

What to Do When You Are Sued for Securities Fraud

Exposure to securities class action lawsuits is an unfortunate fact of life for public companies, particularly high-technology companies. The plaintiffs' securities bar files about one lawsuit a day against a public company and its officers and directors alleging that the Company and the named individuals misled shareholders, over a period of time, concerning the Company's business and its prospects. The sheer number of lawsuits being filed is of little comfort, of course, when you and your company are accused of fraud. Misery does not love company when it comes to securities litigation.

The purpose of this article is to guide officers and directors of public companies through the days and weeks following the filing of a securities action and to demonstrate the value of acting deliberately on some important fronts at the outset of a securities class action lawsuit. A secondary purpose is to educate the targets of these actions to the laconic pace of a securities class action.

1) What Happens First

In all likelihood, you will learn that you and your Company have been sued for securities fraud when you read a press release announcing the suit issued by a plaintiffs' class-action law firm. The press release will summarize, vaguely, the allegations in the complaint and will ask potential class members interested in becoming lead, or representative, plaintiffs to contact the issuing law firm.

This first press release must be issued pursuant to the Private Securities Litigation Reform Act of 1995. Congress had a worthy goal in mind when it crafted the requirement that the first plaintiff to file a class action complaint must issue a press release announcing the suit. Congress wanted to end the "race to the courthouse" endemic to securities actions. Prior to the Reform Act, the law firm that filed the first complaint had a better than average chance of being appointed to the lucrative position of lead counsel. Congress rightly thought that system created an incentive to file reflexive, poorly-researched complaints.

In reaction, Congress created the notice procedure. The first plaintiff is to issue a press release and other, prospective plaintiffs have a chance to research the allegations and decide whether to compete for the position of lead plaintiff. The lead plaintiff with the largest holdings in the Company obtains a presumption in his favor.

Congress had a good idea -- in theory. In practice, the notice procedure has been terrible for companies and individuals sued in securities cases. The problem started when courts permitted plaintiffs to "aggregate" individual plaintiffs into one "lead plaintiff". This gave plaintiffs attorneys an incentive to constantly market their complaint in search of additional plaintiffs. So, plaintiffs' attorneys sometimes file several, identical complaints on behalf of different representative plaintiffs, each time issuing press releases seeking more plaintiffs. Or, plaintiffs' counsel may issue a press release "announcing class periods" for complaints against several companies, again hoping to obtain additional plaintiffs for the competition for lead plaintiff and lead counsel.

So, the race to the courthouse, which was largely an unpublicized event, has been replaced by an irritatingly public "race to the business wire". The consequence is that when you are sued for securities fraud you may have to brace yourself for weeks of plaintiffs-lawyer press releases dominating the Yahoo Finance headlines about your Company.

2) Speaking of Press Releases. . . .

Well, they issued a press release (or many press releases), should you? In practice, some companies do and some don't. There are cases to be made for each approach.

Pro: The Company may be besieged with phone calls from shareholders asking what its response to the lawsuit will be and you may want to respond once in a press release instead of numerous times on the telephone. It is less likely that analysts or the financial media will call about the suit. They have seen enough of these lawsuits to know that nothing will happen right away that will materially affect your business and to know that you will not say anything interesting about the lawsuit in any event.

Reducing the amount of time spent responding to shareholder inquiries is about the only reason for issuing a press release. Indeed, in some recent cases we have seen speculation from shareholders wondering if the allegations in the complaint are true because the Company did not issue a press release denying them. If you decide to issue a release, consult your legal counsel about the language of the release. If experience is any guide, the release will state that the Company has received notice of a shareholder lawsuit and intends to defend itself vigorously about the allegations in the complaint.

Con: It is our opinion that the bland press release issued in response to the filing of a class action lawsuit does not really stem the tide of shareholder inquiries. Shareholders know a rote, boilerplate response when they see it and it usually does not assuage them. Institutional investors and analysts certainly are not influenced in any way by the press release.

Also, we think a Company's first public statement concerning a securities class action should be preceded by a thorough review of the complaint and consultation with litigation counsel concerning the seriousness of the allegations. It's easy to say, and often true, that a complaint lacks merit and the Company will defend it vigorously. What if the Company, after reviewing the complaint, decides it wants to settle the action quickly? That's not consistent with "vigorously defending" the action. We think a responsive press release is jumping, perhaps off a curb, but jumping all the same, before you look.

It's also worth noting that the filing of a securities case is rarely the occasion for filing a Report on Form 8-K; the potential liability, to the extent one exists at all, is too remote. The Company, incidentally, will have to put a description of the lawsuit in subsequent '34 Act filings.

3) Call your Board

Your board, ideally, should not find out about a securities class action from a plaintiff-issued press release. As a matter of form and good business practice, you should give your directors a call letting them know about the complaint and assuring them that you are taking the proper steps to deal with the matter. This is particularly important if the directors are named as defendants or if the lawsuit raises questions about board-approved actions, such as financial restatements.

4) Notify Your Insurance Broker

Securities actions fall within the scope of Directors and Officers Liability insurance coverage. D&O policies are typically claims-made policies providing that a company must provide carriers with prompt notice of a claim. Call the broker that placed the D&O policy, tell the broker about the lawsuit, and send the broker a copy of the complaint. Ask your broker to contact the carrier (or carriers) and notify them of the suit. Also make sure that you have a copy of the applicable insurance policy. Thorough defense counsel also will notify your carriers of the lawsuit. Two notices are better

than none.

Finally, if you are in the process of renewing insurance coverage or obtaining new or additional coverage, you should disclose the presence of the securities action. In this circumstance, you should involve corporate or defense counsel in the renewal process, as important issues such as policy exclusions and the course of future settlement negotiations may be implicated.

5) Preserve Your Documents

The Reform Act mandates that companies must take reasonable measures to ensure that relevant documents are not discarded during the Reform Act's mandatory discovery stay. A conservative approach to complying with this requirement is to ensure upon notice of the lawsuit that you preserve documents created during the quarter immediately preceding the Class Period identified in the Complaint (and mentioned in the press release) and documents created through the date the Complaint was filed which relate to that period.

You should do two things immediately to comply with this requirement. First, send a memo to key personnel telling them to preserve all documents (electronic and paper) pending more detailed instructions. When you retain defense counsel, work with them to draft a detailed document preservation memorandum and determine in conjunction with defense counsel who the recipients of the memorandum should be.

Second, contact your MIS manager and inform him of the requirement. The Reform Act's document preservation mandate extends to electronic data. The easiest way to describe to your MIS manager his obligation to preserve documents is to tell him that you need a keep a snapshot of all electronic data in existence that was created one-month before the Class Period through the present.

Experience has taught us that there are a few things that an MIS manager should do right off the bat. First, if the Company rotates back-up dates, *i.e.*, writes over tapes containing data from an earlier point in time, that practice should be stopped until counsel, in conjunction with the MIS manager, does a full review of the steps that need to be taken with respect to electronic data.

Second, the MIS manager should make sure that departing employees' hard drives which may contain data created immediately before and during the Class Period are not erased and put back into circulation after a lawsuit is filed. For example, suppose the announcement that incites a lawsuit happens on Day 1, a lawsuit is filed on Day 2, and the Sales VP resigns on Day 3 and leaves the Company on Day 10. Do not erase and recirculate his hard drive on Day 11 or later.

Third, the MIS manager should take a hard look at what the Company has available in terms of electronic history. The Company's litigation counsel will invariably want to know what the electronic landscape looks like and it will expedite matters to gather this information at the outset of the case.

6) Notify Your Auditors

The Company's independent auditors accountants will invariably learn of the litigation at some point, but it is important that you notify the auditors of the lawsuit if they are in an audit cycle. Before making decisions in conjunction with your auditors concerning reserves or accruals for the litigation, you should talk with your outside litigation counsel.

7) Do Not Create "Post-Mortems"

First, a little background. Securities class actions obviously are filed after a stock drop. Stock drops can be

caused by any number of factors, too numerous to discuss in detail. Sometimes stock drops are caused by business events that warrant significant analysis, such as a revenue miss or the failure to launch a new product in a timely manner. It's common and good practice for companies to document the results of the inquiry and the possibility of litigation relating to those events should not alter this otherwise good business practice.

That being said, don't undertake an analysis of "what went wrong" in reaction to the fact that a suit was filed. You should not and need not create a document entitled "Why We Were Sued" or any variation on that theme. Don't let a lawsuit cause you to undertake an analysis that you would not otherwise conduct.

The reason for this is that the "post-mortem" inevitably will contain a discussion of how the problem could have been prevented or how warning signs were evident and ignored. Unfortunately, although this analysis may make good business sense, it is almost certain to be "discoverable" in the lawsuit. The report will give plaintiffs a roadmap to prosecuting their case, and they will try to use the report to show the Company should have known of the problems sooner.

The issues will not go without analysis. Your outside litigation counsel will do an investigation concerning the allegations of the Complaint and the relevant causal factors. Those documents will be protected by the attorney-client privilege and the work-product doctrine and will not be discoverable.

8) Call Other Companies

As noted at the outset of this piece, securities class actions are common. Ask your general counsel or another officer if they know someone who has been through a securities class action. It's useful to gain the perspective of a class-action veteran on a variety of issues, such as the amount of executive mindshare devoted to securities class actions, the pace of these cases, the names of experienced securities class actions defense counsel.

9) Hurry Up and Wait

Compared to business, the pace of litigation is glacial. Compared to ordinary litigation, the pace of securities litigation is, well, glacial. Part of the slow pace, particularly at the outset of a matter, is mandated by the Reform Act, which set up a slow, initial schedule to allow the contest for lead plaintiff to play itself out.

Very little happens in the first several months in the life of a securities class action. On Day 1, the Complaint is filed and the first-filed plaintiff issues notice. On Day 60, plaintiffs file their motions to be appointed lead plaintiff. By Day 90, the court is supposed to have issued an order appointing a lead plaintiff. This date may slip due to the court's docket, or hearing schedule.

After a lead plaintiff is appointed, that plaintiff typically takes anywhere from 30-60 days to file an amended complaint. Then, defendants have 10 days to respond, *i.e.*, to move to dismiss the amended complaint. Motions to dismiss are complex, however, and such a motion may be extremely complex depending on the type of allegations and amount of factual detail in the complaint. So, it is fairly standard for defendants to obtain 30-60 days to file a motion to dismiss. Plaintiffs will want a similar amount of time to respond, and defendants will then seek up to a month or more to reply. The court will need two to three weeks to consider the motion before a hearing takes place. There may then be a long delay, depending on the judge, while the parties wait for a decision on the motion.

So, most of a year has passed in the life of a securities case and the only real litigation event has been a motion to dismiss. The schedule may move a little faster if the court or the parties want to move it a little faster. Defendants have little incentive to rush because discovery is stayed during the pendency of a motion to dismiss.

Even if your case is one that should not, and will not, survive a motion to dismiss, you have to prepare yourself for delayed gratification. The best way to use the protracted dormant period at the beginning of a securities case is to work with your outside counsel to conduct a factual analysis and formulate a strategy for defending the case.

10) **Don't Let a Securities Class Action Disrupt Your Business**

The most important lesson of all: focus on your business, not the lawsuit. Because of the pace and the initial focus on purely legal motions, your involvement in the defense of a securities class action should be minimal in the first year or so. Work with your outside counsel to determine your necessary involvement in the investigation and defense of the action. Securities class actions are lawyers' problems. Let the lawyers deal with it and concentrate on your business.