the candor with which the company shared information in its report with the SEC or other agencies, including law enforcement.[33]

Under the Cooperation Program, the SEC has discretion to enter into written cooperation agreements with both companies and individuals, including deferred prosecution agreements and non-prosecution agreements, where deemed appropriate.

Given that the Cooperation Program is still relatively new, it is difficult to predict whether and to what extent the SEC will show leniency to a cooperating company. Thus, any decision to cooperate should not be undertaken without careful consideration of all of the potential benefits and risks. As for benefits, several SEC releases suggest that in cases dealing with individuals who report potential securities fraud by coworkers or employers, cooperators receive preferential treatment in any resulting investigation and enforcement action.[34] For corporate entities, the SEC may

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the Relationship of Cooperation to Agency Enforcement Decisions) (the "Seaboard Report").

[33] *See id.*

[34] *See* Press Release, SEC Announces First Deferred Prosecution Agreement With Individual (Nov. 12, 2013), *http://www.sec.gov/News/PressRelease/Detail/PressRelease/13705403 45373;* Press Release, SEC Charges Husband and Wife with Defrauding Seniors Investing in Purported Charity (Feb. 4, 2013), *https://www.sec.gov/News/PressRelease/Detail/ PressRelease/1365171512714*; Litigation Release, SEC Credits Former Axa Rosenberg Executive for Substantial Cooperation during Investigation (Mar. 19, 2012), http://www.sec.gov/litigation/litreleases/2012/lr22298.htm.

negotiate settlements involving less severely worded complaints and administrative orders, which is important in avoiding or mitigating disadvantages in follow-on litigation. The SEC may also be less punitive in the calculation of immediate monetary relief, for example focusing on disgorgement while reducing or waiving fines and penalties.

On the other hand, there are significant uncertainties associated with cooperation. Foremost, any leniency in exchange for cooperation cannot be assured until the SEC's investigation is completed.[35] Thus, the involvement of multiple individuals or companies could seriously delay any hoped for early resolution by cooperation. Other factors, including the status of relationships with employees – possibly whistleblowers – could complicate how the SEC views a company's cooperation status. The SEC has indicated that every case will be considered unique, and thus the value of any assistance provided is subject to subjective factors outside of anyone's control, including the political climate and shifting agency priorities. Cooperating with the SEC does not foreclose action by other regulators, including state regulators and other law enforcement.

Top Challenges of Defending a Client Accused of Securities Fraud

First, it is crucial to learn as much as possible about the underlying facts in order to avoid taking positions with adversaries, the court, or the government that are not well supported. Clients faced with securities litigation often are stressed and strapped for time and attention. Yet, time must be made to help counsel get up to speed, including by facilitating interviews with key witnesses and collecting important documents and e-mails for counsel's review. Defense counsel must be sufficiently informed to thoughtfully work through the issues, claims, and allegations to develop a sound defense strategy that will not be undermined by information uncovered later that could otherwise damage the client's credibility and defense.

Second, it is paramount to analyze potential conflicts of interest and assess any needs for separate legal representations up front. This requires a strong grasp on potential conflicts of interest among any potential clients and

[35] *See* SEC Enforcement Manual § 6.2.2.

others who may require legal representation, and efforts to ensure that actual and potential conflicts are fully vetted, disclosed, addressed, and avoided. Trust and confidence are the foundation of any effective legal representation. It is important to be mindful that actual and apparent alliances (and adversities) based on joint representation versus separate representation are signals to the government, the court, and other parties about potential conflicts.

Third, it is crucial to help clients manage the knowledge needs and expectations of multiple interested constituencies, which may include the SEC, other enforcement agencies, outside financial statement auditors, corporate employees who may plug into rumor mills and read about worrisome events in the press, members of the management team and the board of directors, as well as outside investors, major creditors and business partners, and even whistleblowers. Under both Dodd Frank and Sarbanes Oxley, whistleblowers are entitled to protection from retaliatory employment actions in response to raising potential problems.[36] Further, under Dodd Frank, whistleblowers may become entitled to a large bounty award if they report new information to the SEC that leads to a million-dollar recovery.[37] The whistleblower's report to the SEC regarding the company's response may become considered in connection with an SEC investigation or other enforcement action. For this reason, it can be important to ensure that whistleblowers receive information about the company's response to their concerns in order to establish a record of good corporate governance.

Fourth, it is imperative to ensure that corporate indemnity, contractual indemnity, and insurance coverage are triggered and responding to the client's need for defense funding. It is important to read the relevant D&O insurance policies for coverages, exclusions, and limitations. For example,

[36] Sarbanes Oxley prohibits retaliating against employees for reporting what they "reasonably believe" to be a violation of the federal laws regarding mail, wire, and bank fraud, securities fraud, and "any rule or regulation of the Securities and Exchange Commission." 18 U.S.C. § 1514A. Dodd Frank added to these protections by, among other things, providing that no employer may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against a whistleblower in terms of employment for reporting such claims. 15 U.S.C. § 78u-6(h)(1).

[37] SEC rules implementing this aspect of Dodd Frank may be found at 17 C.F.R. § 240.21F.

policies may contain exclusions for government investigations until and unless a formal investigation is specifically aimed at the insured. If a client is found liable for a violation, insurance coverage exclusions may be invoked and, for individuals, corporate indemnities may be revoked or denied. It is important to understand and communicate with clients regarding the resources available to defend and protect them, how to access and secure those resources, and their limitations.

Conclusion

Although the SEC and other federal agencies do not play a direct role in private securities litigation, they can have a significant influence on the process and outcome. One of the most significant impacts arises in the context of SEC enforcement action accompanied or followed by private litigation. In discovery, private plaintiffs may seek whatever information, documents, and testimony has been turned over to the SEC, the FDIC, the FTC, the FDA, or any other adverse government entity, including privileged information.[38] This information can provide a litigation roadmap for private plaintiffs.

Another area where SEC enforcement actions have a potentially enormous collateral impact arises out of a new SEC policy, announced in 2013, that the agency may require, as a condition of settlement, an admission that the SEC's unproven allegations are true.[39] Traditionally, the SEC did not require an admission in a settlement absent a prior related conviction; thus, a party could settle with the SEC without admitting or denying the government's allegations. The settlement would have no collateral estoppel

[38] Almost all courts have rejected the concept of "selective waiver" by which a client seeks to withhold attorney client privileged information and work product from a private plaintiff while providing the information to the government. *See, e.g., Pac. Pictures Corp. v. United States Dist. Court*, 679 F.3d 1121, 1127 (9th Cir. 2012) (noting that ten federal circuit courts of appeals have adopted this approach).

[39] The SEC's policy was articulated after a closely followed 2011 decision by Judge Rakoff of the Southern District of New York refusing to approve the SEC's settlement with Citigroup which allowed the Citigroup to "neither admit nor deny" the alleged wrongdoing. *SEC v. Citigroup Global Mkts. Inc.*, 827 F. Supp. 2d 3336 (S.D.N.Y. 2011). Although Judge Rakoff's decision was overturned by the Second Circuit, *SEC v. Citigroup Global Mkts. Inc.*, 673 F.3d 158 (2d Cir. 2012), his public condemnation of the SEC's policy "neither admit nor deny" policy made its mark.

effect in private litigation, where plaintiffs still would have to prove their case. Private plaintiffs may seek to invoke a settlement admission, however, as having collateral estoppel effect in establishing elements of a private claim. Of perhaps greater concern, an admission may trigger denial of corporate indemnity, advancement, and insurance coverage for past and ongoing defense costs. Moreover, funds already provided for defense may be subject to demands for a claw back or repayment if the admitted misconduct would have been subject to insurance coverage exclusions or non-indemnifiable under general corporate law.

Several other significant developments impact the likelihood and risk of SEC enforcement actions. First, the SEC has begun using sophisticated data mining and analytical tools to identify potential insider trading and other securities violations. In the past, such data might only have been found by chance or through a tip, but the SEC's new data mining techniques increase the ability of the SEC to identify and bring enforcement actions in complex areas such as public finance involving complex securities instruments, and financial statement reporting. Thus, the SEC is becoming an even more sophisticated adversary.

Second, the Dodd Frank Act empowered the SEC to secure a home court advantage by seeking a broader array of remedies in administrative proceedings against non-regulated parties that previously could only be sought in a federal court action, such as significant monetary penalties.[40] Recent high profile SEC losses in federal court, such as the Mark Cuban insider trading trial, have made the home court advantage even more attractive to the SEC. Some defendants have challenged the SEC's use of administrative proceedings by asking federal courts to enjoin such proceedings on grounds that the SEC has used this forum selectively to disadvantage defendants: administrative proceedings afford defendants limited discovery and no right to a jury in a time constrained "star chamber"

[40] Specifically, Section 929 of Dodd Frank made civil money penalties uniformly available in administrative proceedings brought against "any person." Previously, the SEC was required to seek an order from a federal district court in a civil action to impose such penalties against anyone other than regulated entities such as broker-dealers and investment advisers and their associated persons.

type proceedings from which the first appeal is to Commission itself—the entity that authorized the enforcement action in the first place—and only after that to a federal court. So far, challenges to the SEC's use of administrative proceedings have not been successful.[41]

Third, the aggressive reach of SEC enforcement action in insider trading matters may be curbed following a significant insider trading loss in *US vs. Newman*, a criminal case brought by the US Attorney's Office in the Second Circuit.[42] The Second Circuit reversed the convictions of two individuals who had received and traded on non-public material information (tippees) without knowing the source of the information and, therefore, without knowing that the information was provided in breach of the source's fiduciary duty to his employer or that a personal benefit had been received by the tipper. The Second Circuit held that the personal benefit received by the tipper must be real and not ephemeral. This decision should make it more difficult for the SEC and the US Attorney's Office to bring cases involving insider trading against tippees, especially remote tippees. The Second Circuit denied the government's motion for an *en banc* hearing.

Key Takeaways

- To avoid and mitigate securities fraud charges, companies should set a strong tone of compliance at the top of the organization and ensure that proper disclosure controls are in place. For instance, companies should set up disclosure committees to make sure that all disclosures are vetted properly and in a timely manner, and work with both inside and outside counsel who are well versed in

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[41] For example, in *Jarkesy v. SEC*, 48 F. Supp. 3d 32 (D.D.C. 2014), the Court held that it may not exercise subject matter jurisdiction over a constitutional challenge to the SEC's decision to pursue a hedge fund manager in the SEC's own administrative forum, as opposed to a federal court action. The fund manager argued, among other things, that the agency's settlement with another fund manager for the same conduct, on the one hand, and the agency's decision to continue its case against him, on the other, prevented him from receiving an impartial hearing, thus violating his constitutional rights to due process and equal protection.
[42] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

these areas.

- When there is a crisis situation, such as a restatement or cybersecurity breach, companies should be careful to avoid premature public assurances of containment before internal investigation provides a sound basis for disclosure.
- In representing clients accused of securities violations, counsel should take care to learn the facts and study the law before taking positions with government regulators, courts, and other adversaries that may be undermined by information uncovered later. While some arguments and defenses are obvious, others are not and each situation is unique.
- Counsel should also promptly take steps to help clients secure corporate and contractual indemnification rights and insurance coverage for defense costs. In some cases, if a client is found liable for securities fraud, coverage exclusions may be invoked and indemnity may be denied or revoked.
- Stay up to date on legal developments and law enforcement initiatives. Be careful out there.

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