504:Securities Litigation & Enforcement Actions: What You Need to Know

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Paul R. Bessette heads Akin Gump Strauss Hauer & Feld LLP's securities litigation practice group in Austin, Texas.

Mr. Bessette has been lead counsel in scores of cases nationwide defending companies, officers and directors, underwriters, and accountants in shareholder class action lawsuits, derivative litigation, and SEC proceedings. He has extensive experience in accounting fraud, restatements and class certification issues, and is a frequent speaker and author on shareholder litigation, corporate disclosure, and corporate responsibility.

Gardner G. Courson

Gardner G. Courson joined the new Tyco law department, as vice president and deputy general counsel, litigation in Princeton, New Jersey. In this position, he has responsibility for Tyco's global litigation docket, including coordinating the company's positions in an SEC enforcement investigation.

Mr. Courson practiced as a trial lawyer for nearly three decades, and is admitted to six of the United States Courts of Appeals and the U.S. Supreme Court. He is the former managing partner of the Atlanta office of McGuireWoods and was a member of the firm's board of partners before leaving the firm to join Tyco. Mr. Courson has successfully handled hundreds of lawsuits across the U.S., focusing on complex employment, labor relations, and related business tort issues. He has acted as employers' legal advisor in numerous individual and class actions and is widely viewed as an authority on litigation management, alternative fees, and the use of technology in the practice of law.

He is a fellow of The College of Labor and Employment Lawyers, recipient of the General Counsel's Award for Achievement in Diversity from the DuPont legal department, and a member of the advisory board of the University of Virginia's McIntire School of Commerce.

Mr. Courson graduated from the University of Virginia and Emory University School of Law in Atlanta.

Edward S. Knight

Edward S. Knight is executive vice president and general counsel of the Nasdaq Stock Market, Inc. In this role, Mr. Knight is responsible for providing legal counsel to senior management and for overseeing the quality of legal services across the organization. He is also responsible for government relations, listing qualifications, and market regulation.

Mr. Knight served as the chief legal officer of the National Association of Securities Dealers (NASD) until becoming NASDAQ general counsel. Prior to joining the NASD, Mr. Knight served as general counsel of the U.S. Department of the Treasury. Upon his departure, Mr. Knight received from Treasury Secretary Robert Rubin the Alexander Hamilton Award, the department's highest award, for exemplary service to the department, and also received the Honor Award from the Secret Service,

which the department oversees. Before this position, Mr. Knight served as executive secretary and senior advisor to the secretary of the Treasury. Prior to his tenure at the Treasury, Mr. Knight was with the law firm of Akin, Gump, Strauss, Hauer and Feld in Washington, DC.

Mr. Knight's accomplishments at the Treasury Department include his critical involvement in the United States' provision of bilateral assistance to the Government of Brazil in the fall of 1998 and to the Government of Mexico in 1995. He also led the legal team that successfully privatized the U.S. Enrichment Corporation in July 1998. He also was on the commission that restructured the Internal Revenue Service in 1996 and led the legal team that advised Treasury Secretary Rubin in 1995 and 1996 on the debt limit crisis. Mr. Knight is a member of the ABA, the Council on Foreign Relations, and the board of directors of the Software and Information Industry Association.

Mr. Knight received his BA, with honors, from the University of Texas at Austin and his JD from the University of Texas Law School, and sits on the law school's alumni board of directors.

Thomas A. Zaccaro

Thomas A. Zaccaro is a partner at Akin Gump Strauss Hauer & Feld LLP located in Los Angeles. His practice encompasses complex civil, commercial and criminal litigation in state and federal courts. In particular, Mr. Zaccaro represents corporations and their officers and directors in securities litigation, class action litigation, and SEC and criminal investigations. He also represents individuals in white-collar criminal cases, grand jury investigations, and congressional hearings. He has argued cases before the U.S. Courts of Appeals for the 2nd and 9th Circuits and numerous federal district courts.

Prior to joining Akin Gump, Mr. Zaccaro was the regional trial counsel of the SEC's Pacific regional office, where he was responsible for the management and supervision of all enforcement litigation and administrative proceedings conducted within the Pacific region, and acted as lead counsel in numerous enforcement actions involving violations of the federal securities laws, including financial fraud, accounting fraud, insider trading, offering fraud, Ponzi schemes, and sales of unregistered securities. Mr. Zaccaro also previously served as an assistant U.S. attorney for the Southern District of New York and as a trial attorney at the Department of Justice, Organized Crime and Racketeering Section.

Mr. Zaccaro has served as a panelist and spoken at numerous conferences, including the California Banker's Association Annual Meeting, "Corporate Governance Panel," Association for Corporate Growth, "Sarbanes-Oxley Act," and The SEC Institute, Inc., "Staying Out of Trouble with the SEC."

Mr. Zaccaro received his BA, magna cum laude, from Georgetown University and his JD, cum laude, from the Boston College Law School, where he served as executive editor of the *Boston College International and Comparative Law Review*.

THE CURRENT LANDSCAPE FOR SECURITIES LITIGATION

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The landscape of securities litigation has undergone dramatic changes over the past decade. Not since the era of the New Deal reforms that resulted in the 1933 and 1934 Acts has Wall Street seen such tumultuous times. The pendulum of reform has swung from the pro-business Private Securities Litigation Reform Act of 1995 ("Reform Act") to the pro-investor Sarbanes-Oxley Act of 2002 ("SOX"). Although the law interpreting SOX is still developing, its passage did not repeal or amend the Reform Act's procedural safeguards and heightened pleading standards. As courts struggle to reconcile the inherent tension between the underlying principles of the two Acts, they must walk a fine line.

An examination of the latest trends in the case law demonstrates that courts are indeed trying to walk that line. For example, a number of courts have applied the Reform Act's heightened pleading standards recently with more precision than in years past, not only requiring that plaintiffs plead falsity with particularity, but also prohibiting the practice of group pleading and clarifying the standard for corporate scienter. But one area in which some courts have struggled is enforcing the Reform Act's safe-harbor provisions.

In the class-certification context, more courts are beginning to analyze carefully whether plaintiffs have carried their burden to meet Rule 23's requirements. In particular, courts have recognized that plaintiffs using the fraud-on-the-market presumption of reliance must demonstrate at the class-certification stage that the market for the defendant company's stock was efficient because otherwise individual issues of reliance will predominate, making class certification inappropriate. And if plaintiffs rely on expert testimony to demonstrate market efficiency, some courts now recognize that it is appropriate to examine the expert's reliability.

The Supreme Court soon will determine what plaintiffs need to plead and prove to establish the necessary element of loss causation—will it side with those circuits holding that plaintiffs must show a link between the alleged misstatement and the stock-price decline, or with the Ninth Circuit, which requires only a showing that the price was artificially inflated? The Supreme Court also may have to address, again, the extent of potential secondary liability for actors who do not actually make alleged misstatements. The reemergence of secondary liability after *Central Bank* appears to be borne out of the courts' desire to ensure that actual wrongdoers are held responsible for harm to shareholders without enlarging the net of responsibility so much that it captures innocent bystanders.

Electronic-data discovery also creates pitfalls for the unwary. Especially in securities litigation, where the burden of producing relevant documents falls disproportionately on defendants, the courts' efforts to properly allocate the parties' interests in a rapidly changing technology environment will have an enormous impact on how discovery is conducted in the next few years.

Finally, the public companies themselves continue to adapt to the brave new world of SOX. Skyrocketing compliance costs and D&O premiums have become the norm. Companies are spending more resources on internal controls and compliance and D&O policies, yet they are more likely than ever before to face the possible rescission of their D&O policies.

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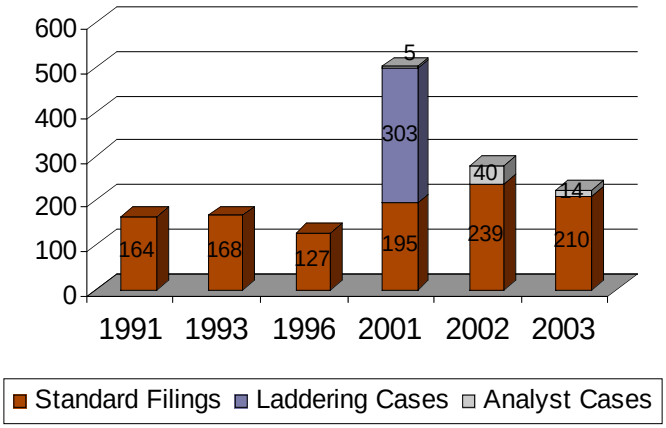
As the abrupt swing of the pendulum begins to slow, it appears that courts are edging closer to a middle ground. In this article, we provide a brief overview of the most recent developments and statistics so that the reader can draw his or her own conclusions about where we have been and where we appear to be headed.

EMERGING TRENDS IN SECURITIES FRAUD FILINGS

How Many?

The number of securities fraud class action lawsuits—though down significantly from the 2001 levels following the bursting of the tech bubble—still exceeded the level attained during the pre-Reform Act era. Some 224 securities class actions were filed in 2003 (see below).[i]

Number of Federal Class Actions Filed Nationwide



Source: E. Buckberg, T. Foster, & S. Plancich, National Economic Research Associates, Inc., *Recent Trends in Securities Class Action Litigation: 2003 Early Update*, Feb. 2004.

New Players Among the Plaintiffs' Firms

The recent split of class-action powerhouse Milberg Weiss Bershad Hynes & Lerach leaves open the question of which plaintiffs' firm will emerge as the leader this year. Five firms specializing in securities litigation made this year's "Plaintiffs' Hot List," including the newly formed Milberg Weiss Bershad & Schulman, its West Coast counterpart, Lerach Coughlin Stoia Geller Rudman & Robbins, and Bernstein Litowitz, which topped the list.[ii]

Two factors that consistently have proven crucial to the success of plaintiffs' firms in this field are institutional investors and internal manpower.[iii] Although the percentage of institutional investors serving as lead plaintiffs has decreased since 2002, major investors still represented 42% of the lead plaintiffs in cases filed in 2003.[iv] In addition, union and public pension funds are serving as lead plaintiffs in a steadily rising number of cases.[v] Internal manpower is critical because securities cases have become more labor intensive since the Reform Act, especially at the motion-to-dismiss stage. Even post-split, Milberg Weiss's and Lerach Coughlin's staffs far outnumber those at other securities class action firms, giving both of them a significant leg up on the rest of the pack.[vi]

Settlements

Yearly comparison of averages & means. For the first year since passage of the Reform Act, the average settlement value for securities class actions declined in 2003 (driven by a decrease in the number of settlements occurring during the year).[vii] Almost 85% of all settlements in 2003 settled for less than $20 million.[viii] Indeed, the median settlement amount for all post-Reform Act cases is $6 million, which suggests that a small number of very large settlements drive the higher average settlements.[ix] The average settlement amount for post-Reform Act settlements is

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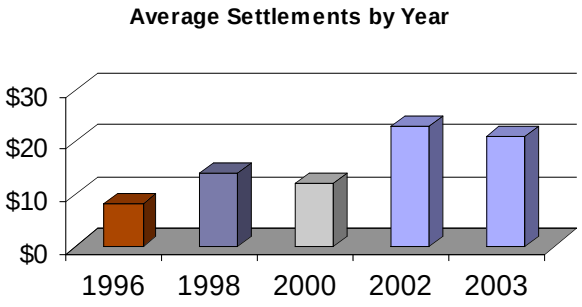
$18.6 million, bringing the total amount of all settlements since the Reform Act to $9.4 billion.[x]



Source: Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Case Settlements – Cases Reported Through December 2003* (2004).

Impact of Accounting Allegations and Insider Trading. The median settlement value as a percentage of estimated investor losses increases substantially when plaintiffs allege a GAAP violation, increasing from 3.6% to 5.0% of estimated investor losses.[xi] Interestingly, in cases in which insider trading has occurred, the median settlement is 3.0% of estimated losses, but it increases to 4.8% when no insider trading has occurred.[xii]

Top Plaintiffs' Firms by Settlement Amount. In 2003, the top three plaintiffs' firms in terms of highest total dollar amount of settlements were as follows:

- Milberg Weiss Bershad Hynes & Lerach: settlement total of $2.1 billion with 65 settlements averaging $32.5 million;
- Bernstein Litowitz Berger & Grossman: settlement total of $950 million, with 9 settlements averaging $105.6 million;
- Grant Eisenhofer: settlement total of $610.5 million, with 3 settlements averaging $203.5 million.[xiii]

Restatements and Alleged Accounting Fraud

Number of Restatements Remains High.[xiv] There were slightly fewer restatements arising out of accounting errors in 2003—323—than the 330 restatements in 2002, but an increase of 20% over the 270 restatements in 2001. Thus far, in the first two quarters of 2004, 52 companies have filed Forms NT-10K indicating that they were considering restating a prior financial period.[xv]

At the same time, the number of public registrants is decreasing. Since 1999, the number of public registrants has decreased approximately 14%, while the number of restatements has risen by 53%. To put it another way, the number of restatements per 1000 public registrants has risen from approximately 21 in 1999 to approximately 36 in 2002.[xvi]

Securities Fraud Class Actions Alleging Accounting Fraud. Shareholder suits alleged significant accounting fraud in approximately 110 cases, or 63% of the 175 "traditional" federal securities fraud cases filed during 2003.[xvii] This reflects the plaintiff bar's continued scrutiny of companies that are allegedly cooking the books. These 110 cases can be categorized into five distinct types of accounting fraud allegations:[xviii]

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2003 Accounting Fraud Cases by Type		
Type of Accounting Fraud	**Occurrences**	**Percentage**
Bogus Revenue	9	8%
Premature Revenue	33	30%
Expense Deferral	35	32%
Burying Liabilities	5	4.5%
Other	40	36%
	122	110.5[xix]

Expense deferral and premature revenue recognition remain the most commonly alleged accounting fraud. The significant decrease (from 13% in 2002 to 4.5% in 2003) in cases alleging the burying of liabilities outside the reported financial statements through the use of SPEs or undisclosed debt guarantees suggests that the recent revisions and clarifications by the Financial Accounting Standards Board has had a positive effect.[xx]

In 2003, only 28 of the 110 total cases alleging accounting fraud were based on a company's restatement. This suggests that companies whose auditors continue to "approve" their financial statements (*i.e.*, did not restate) are nonetheless still at risk for being sued for securities fraud.

Re-Targeting Smaller Companies

Securities fraud class actions against big corporations make the headlines, but a far larger number of smaller companies face bet-the-company class action suits. As institutional investors take a greater role in shaping securities litigation and settlements extend out over a large time period, plaintiffs are forced to change their business model. Small companies are the perfect prey: fewer shareholders, less control over the legal system, and accordant fast settlements.[xxi] Smaller settlements in higher volume fill the coffers of contingent-fee-dependent plaintiffs' lawyers.

The exponential cost of compliance with the rigid internal controls imposed by SOX also hits smaller companies the hardest. Faced with such material increases in corporate-governance and internal-control spending, these companies are the most likely to skimp on compliance expenditures.

Finally, smaller companies have a higher number of restatements: in 2003, 44% of restatements involved companies with less than $100 million in revenue and 72% involved companies with less than $500 million in revenue.[xxii]

UPDATE ON KEY LEGAL ISSUES

Courts Require Precision: The Demise of Group Pleading and Collective Scienter

The Fifth Circuit's recent decision in *INSpire* marks the death of two pro-plaintiff presumptions.[xxiii]

First, the Fifth Circuit is the first circuit court to address whether the group-pleading doctrine survived the Reform Act. District courts have split on the issue, and each circuit before now that had the

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opportunity to face it expressly declined to do so.[xxiv] The group-pleading doctrine allows plaintiffs to attribute statements to defendants based only on their corporate titles, under the assumption that the individuals were part of a group that likely put together the documents containing the alleged misstatements.[xxv] The court in *INSpire* rejected group pleading as irreconcilable with the Reform Act's requirement that plaintiffs must plead specific facts as to each act or omission by each defendant.[xxvi] Therefore, at least in the Fifth Circuit, plaintiffs now must distinguish among the defendants and link each defendant to his or her part in the alleged fraud—that is, the connection between an individual defendant and an allegedly fraudulent statement must be specifically pled.

Second, the *INSpire* court made a similar pronouncement with respect to pleading a corporation's scienter. Before *INSpire*, no circuit had addressed the presumption of collective scienter since the Ninth Circuit expressed its disapproval in 1995.[xxvii] Theoretically, under the doctrine of collective scienter, a court could infer that a corporation had the requisite state of mind by imputing to it the collective knowledge of all its employees—if one defendant made a statement, then another defendant's knowledge of its falsity could suffice to hold the company responsible.[xxviii] The Fifth Circuit found that this doctrine was incompatible with the Reform Act and held that plaintiffs must show the scienter of at least one corporate officer or employee who made a false statement to, in turn, attribute scienter to the company.[xxix] Thus, the corporation's liability is derivative of, or concurrent with, its officer, director, or employee liability.

The *INSpire* decision makes pleading considerably more burdensome for plaintiffs in the Fifth Circuit and has already begun a similar uphill battle in district courts around the country.[xxx]

Safe Harbor: The Seventh Circuit Decides It Is Not So Safe

A recent decision from the Seventh Circuit may present another securities fraud issue for the Supreme Court. Until last month, the circuits that had addressed the Reform Act's safe harbor had remained faithful to the legislative history and unanimously agreed that the safe harbor contains two *independent* prongs, both of which protect defendants from liability (and even discovery) for certain forward-looking statements.[xxxi]

The legislative guidance on the safe harbor is extensive and unambiguous—the safe harbor was enacted to protect and encourage senior managers, those with access to the best information, to provide forecasts to the market.[xxxii] The provision's first prong allows management to make projections tempered by substantive, firm-specific cautionary language without fear of liability.[xxxiii] The second prong similarly insulates management for projections made without actual knowledge of their falsity.[xxxiv] Courts look solely to the adequacy of the cautionary language under the first prong and solely to the defendants' state of mind under the second.[xxxv] The two analyses do not overlap—if a company meets either of the safe harbor's tests, then its forecasts are absolutely protected.[xxxvi]

In *Asher v. Baxter International Inc.*, however, the Seventh Circuit conflated the safe harbor's two prongs, holding that only after discovery as to what the defendants *knew* could the court identify "important"

variables that would have affected the company's forecasts at the time the projections were made.[xxxvii] Albeit with good intentions, the court ignored the contradictory legislative history: "[t]he Conference Committee specifies that the cautionary statements identify the 'important' factors to provide guidance to issuers and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made."[xxxviii]

Plaintiffs undoubtedly will embrace this decision. If the Seventh Circuit's opinion is any indication of a new wave of similar interpretations, then it is not only companies that should take heed—without the freedom to give quality projections, it is investors who may pay the highest price.

The Upside of a Stock Price Decline: Rebutting Reliance

All class action complaints hinge on a decline in a company's stock price, but the Fifth Circuit recently concluded that a stock price decline alone may not necessarily show reliance.[xxxix] In *Nathenson*, the court held that certain misstatements "were not actionable under a fraud-on-the-market theory" as a matter of law because the historical closing-price data demonstrated that the Company's stock price actually declined in the months following those misstatements.[xl] The court concluded that because the stock price declined following the alleged misstatements, the market did not rely on the alleged misstatements (if the market had relied on the misstatement, then the stock price would have increased).[xli]

In *Crossroads*, the Fifth Circuit clarified the showing required for plaintiffs who attempt to use the fraud-on-the-market presumption of reliance. The plaintiffs in that case asserted that a stock price decline at the end of the class period proved reliance for all the previous alleged misstatements. The court rejected this overly simplistic approach:

> [P]laintiffs cannot trigger the presumption of reliance by simply offering evidence of any [stock price decline] following the release of negative information. Such evidence does not raise an inference that the stock's price was actually affected by an earlier release of positive information. To raise an inference through a decline in stock price that an earlier false, positive statement actually affected a stock's price, the plaintiffs must show that the false statement causing the increase was related to the statement causing the decrease. Without such a showing there is no basis for presuming reliance by the plaintiffs.[xlii]

Plaintiffs also must parse out news unrelated to the alleged fraud: "to trigger the presumption, plaintiffs must demonstrate that there is a reasonable likelihood that the cause of the decline in price is due to the revelation of the truth and not the release of unrelated negative information."[xliii] Significantly, the court determined as a matter of law that one piece of negative information in that case (the announcement of a stop-shipment of a key product line) did not play a significant role in the price decline and therefore was not actionable under a fraud-on-the-market claim.[xliv]

Finally, the Fifth Circuit eliminated from liability another class of statements—so-called "confirmatory" statements (alleged misstatements where the information had been released to the market previously). Claims based on these statements should be dismissed because such confirmatory information is already incorporated into the stock price under a fraud-on-the-market theory.[xlv]

The Fifth Circuit opinion in *Crossroads* demonstrates that courts are beginning to require more than mere hollow assertions of reliance. This rigorous analysis may enable defendants to eliminate many allegations at the pleading stage or at summary judgment without an intrusive fact-intensive review.

Balancing the Experts: Class Certification as a New Battleground

Since the Supreme Court announced in *Amchem Products, Inc. v. Windsor*[xlvi] that securities fraud class actions are the type of case that "readily" meets the Rule 23 class action requirements, plaintiffs have slid by with little to no effort at the class-certification stage.[xlvii] Courts now are beginning to take a closer look at class certification and its accordant settlement pressure, however, and are requiring plaintiffs to meet their burden of proof. Defendants can pose a vigorous battle at the class-certification stage by challenging the adequacy of figurehead class representatives[xlviii] and, in appropriate cases, arguing that individual issues of reliance will predominate because the market for the company's stock was inefficient.

Experts play a key role in challenging market efficiency. Many plaintiffs mistakenly believe that they bear no burden because reliance is presumed under the fraud-on-the-market theory. This is wrong. To invoke the fraud-on-the-market presumption in the first place—a necessary prerequisite to proving that common issues of reliance will predominate—plaintiffs bear the burden to prove that the market for a company's stock was efficient.[xlix] That is, they must show, among other things, that the stock price responded immediately to new company-specific information during the alleged class period.

But any expert opinion must comport with the rigors of *Daubert v. Merrell Dow Pharms., Inc.*[l] Expert witnesses using suspect methodologies may be excluded at the class-certification stage.[li] And while some courts (in contexts other than securities fraud class actions) reject motions to exclude expert testimony at the certification stage as premature, better-reasoned cases recognize that the *Daubert* analysis is not an improper inquiry into the merits because market efficiency is integral to the class-certification question.[lii]

Millions of Dollars in the Balance: the Element of Loss Causation

The Supreme Court will decide soon what plaintiffs must show to establish the element of loss causation in any section 10b-5 case. This element requires that plaintiffs prove defendants' misrepresentations proximately caused their investment losses.[liii] The Second, Third, Eleventh, and arguably Fifth Circuits swing the pendulum toward defendants—these courts require that plaintiffs prove that the stock price decline was directly linked to the alleged misstatement.[liv] The Eighth and Ninth Circuits swing the pendulum toward plaintiffs and effectively eliminate loss

causation as an element—they require only a showing that plaintiffs bought the security at an artificially inflated price.[lv]

The split between the circuits hinges on a single inquiry: do plaintiffs need to identify a "corrective disclosure" related to the alleged misstatements to prove loss causation?[lvi] In *Dura*, the alleged class period ended with the company's announcement of disappointing sales and earnings in February 1998, after which its stock price dropped from highs of $53/share to $20/share.[lvii] Plaintiffs, however, attributed some of their losses to allegedly false statements about a new asthma device. But the FDA did not reject the device (and the stock price did not decline in response) until ten months later—well after the close of the purported class period. The Ninth Circuit held that even though the asthma device had nothing to do with the stock price decline at the end of the alleged class period, it nonetheless could have contributed to shareholder losses because shareholders allegedly purchased the stock during the class period at inflated prices due to misrepresentations regarding the asthma device.[lviii] The defendants appealed the decision and the Supreme Court will hear the case in its 2005 term.

In this appeal, the Solicitor General filed an amicus brief on behalf of the SEC, contending that the Ninth Circuit's decision was wrongly decided.[lix] The SEC pointed out that the decision renders loss causation indistinguishable from transaction causation. The amicus brief also explained that an investor who purchased stock at an inflated price could recoup part or all of her overpayment by simply reselling the stock at the inflated price before any curative disclosure.[lx] This hotly contested issue has persuasive arguments on both sides, so the question of whether there must be a "corrective disclosure" to establish loss causation remains Wall Street's multi-million dollar question.

Electronic Discovery: Pitfalls Abound for the Unwary

Over the past few years, one of the most rapidly changing areas of the law has been electronic-document discovery.[lxi] In securities litigation, as in other types of litigation, e-mail and other electronic documents have become primary discovery targets. Courts have worked to define the appropriate parameters for electronic-document discovery, addressing issues such as cost allocation, the preservation of electronic evidence and the inadvertent production of privileged documents.

Cost allocation and document preservation are two important issues facing companies sued for securities fraud. In securities class actions, discovery burdens fall more heavily on defendants because virtually all the relevant documents are in their possession. If a complaint survives the motion to dismiss, plaintiffs' counsel often uses electronic discovery requests not only as a means of seeking relevant information, but also as leverage to increase the settlement value of a case. Although the requesting party bears the burden of demonstrating why metadata, embedded edits, or production in native format is relevant to the subject matter of the dispute, courts unfamiliar with the technological issues related to e-discovery often base their rulings on the mere accessibility of the data, without a full appreciation for the burden such production places on the responding party. But some courts recently have engaged in a thoughtful analysis of a number of factors and have shown a

willingness to shift some of the production costs to the requesting party.[lxii]

Two recent decisions underscore the growing importance of e-discovery and the risks of withholding, or even inadvertently not producing, all relevant e-mails. In *United States v. Philip Morris USA Inc.*, the district court found that eleven high-ranking employees with responsibilities for issues relevant to the lawsuit failed to follow the company's internal procedures for document preservation.[lxiii] The court found that a significant number of e-mails were lost, and that it was impossible to accurately assess the harm and prejudice to the requesting party.[lxiv] As a remedy, the court ordered that any individuals who had failed to comply with the company's internal document-retention program would be precluded from testifying in any capacity at trial. The court also assessed a $2.75 million sanction against the company and sanctions of $250,000 per individual against the eleven managers and/or officers who failed to comply with the company policy.[lxv]

Similarly, in *Zubulake v. UBS Warburg LLC*, fifth in a line of influential e-discovery decisions from the same case, Judge Shira A. Scheindlin imposed sanctions against UBS because UBS employees failed to preserve deleted e-mails, despite both in-house and outside counsel's instructions to retain relevant electronic evidence.[lxvi] As a result, some e-mails were completely destroyed and others were not produced until almost two years after they were originally requested.[lxvii] Sanctions against the company included an order to (1) restore and produce relevant documents from a certain backup tape, (2) pay for the re-deposition of relevant UBS personnel based on the late-produced e-mails and the material produced from the tape, and (3) pay all attorneys' fees related to the motion.[lxviii] In addition, the court decided to give an adverse-inference instruction to the jury, which will allow them to infer that the destroyed evidence would have been unfavorable to UBS.[lxix]

UBS's in-house and outside counsel had issued and re-issued document-preservation instructions to company employees.[lxx] Outside counsel had informed UBS's information technology personnel to stop recycling backup tapes as soon as e-mails on the tapes were requested.[lxxi] Every UBS employee mentioned in the opinion (except one) had either personally spoken to UBS's outside counsel about the duty to preserve e-mails or had received at least one of in-house counsel's e-mails instructing employees to preserve and segregate such documents.[lxxii] Nevertheless, the *Zubulake* court held that UBS's counsel failed to properly oversee UBS's discovery efforts in a number of important ways.[lxxiii] The court listed steps that counsel should take to ensure compliance with the preservation obligation, as a guideline for typical cases.[lxxiv] These steps include (1) issuing a "litigation hold" at the outset of litigation and periodically reissuing it, (2) directly communicating with the "key players" in the litigation and periodically reminding them that the preservation duty is still in place, and (3) instructing all employees to produce electronic copies of their relevant active files and insuring that all backup media that the party is required to retain is identified and stored in a safe place.[lxxv] While it remains to be seen whether other courts will uniformly adopt the *Zubulake* standard, the trend in the case law is clear—failure to preserve and produce electronic data may result in substantial monetary sanctions and adverse instructions and other limitations at trial.

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Secondary Liability: Silence May Not Be Golden Anymore

Judge Melinda Harmon's recent decision in *In re Enron Corp. Sec., Deriv. & ERISA Litig.* may eventually result (directly or indirectly) in another question for the Supreme Court.[lxxvi] The *Enron* decision represents a distinct step away from the Supreme Court's landmark decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, holding that section 10(b) provides only for primary liability, not aiding-and-abetting liability.[lxxvii] In *Central Bank*, the Supreme Court left some room for secondary actors to be held primarily liable by noting that a secondary actor "who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5."[lxxviii] Since *Central Bank*, the circuit courts have split over exactly what it takes for a secondary actor to face primary liability.[lxxix] In *Enron*, the court rejected both circuit-court rules and adopted a rule promoted by the SEC in an amicus brief, which allows liability to be imposed on a secondary actor who "creates" a misrepresentation, even if the secondary actor was not publicly identified and the statement was disseminated by others.[lxxx] Criticized by the defense bar and praised by the plaintiffs' bar, *Enron* is another example of courts' efforts to keep as defendants all those potentially liable, although the court may have exceeded the statutory bounds. Given the case's prominence and the Supreme Court's emphasis on the statutory text and on the need for predictability in this area after *Central Bank*, it is likely that the high court will take up the issue of secondary liability again when the opportunity arises.

IMPACT ON BUSINESS

Regulators Wield a Big Stick

There is one area where the pendulum has swung clearly away from defendants: SEC enforcement actions. As SEC Enforcement Division Director, Steve Cutler, joked about New York Attorney General Elliott Spitzer (the attorney credited with exposing many high-profile corporate scandals):

> Dear God: It's my understanding that you are everywhere, including, apparently, the State of New York. As I read the Stamp Act of 1765 you are subject to regulation and taxation by the State of New York. While you are and should be the primary regulator of humanity, I have some ideas I'd like to share with you.

Penalties (including disgorgement and interest)—while ostensibly limited by statute—appear to have no bounds:[lxxxi]

- $1.4 billion—ten Wall Street banks for analyst conflicts
- $750 million—WorldCom for accounting fraud
- $375 million—Bank of America for mutual fund trading abuses
- $250 million—Alliance Capital Management mutual fund trading abuses
- $100 million—Credit Suisse First Boston for IPO violations

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SOX Continues to Increase the Cost of Doing Business

The Cost of Compliance. As companies begin to adopt and implement new policies and procedures to comply with SOX's extensive requirements, all indications are that the costs of compliance are significant. According to a recent study, the average cost of being a public company has nearly doubled—increasing from $1.3 million in 2002 to an astounding $2.9 million for 2003.[lxxxii] Although much of this increase is a result of skyrocketing D&O insurance premiums (up 158% since the passage of the Reform Act), accounting fees for companies with annual revenue under $1 billion have also increased from $695,000 in 2002 to $824,000 in 2003, a 19% increase.[lxxxiii] And legal fees increased from $404,000 to $468,000.[lxxxiv] Unfortunately for the small and mid-cap companies, many of the expenses associated with compliance do not vary greatly based on the size of the organization.

Section 404 Compliance Process. Since SOX's passage, companies have struggled to implement its many new requirements on a timely basis. Most recently, companies and their corporate counsel have been engaged in the process of working with internal and external audit teams to meet the November 15, 2004 deadline for compliance with section 404, which requires a separate management report on internal-control effectiveness.

As the compliance deadline nears, the number of companies disclosing material weaknesses or significant deficiencies has increased steadily. In the three-month period from March 2004 to May 2004, the number rose from 28 companies in March to 39 in April, and jumping to 51 in May.[lxxxv] The most common type of problems cited related to financial systems and procedures—49% of the May disclosures were in this category.[lxxxvi] Many companies disclosed numerous problems with their financial systems, not just isolated issues.[lxxxvii] Likewise, many companies reported problems in multiple categories, for example, reporting personnel issues such as a lack of employee training in conjunction with problems with their accounting process.[lxxxviii] The most notable example, reporting the largest number of material weaknesses, was MCI, which emerged from bankruptcy protection in April.[lxxxix]

Industry watchers expect the number of companies reporting "significant deficiencies" to increase once section 404 becomes effective because the Public Company Accounting Oversight Board's definition of the term has lowered the threshold for a reportable condition.[xc] A deficiency now becomes relevant if there is "*a remote possibility* that a deficiency will cause a misstatement that is more than inconsequential."[xci] It is too soon to tell what effect management's disclosure of weaknesses in internal controls will have on class-action litigation, but the plaintiffs' bar likely will try to use such disclosures as evidence of management's knowledge of problems, especially if such a disclosure is followed by a restatement. But SOX's emphasis on early disclosure of remotely possible problems may negate plaintiffs' ability to use the disclosures. If a company can show that it took immediate steps to remedy the identified problems, working in conjunction with its auditors, then it seems unlikely that the plaintiffs' bar will get much mileage out of the disclosures even if the reported problems result in a later restatement.

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Perilous Times Continue in the D&O Insurance Market

Since 2001, the rapid increase in securities fraud class action filings and the growing settlement values that have accompanied them have led insurance companies to increase premiums, limit the scope of their coverage, and make greater attempts to rescind coverage in specific cases.

D&O Insurers Lost Billions, Leading to Increased Premiums. D&O insurers do not appear to view the decline in 2003's average settlement value as significant. This is likely because the decline was driven by a decrease in the number of settlements occurring during the year and by the lower number of cases filed in 2001.[xcii] According to AIG's *D&O Insurance in 2003/2004 Briefing Paper*, "[s]imply put, until loss costs and drivers of D&O litigation (such as restatements, corporate governance scandals and the creative applications of the plaintiff bar) stabilize, premiums will need to continue to increase."[xciii]

In fact, a recent study indicated that the average publicly traded company's D&O insurance premiums increased by approximately 33% from the 2002 average of $639,000 to $850,000 in 2003.[xciv] In addition, insurers increasingly require higher retention amounts as a mechanism to align the company's interests with the insurance provider and discourage companies from settling cases quickly which might otherwise be defeated on the merits.

Aggressive Attempts to Rescind Continue. The growing trend of insurers attempting rescission only has been exacerbated by the fact that more and more insurers are facing financial strain from their D&O business as well as from losses in excess casualty, medical malpractice and surety markets.[xcv] And, as a recent decision in the Western District of Washington shows, these efforts are beginning to be successful. In *Cutter & Buck Co., Inc. v. Genesis Ins. Co.*, the court allowed an insurer to void a company's entire D&O policy, holding that one defendant's knowledge and intent to deceive could be imputed to all the otherwise innocent officers and directors and the company.[xcvi]

Efforts to rescind D&O policies not only divert a company's attention from defending the securities litigation, but also can cause a company to incur additional significant legal expenses as it seeks to enforce its insurance coverage.

Bankruptcy and a Victory for Directors. After Enron, a number of bankruptcy decisions held that D&O proceeds should be treated as an asset of the corporate bankruptcy estate, leaving directors and officers without access to defense or indemnity costs. The most prominent case—*Adelphia*—was vacated by the district court, which held that the directors were entitled to the proceeds.[xcvii] Another district court even required the D&O insurer to advance defense costs to the director while staying the rescission action.[xcviii] This precedent is a victory for directors who continue to face increased liability.

What are Insurers Going to Do? Fortunately for companies and investors, insurers do recognize that their long-term viability depends on their ability and willingness to provide coverage when it is needed. The recent AIG Briefing Paper suggests that it is those companies who have less of a stake in the D&O industry who are more quick and willing to rescind when

times are tough. AIG, therefore, recommends that a company pay careful attention to whether its insurer has a long-term and large net commitment to the D&O business to decrease the risk of rescission. In addition, insurers are creating new policies that will cover directors' and officers' personal assets to encourage individuals not only to join corporate boards but also to take the entrepreneurial-type risks upon which corporate America relies.

CONCLUSION

As this overview demonstrates, courts are beginning to find a middle ground that satisfies both the defendant-protective Reform Act and the investor-protective SOX. The Supreme Court's upcoming 2005 term has the potential to further define the pendulum's position.

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[i] E. Buckberg, T. Foster, & S. Plancich, National Economic Research Associates, Inc., *Recent Trends in Securities Class Action Litigation: 2003 Early Update*, Feb. 2004. The 224 securities litigation class actions reported include analyst and mutual fund cases. In contrast, Cornerstone Research reports 175 "traditional" class actions were filed in 2003. *Securities Class Action Case Filings 2003: A Year in Review*, *available at* <http://securities.stanford.edu/clearinghouse_research/2003_YIR/2003051104.pdf>.

[ii] *The Plaintiffs' Hot List*, NATIONAL LAW JOURNAL, July 26, 2004.

[iii] Leigh Jones, *Who Will Take the Lead?*, NATIONAL LAW JOURNAL, July 26, 2004.

[iv] PricewaterhouseCoopers, *2003 Securities Litigation Study* (2004).

[v] *Id*.

[vi] Jones, *supra* note 3.

[vii] Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Case Settlements – Cases Reported Through December 2003*, at 1 (2004).

[viii] *Id*. at 2-3.

[ix] *Id*.

[x] *Id*. These averages exclude Cendant Corporation's settlement of $3.1 billion in 2000. Including this settlement, the average and total amount of all post-Reform Act settlements are $25.2 million and $12.7 billion, respectively.

[xi] *Id*. at 7.

[xii] *Id*. at 12.

[xiii] Securities Class Action Services, *The SCAS 50 for 2003* (2004).

[xiv] Statistics in this subsection were derived from Huron Consulting Group, *2003 Annual Review of Financial Reporting Matters*, Feb. 2004.

[xv] Statistic provided by 10Kwizard.com by identifying all companies who filed a NT-10K during the first two quarters of 2004 with a narrative containing a reference to one of the following words: restate, restatement, restating or revising.

[xvi] Huron Consulting Group, *An Analysis of Restatement Matters: Rules, Errors, Ethics, for the Five Years Ended December 31, 2002*, Jan. 2003.

[xvii] Cornerstone Research, *supra* note 1, at 2.

[xviii] The data reported here used the same methodology and categorization used in Paul R. Bessette, Michael J. Biles, and Alfred Macdaniel, *Accounting Fraud in 2002: Lessons Learned*, SECURITIES REFORM ACT LITIGATION REPORTER, at 8, Apr. 2003.

[xix] This percentage exceeds 100% because many complaints alleged more than one type of accounting fraud.

[xx] Bessette et al., *supra* note 18, at 9; *see also, e.g.*, FASB Interp. No. 46 (interpreting ARB No. 51 governing SPEs); FASB Interp. No. 45 (detailing new rules governing guarantees).

[xxi] National Union Fire Insurance Company, a member of American International Group, Inc., *D&O Insurance in 2003/2004 Briefing Paper*, at 6-7, Oct. 2003.

[xxii] Joseph Floyd, *Huron Consulting Group Releases 2003 Restatement Results* (2003).

[xxiii] *Southland Securities Corp. v. INSpire Insurance Solutions, Inc.*, 365 F.3d 353, 363-367 (5th Cir. 2004).

[xxiv] *See e.g.*, *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1019 (11th Cir. 2004); *Dunn v. Borta*, 369 F.3d 421, 434 (4th Cir. 2004); *In re Cabletron Systems, Inc.*, 311 F.3d 11 (1st Cir. 2002).

[xxv] *INSpire*, 365 F.3d at 363.

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[xxvi] *Id.* at 363-65.

[xxvii] *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424 (9th Cir. 1995).

[xxviii] *Id*. at 1435.

[xxix] *INSpire*, 365 F.3d at 366-67.

[xxx] For cases on group pleading, see e.g., *In re Syncor International Corp. Sec. Litig*., N0.02-8560, 2004 WL 1700940, at *20-21 (C.D. Cal. July 6, 2004); *Napier v. Bruce*, No.02C8319, 2004 WL 1194747, at *6 (N.D. Ill. May 27, 2004). For cases on corporate scienter, see *In re Tyson Foods, Inc. Sec. Litig.*, No.01-425-SLR, 2004 WL 1396269, at *12 (D. Del. June 17, 2004).

[xxxi] 15 U.S.C. §78u-5; *INSpire*, 365 F.3d at 372; *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 682 n.3 (6th Cir. 2004) (stating same in dicta); *Winick v. Pacific Gateway Exchange, Inc*., 2003 Fed. Sec. L. Rep. (CCH) ¶ 92,652, *2 (9th Cir. Aug. 15, 2003), *withdrawn pursuant to settlement*; *Greebel v. FTP Software, Inc*., 194 F.3d 185, 201 (1st Cir. 1999).

[xxxii] H.R. CONF. REP. 104-369.

[xxxiii] *See id*.

[xxxiv] *See id*.

[xxxv] *See id*.

[xxxvi] *See id*.

[xxxvii] No. 03-3189, 2004 WL 1687885 (7th Cir. July 29, 2004).

[xxxviii] H.R. CONF. REP. 104-369.

[xxxix] *Nathenson v. Zonagen*, 267 F.3d 400, 418 (5th Cir. 2001); *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657 (5th Cir. 2004).

[xl] 267 F.3d at 418.

[xli] *Id*.

[xlii] *Crossroads*, 364 F.3d at 665.

[xliii] *Id*. at 665.

[xliv] *Id*. at 667.

[xlv] *Id*. at 666.

[xlvi] 521 U.S. 591, 625 (1997).

[xlvii] One two-year survey of class actions in federal court found that 94% to 100% of Rule 23(b)(3) class actions were certified in securities cases. Thomas W. Willging et al., *An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges*, 71 N.Y.U. L. REV. 74, 91 (1996).

[xlviii] *See Berger v. Compaq Computer Corp.*, 257 F.3d 475, 479 & n.4 (5th Cir. 2001) (holding that it is not defendants' burden "to disprove plaintiffs' 'entitlement' to class certification" and requiring class representatives to have a basic understanding of the substantive and procedural issues to manage the case).

[xlix] *Basic Inc. v. Levinson*, 485 U.S. 224, 241-42, 248 n.27 (1988).

[l] 509 U.S. 579 (1993).

[li] *Bell v. Ascendant Solutions, Inc.*, 2004 WL 1490009 (N.D. Tex. July 1, 2004).

[lii] *Compare In re Visa Check/MasterMoney Antitrust Litig.*, 192 F.R.D. 68, 76 (E.D.N.Y. 2000) *with Ascendant*, 2004 WL 1490009, at *2.

[liii] Although case law previously recognized loss causation as an essential element of a 10b-5 claim, Congress made clear in the Reform Act that plaintiffs must plead and prove loss causation. 15 U.S.C. 78u-4(b)(4).

[liv] *Emergent Capital Investment Management, LLC v. Stonepath Group., Inc*., 343 F.3d 189, 196-97 (2d Cir. 2003); *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *rev'd in part on other grounds*, 459 U.S. 375 (1983).

[lv] *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), *cert. granted*, 124 S. Ct. 2904 (2004); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824 (8th Cir. 2003).

[lvi] *Dura*, 339 F.3d at 941.

[lvii] *Id*. at 936.

[lviii] *Id*. at 938-39.

[lix] Brief for the United States as Amicus Curiae at 9, 2004 WL 1205204.

[lx] *Id*.

[lxi] The Judicial Conference's Advisory Committee on Civil Rules has drafted proposed amended rules that begin to bring guidance and clarity to electronic discovery.

[lxii] *See, e.g., Zubulake v. UBS Warburg*, 217 F.R.D. 309 (S.D.N.Y. 2003); *Murphy Oil USA, Inc. v. Fluor Daniel, Inc.*, 2002 WL 246439 (E.D. La. Feb. 19, 2002).

[lxiii] *United States v. Philip Morris USA Inc.*, -- F. Supp. 2d --, No. Civ. A. 99-2496 GK, 2004 WL 1627252 at *1 (D.D.C. July 21, 2004).

[lxiv] *Id*. at *2.

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[lxv] *Id.* at *3 & n.1.

[lxvi] *Zubulake v. UBS Warburg LLC*, No. 2 Civ. 1243, 2004 WL 1620866, at *1 (S.D.N.Y. July 20, 2004).

[lxvii] *Id.* at *15.

[lxviii] *Id.*

[lxix] *Id.*

[lxx] *Id.* at *2.

[lxxi] *Id.*

[lxxii] *Id.*

[lxxiii] *Id.* at *11.

[lxxiv] *Id.* at *9-10.

[lxxv] *Id.*

[lxxvi] *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

[lxxvii] *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

[lxxviii] *Id.*

[lxxix] The Tenth, Second, and Eleventh Circuits adopted a bright-line test, under which a secondary actor faces primary liability if the secondary actor made a material representation or omission and the misrepresentation is attributed to the actor at the time it is publicly disseminated. *See, e.g., Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996); *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194 (11th Cir. 2001). The Ninth Circuit adopted a substantial-participation test, which allows primary liability to attach to a secondary actor who "substantially participates" or plays a "significant role" in preparing others' fraudulent statements, even if the statements are not publicly attributed to the secondary actor and he does not directly make them. *See, e.g., In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615 (9th Cir. 1994). Whether or not the statement is publicly attributed to the secondary actor appears to be the defining difference between the two tests.

[lxxx] *Enron*, 235 F. Supp. 2d at 585-91.

[lxxxi] Amy Borrus & Paula Dwyer, *The SEC's Top Cop*, BUSINESS WEEK, at 118, June 21, 2004.

[lxxxii] Thomas E. Hartman, *The Costs of Being Public in the Era of Sarbanes-Oxley*, FOLEY & LARDNER ANNUAL STUDY, May 19, 2004, *available at* <www.fei.com>.

[lxxxiii] *Id.* at 14.

[lxxxiv] *Id.*

[lxxxv] Erin Klein, *51 Internal Control Weakness Disclosures Filed in May*, COMPLIANCE WEEK, at 10, July 2004.

[lxxxvi] *Id.*

[lxxxvii] *Id.*

[lxxxviii] *Id.*

[lxxxix] *Id.*

[xc] *Id.* at 11.

[xci] *Id.* (emphasis added).

[xcii] *Id.* at 1-2.

[xciii] National Union, *supra* note 21, at 12.

[xciv] Hartman, *supra* note 82, at 14.

[xcv] National Union, *supra* note 21, at 16.

[xcvi] 306 F. Supp. 2d 988 (W.D. Wash. 2004).

[xcvii] *See, e.g., In re Adelphia Communications Corp.*, 285 B.R. 580 (Bankr. S.D.N.Y. 2002), *vacated and remanded*, 298 B.R. 49 (S.D.N.Y. 2003).

[xcviii] *Assoc. Electric & Gas Ins. Services, Ltd.*, No. Civ. A. 02-7444, 2004 WL 540451 (E.D. Pa. Mar. 17, 2004).

