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HOT TOPIC

US SECURITIES LITIGATION AND ENFORCEMENT

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CD: Could you outline some of the key trends you are seeing in securities litigation and enforcement? Has the volume of class actions in this area increased in recent years?

Butler: One important new development is the announcement in June 2013 that the SEC intends to seek admissions of wrongdoing from more defendants as a condition of settlement in fraud actions. While the consequences of this policy shift remain to be seen, defendants may increasingly choose to go to trial in such cases rather than accept settlements requiring admissions of guilt. Another development is that the SEC appears to be shifting its resources to focus on insider trading and accounting-related enforcement actions. Along these lines, the SEC announced in July that it has formed a Financial Reporting and Audit Task Force, underscoring a new emphasis on accounting-related violations. We have not seen a significant increase or decrease in private securities class actions.

Tuttle: The most noticeable trend that has emerged following the credit crisis is the extent to which private securities litigation claims seem to be aligned with the government enforcement priorities or significant enforcement matters. Although a significant cause of that alignment certainly stems from the fact that the issues – the sale of residential mortgage backed securities prior to the financial crisis being the most visible of them – affected significant numbers of institutional investors who have the incentives and resources to pursue securities claims on a class or individual basis, the increasing aggressiveness of government enforcement efforts by the SEC, the Department of Justice and even non-US authorities provides a significant boost to those civil claims, particularly as the authorities increasingly insist upon admissions or acknowledgements of facts or responsibility for violations. I do not believe the volume of class actions has increased in a long-term sense and think the various studies that track them demonstrate that fact; rather the post-crisis market has seen a return to a more normalised level of securities class actions that is greater than the pre-crisis lows but still below the peaks seen in the late 1990s and in the wake of the internet bubble.

Dubbs: The volume of securities class actions has generally been stable over the last three to five years. There was an apparent bump as a result of the financial credit crisis cases, as there have been bumps in the past with respect to the high-tech bubble, options back-dating, and so on. However, there are roughly 100 securities class actions filed per year. Any discussions of trends at this point is probably skewed as a result of the credit crisis litigation, given its size and immediacy. That litigation was pursued both on a class basis and more recently as a series of individual cases, the latter being itself a

separate interesting trend. The class cases resolved themselves against some of the major players at substantial levels although, with one exception, below the $1bn dollar level. The era of $1bn-plus settlements in prior years took place in a different economic context, and the perception, which is backed up by the data, was that huge restatements put the plaintiffs on first base if not further at the outset. The financial credit cases generally did not have restatements or restatements as 'powerful' as in earlier years.

Smith: What we are seeing today is the middle to tail end of financial crisis litigation and enforcement actions. The US federal government has devoted great energy, as have some state attorneys general, to determining whether to bring actions against banks related to mortgage-backed securities. Those investigations are progressing and in the next 12 to 18 months, I would suspect this activity will wind down. Likewise, in terms of private securities litigation, we have seen some settlements already come to light, and over the next 12 to 18 months, cases will likely either go to trial or settle. The credit crisis has driven most securities litigation since 2008, and related enforcement activity has remained relatively constant since then. This activity is likely to continue, although I'd expect the focus to change. Regulators have increased their staff after the financial crisis and they will now need to deploy that staffing on other issues. Mary Jo White, Chairwoman of the SEC, has stated that regulators will be looking at other areas to target enforcement activity. Often, those target areas end up being fruitful ground for private securities litigation as well.

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CD: What common types of claims and allegations are you seeing on a regular basis?

Tuttle: Consistent with a generally observed decline in accounting restatements and accounting fraud focused government enforcement actions, I think that there seem to be fewer securities class actions focused on accounting-related misstatements. The financial crisis cases focus more on the disclosures made in connection with the sale of securities and seek both to gain the advantages

of claims made under the Securities Act of 1933 and avoid the enhanced pleading requirements of Section 10(b) claims under the Securities Exchange Act of 1934. In general, non-accounting disclosure-focused claims seem to be the most prevalent claims as plaintiffs – and government enforcement authorities – are very aggressive in trying to find some fact or collection of facts that either were not disclosed or that differ from what was disclosed and to use those facts to claim that the risks or other characteristics of the securities being sold were misrepresented to investors.

Smith: Common claims are essentially the classic Rule 10b-5 and Securities Act claims that people have always brought in public company situations; the difference is just the subject matter of the cases. On the private side, claims are generally the same that we have historically seen, generally fraud-based or strict liability disclosure or omission claims. On the government side, at least in the financial institutions area, the biggest change and development has been the Department of Justice's (DOJ) use of the Financial Institutions Reform and Recovery Enforcement Act (FIRREA), which creates a civil cause of action for the government relating to conduct that violates certain criminal laws. It is not a criminal statute. For the financial crisis, the statute of limitation has run its course on criminal actions. FIRREA has a 10-year statute of limitations, and the government is using this law to attempt to recover penalties for financial crisis-related matters. This has been a recent development, and we will continue to see these cases develop moving forward.

"FIRREA has a 10-year statute of limitations, and the government is using this law to attempt to recover penalties for financial crisis-related matters."

Charles (Chuck) Smith, Skadden, Arps

Dubbs: Allegations based on restatements have become almost as rare as unicorns as have other purely narrow, accounting-based allegations. There are of course exceptions to this but I believe that to be a trend. Common law fraud or other common law causes of action are being asserted more in individual cases in state courts that assert mortgage backed claims.

Butler: The most common type of private securities class action remains the 'stock drop' case in which a significant decline in a public company's stock price, regardless of the cause, is followed

immediately by allegations that the company engaged in fraud directed at shareholders, either because the company made optimistic statements in its public disclosures leading up to the decline in stock price or because the company failed to disclose negative information that eventually became public. Plaintiff-side lawyers continue to use such allegations to bring claims under section 10(b) of the Securities Exchange Act of 1934 and, in appropriate cases, under sections 11 and 12 of the Securities Act of 1933.

CD: What is the role of government activity in securities litigation generally and credit crisis litigation in particular? To what extent have organisations such as the SEC, CFTC and FINRA increased their enforcement activities?

Dubbs: As a general proposition, government involvement in a particular securities litigation is viewed as a measure of the potential strength of a securities class action and becomes a factor in settlement. Given that in the credit crisis cases the government has been relatively late to the party, this may be yet another factor that explains why there have been fewer $1bn settlements than in previous times when disclosures in large high cap companies have been disclosed relatively early with SEC activity. There also has been lots of discussion concerning increased enforcement by the SEC under its new Chairman Mary Jo White, but we shall see. My sense is that the Commission is swamped with writing Dodd-Frank rules, and so if there is going to be an uptick in SEC enforcement action, it has not become particularly evident. Importantly, however, Chairman White's announcement that the SEC enforcement program will now emphasise accounting allegations could be a 'game changer' for the plaintiff's bar.

Butler: The SEC and CFTC claim to have significantly increased their enforcement activities in recent years. The increase in activity, however, has not necessarily led to successful enforcement actions. For example, in December 2013, a federal jury in Kansas rejected all 12 of the SEC's claims against Stephen Kovzan, the CFO of NIC Inc. After litigating against Kovzan for nearly three years, the SEC lost on every claim despite the fact that three other former officers of NIC Inc., including the CEO, had already settled similar claims by agreeing to pay a total of $2.8m. Indeed, there are a number of other examples of cases in recent years in which the SEC has filed enforcement actions with great fanfare only to see its claims eventually rejected by a judge or a jury.

Smith: In the press, the criticism of the US government with respect to the financial crisis is that its enforcement activity was "too little, too late". My view is that such criticism is not fair. I think the government investigated for potential criminal

and securities violations at the time of the credit crisis and determined that it could not make the cases. It brought some criminal cases and obtained convictions against people like mortgage brokers who were clearly committing mortgage fraud. With respect to financial institutions, in the early years the regulators did their job, which was to separate the politics from the merits and to deal with the merits of the issues to determine whether they had a case. In more recent years, in particular with the FIRREA investigations, there is a sense that the merits matter less, and that these actions are more about politics and scapegoating. Consequently, cases are being brought against financial institutions that, but for the blood in the water as a result of the press coverage, would not have been brought.

Tuttle: The government continues to play a significant role in securities litigation and has been a major factor in the credit crisis matters. Although the regulatory agencies and organisations such as the SEC, CFTC and FINRA have brought a number of cases and focused attention on a range of issues coming out of the financial crisis, the most significant factor in the crisis cases, however, has been the Department of Justice. Using the civil investigative powers and enforcement remedies available under FIRREA, the DOJ has brought a number of major cases already and has indicated that it will bring a significant number of additional large matters involving mortgage-backed securities and other financial crisis issues. Given the 10-year statute of limitations in FIRREA and the ability of the DOJ to extract large penalties from participants in the RMBS market, it seems likely that they will continue to play the most significant role in these cases for the next year or so.

CD: What are some of the most challenging aspects of financial credit crisis litigation?

Smith: The most challenging aspect is the public perception that somebody must have done something extremely bad because the economy suffered so much. In fact, the worldwide economy has gone through bubbles over centuries; often, those bubbles don't involve misconduct by individuals or organisations but rather the classic bubble symptoms of irrational exuberance. The challenge in litigating these cases, whether against private parties or the government, is finding a way to neutralise that natural instinct for retribution, which in my view, is wrongly aimed at financial institutions.

Tuttle: There are three significant challenges in litigating cases arising from the credit crisis. First, the age of the issues and the substantial amount of hindsight-based analysis makes it very difficult to focus witnesses on what they knew and did with respect to matters that happened at least six or seven years ago. Second, many of the practices that

are now being questioned or criticised in the market for mortgage-backed securities were relatively standard across the participants in the market and, in fact, were 'assumed' by even the regulators as the disclosure requirements and other regulations were developed around those accepted practices. Thus, although the practices being criticised were not specifically prohibited by the regulations and the disclosures that plaintiffs or authorities claim were omitted were not expressly required, the fact that the regulations were built around the existing market practices means that they are not expressly endorsed in the rules either. That silence creates both the risk for companies and individuals and makes the defence more complicated. Finally, the political pressure on enforcement authorities to hold companies and individuals 'responsible' for the financial crisis has created a very difficult environment and has led to increasing aggressiveness in the regulatory and enforcement matters arising from the crisis.

Dubbs: The financial credit crisis litigation has had a number of challenging aspects. The first was that the judiciary, like many Americans, believed that if all of this happened at once no one could be held responsible, and, therefore, whether it was articulated this way or not, many started with the predisposition that the plaintiffs were engaged in hindsight bias and reverse engineering legal theories to fit a broad-based macro phenomenon. In addition, there were other almost perverse factors at play. For example, in the case against Countrywide, one of the defences was that even though disclosures to securities holders might have been problematic, all of the relevant information was argued to be on the market and impounded into the stock price because it could be found in the myriad offering materials for individual RMBS or RMBS-based products. That is, one just had to look hard enough and put it together and, therefore, there could be no harm and no foul. Although this theory is far-fetched, it presented a substantial jury risk.

Butler: One challenge in defending cases arising from the credit crisis is the insistence of many pundits and interest groups that someone – anyone – should be punished for the crisis. This general perception that there must be a wrongdoer behind every financial loss can be an obstacle to achieving a fair hearing of a claim. Compounding the difficulty, litigation in this area frequently involves complex financial products and complicated payment streams that can be difficult for lawyers to understand, let alone explain coherently to a judge or jury. Such cases often rely heavily on expert witnesses and the choice of expert witness can make or break a case.

CD: What key factors account for the size of settlements in credit crisis litigation?

Butler: In financial product litigation, one key factor is the complexity of the product involved and the difficulty of explaining complicated payment streams to a judge or jury. The more complex the product, the more likely it is that an expert witness on the plaintiff side will be able to argue for a large sum of damages, regardless of the 'right' amount of damages. If the product is sufficiently complex, there will be concern that the finder of fact will not be able to make an independent assessment of financial loss, and the defendant will feel pressure to enter a settlement even if the size is out of proportion to the actual loss.

Tuttle: The key driver of the size of crisis-related litigation settlements is really the size of the losses in the securities or financial products that underlie the claims in the cases or investigations. On the civil side, when faced with plaintiffs claiming substantial declines of the sort experienced in the residential mortgage-backed securities issued before the financial crisis, the risks of adverse judgments increase in proportion with the size of the potential losses. When combined with the risks inherent in litigating cases related to a market-wide event subject to the extraordinary amount of hindsight analysis and bias as the financial crisis, the size of the potential losses and damages unsurprisingly result in significant settlements. On the enforcement side, a similar dynamic plays out, particularly in the DOJ-led FIRREA cases, where penalties can be based on the losses purportedly caused by the violations being charged. The potential for large penalties increases the litigation risks for companies facing these investigations and will certainly contribute to the size of settlements.

> **"The potential for large penalties increases the litigation risks for companies facing these investigations and will certainly contribute to the size of settlements."**
>
> *Jonathan Tuttle,*
> *Debevoise & Plimpton*

Dubbs: As a general matter, the complexity of trying securities cases before juries leads to a discount from liability notwithstanding the theoretical exposure created by a certified class case. This factor in my view was heightened with respect to the financial credit crisis litigation. Although the SEC in the Tourre case prevailed in explaining a synthetic CDO to a jury and the misrepresentations related to it, many of the plaintiffs' bar thought, and thinks, that such difficulties were and are formidable and, without being able to wrap oneself in the 'stars and stripes', it would be almost impossible to overcome.

And one must remember that the SEC Tourre case was about one deal whereas most of the credit crisis litigation deals with a pattern of deals or in essence the disclosures resulting from how the RMBS 'machinery' of someone in the production stream worked.

CD: What are the implications of the US Supreme Court's recent grant of certiorari in *Halliburton v. Erica P. John Fund, Inc.*?

Tuttle: The most significant implication is the possibility that the Supreme Court will overturn or significantly restrict the 'fraud-on-the-market' presumption from *Basic v. Levinson*. Currently, unless rebutted by evidence showing that the market for a particular security is not efficient, securities litigation plaintiffs are entitled to a presumption of reliance on alleged misstatements through the orderly dissemination of information in an efficient market. Overturning this presumption at the most extreme end could require individualised proof of reliance or so-called 'eyeball' reliance, forcing plaintiffs to demonstrate that they were actually aware of and relied on the alleged misstatements at the time they purchased the securities at issue.

Smith: All of us are wondering what will happen in *Halliburton* and are watching it closely. At issue in *Halliburton* is the potential reversal of the precedent of *Basic Inc. v. Levinson*, which is the precedent that allows the court to presume reliance if there is a public market of widely traded securities. In those situations, *Basic* and its progeny contend that you do not have to prove individual reliance because you are relying on the market. If the court were to reverse that notion, it would have huge implications for private securities litigation because it would make it extremely difficult for plaintiffs to certify a class action, which is typically the way these cases progress. One unintended consequence is that it would lead to a multitude of individual actions related to the exact same issues, which would have to be coordinated in some way to avoid the risk of inconsistent judgements and incredible inefficiency in the system of litigating securities issues.

Dubbs: The principal implication of the Supreme Court's grant of certiorari in *Halliburton* is that a drastic ruling could obviously essentially wipe out many securities class actions that are not grounded on prospectus liability, omissions liability or other fact patterns where there are uniform communications to the class by offering materials or routine scripts. In *Halliburton*, the Court must confront the sweeping legislation surrounding securities class actions in the Private Securities Litigation Reform Act of 1995 (PSLRA), and specifically, the statutory structure that addressed the efficiency of the market. Congress found the 'market' 'inefficient' with respect to disclosures of bad news, and having found that the market overreacted after such disclosures, it

instituted a very specific statutory fix with respect to that problem. Otherwise it did not touch the fraud on the market presumption, the efficiency of the market or related questions, even though Congress was urged to do so. The inference, of course, is that Congressional intent can be inferred that it endorsed the presumption.

Butler: The *Halliburton* case gives the Supreme Court the opportunity to revisit the validity of the fraud-on-the-market presumption established in *Basic v. Levinson*, which comes into play in virtually every securities class action. The petitioner in *Halliburton* advocates rejecting the fraud-on-the-market presumption as both inconsistent with empirical evidence and impractical for lower courts to apply consistently. If the Court rejects the fraud-on-the-market presumption, the practical impact would be dramatic. The most common type of securities class action in the US would cease to be viable. The Court may, however, uphold the *Basic* doctrine but rule that evidence to rebut the presumption may be considered at the class certification stage. This would have a less dramatic effect, but would still make securities class actions more difficult to maintain.

CD: What do you think the most likely result will be when the court revisits the 'fraud-on-the-market' doctrine articulated in *Basic Inc. v. Levinson*?

Dubbs: There are a variety of potential outcomes. The Court could abolish the 'fraud-on-the-market' presumption, limiting claims to individual actions with individualised specific reliance on an alleged misrepresentation or omission. *Halliburton* in its petition certiorari to the Court outlines another path, however: "[A]t the least, the presumption should be refashioned to require affirmative proof that the market price was distorted by the particular misrepresentations at issue". This argument is what was advanced in the prior *Halliburton* case but rejected, namely the theory of 'price impact'. In theory, this is nothing more than asking whether the specific alleged misrepresentation or omission impacted the specific market, as opposed to a generalised finding of market efficiency or even market efficiency during a specific period of time for certain kinds of statements. A key problem here as a number of scholars have pointed out is that many statements can only be shown to have 'market impact' ex-post not ex-ante. Thus, a statement to the effect that 'all is well' when the company's key product or potential key discovery is indeed having problems will not result in an immediate price jump. It is what was expected. The impact of that misrepresentation can only be determined ex-post when there is a disclosure of that information and there is a stock drop. The framework that the defence bar would like to establish is one that would limit the rule to ex-ante misrepresentations. Thus, if the company said 'we discovered a cure for cancer',

there would be an increase in the price of the drug company stock which would then go down later if that was disclosed to be false. However, many if not the majority of statements can only be truly discovered ex-post based upon inferences from a drop following a disclosure. Thus, a possible outcome in *Halliburton* is to fashion a rule that would require market efficiency in the sense that the alleged misrepresentation or omission did indeed inflate the market price (whether based upon evidence ex-ante or ex-post) without dealing with the generalisable issue of market efficiency.

Butler: The fraud-on-the-market presumption has been an accepted part of Supreme Court jurisprudence for 25 years. It is difficult to imagine that the Court will abandon it wholesale. It is likely, however, that the Court will decide that evidence may be submitted to rebut the presumption at the class certification stage. Although this may seem to be a narrow procedural ruling, it would have the effect of making securities class actions much more difficult to maintain in the US because it provides an additional ground for denying class certification. In this type of case, a decision denying class certification typically causes the plaintiff to abandon the lawsuit altogether.

Tuttle: Even if the Supreme Court determines to abolish or restrict the fraud-on-the-market presumption, it is hard to imagine that the Court would require the most extreme 'eyeball' reliance in Section 10(b) cases. Doing so would, at a minimum, impose substantial barriers to potential class cases and would completely reshape the securities litigation landscape. There are, however, steps that could be taken to restrict the effect of the presumption or to more closely tie it to materiality. For example, the Court could seek to require affirmative evidence that the market actually reacted to the alleged misstatements at the time they were made or to allow a rebuttal based on the absence of any such reaction. Halliburton sought to introduce that type of evidence at the trial court level, but was prevented from doing so.

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Smith: There is a perception generally that both the academic literature on which *Basic* was based, and the realities of how the markets have worked

over the last five years, going back to the financial crisis, have shown us the limitations of the 'fraud-on-the-market' theory. And so, the court may well put some limits on the applicability of *Basic* and use *Halliburton* to decide that this presumption is not appropriate for all cases, and perhaps provide some guidance on where it is appropriate and where it is not. To give a classic example that is not an issue in *Halliburton*, but is an issue in many other cases, plaintiffs in private cases try to apply the fraud-on-the-market presumption to trading in corporate bonds as opposed to stocks. The bonds are more thinly traded, often in less developed markets, with no pricing transparency – yet parties try to convince courts that nonetheless the presumption of *Basic* should apply and they should be able to certify a class. There has been no guidance from the Court around that set of issues and *Halliburton*, depending on how narrowly or broadly the Supreme Court handles it, may provide guidance that helps in a number of situations.

CD: What general advice can you offer to companies and their D&Os on managing potential claims and related liabilities arising from securities law enforcement?

Smith: Companies often do not have their guard up until it is too late. As a result, they fail to involve their in-house counsel or bring in outside counsel, to consider the implications both for regulatory enforcement and for private securities litigation of what they are doing in response to a whistleblower complaint or in the SEC exam process. My advice generally is when you have a problem, or perceive that a problem may exist, whether in the exam process or linked to an internal whistleblower, it is penny-wise and pound-foolish to try to minimise the problem and not consult with the right people, whether they are inside your company or outside the company, in order to get a handle on the issues as quickly as possible.

Tuttle: The most important way to manage the potential risks of enforcement matters is to get off to a good start in responding to the matters and to avoid some of the pitfalls that can take serious matters and turn them into a full-blown crisis. When contacted by government authorities, it is vital that companies and employees treat the matter appropriately and seriously, and usually that they rely on counsel experienced in dealing with the authorities conducting the investigation. Often, employees or managers not used to enforcement authorities try to minimise the matter, or worse, provide responses that are less than complete or accurate. Even if those types of responses do not rise to the level of a separate, and potentially criminal, problem (and they can), those initial interactions can serve to irreparably damage a company's credibility with the investigating authority and lead to continued problems down the line. Getting experienced counsel

involved to deal with the authorities is not a sign that the company is worried about the inquiry and will not be viewed that way by the government. Instead, it is a sign that the company takes the matter seriously and is committed to responding appropriately with the proper advice.

Butler: One lesson to be drawn from the case law in this area is that companies should be cautious about settling securities law claims too quickly. This area of law has been changing rapidly, and the Supreme Court decisions in the past several years have consistently favoured corporate defendants charged with securities law violations. There is no reason to believe that this trend will end with the *Halliburton* case. Ten years ago, it might have made sense for a company to settle a securities case quickly in order to avoid the expense of litigation. These days, a corporate defendant stands a much better chance of obtaining dismissal of securities claims and avoiding any need to reach a financial settlement.

Dubbs: The risks of committing securities fraud even on a negligent or arguably reckless basis are present notwithstanding a company's belief in the pure hearts of its management. Accordingly, prudent risk management suggests that they obtain insurance at substantial levels depending upon their market capitalisation to guard against that risk. As an aside, insurance premiums are deductible by the corporation while litigation expenses on the part of the class are not. The D&O insurance scheme for securities class actions has of course a fatal flaw in that the carriers write the policies so that the company can choose counsel and direct the course of the litigation. That is a different paradigm than if you or I were involved in the most minor rear-end auto accident where the insurance company minimises its cost by running the show completely. A healthy D&O coverage position also adds another dimension to protecting the company in a more ineffable way. Namely, most class actions in the United States are run by Court appointed lead plaintiffs who are often pension funds. These pension funds have a fiduciary duty to the class as well as a continuing fiduciary obligation to their members to act prudently. Thus, a substantial settlement offer representing a substantial part of a D&O policy presents a fiduciary with a Hobson's choice of taking it and obtaining something for their beneficiaries that is real versus continuing the litigation and assuming the ongoing risks of litigation. If a D&O policy is too small given the capitalisation of the company, it is much easier for a fiduciary in a big case to pursue litigation given that the amounts covered by the D&O policies are relatively small and the Hobson's choice is not created. CD

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