Securities in the Electronic Age
Wall Street LAWYER

January 2010 ■ Volume 14 ■ Issue 1

The Coming Counter-Reformation in Securities Litigation

BY BORIS FELDMAN

Boris Feldman is a Partner in the Palo Alto office of Wilson Sonsini Goodrich & Rosati, P.C. This article reflects only his views, not necessarily those of his firm or its clients. Contact: www.borisfeldman.com.

Since Congress overrode a presidential veto of the Private Securities Litigation Reform Act (PSLRA) in 1995, the plaintiffs' securities bar has been itching for a rematch. With control of both houses of Congress and friends in the Administration, their best shot may be right now—before the mid-term elections in 2010 can create a filibuster firewall in the Senate. What follows are my thoughts on what this "Counter-Reformation" might look like and how it could come about.

Cycles of Righteousness

In the world of shareholder litigation, "who wears the white hat" has fluctuated dramatically in recent decades. In the early 1990s, efforts to cut back on frivolous securities suits emphasized the harm they were doing to innovative, entrepreneurial companies, especially in the biotech sector. That perception—together with generous campaign contributions from accounting firms—led to the two principal pieces of reform legislation. The first, the PSLRA (or, the Reform Act), changed virtually every facet of private shareholder litigation except the substantive standards of liability (and even changed those with respect to forecasts). The second, the Securities Litigation Uniform Standards Act of 1998 (SLUSA), prevented the plaintiffs' bar from circumventing the Reform Act by suing in state court instead.

The years following PSLRA and SLUSA were good to corporate defendants. On the whole, judges took the statutes seriously. Where they did not, appellate courts stepped in to enforce the legislative reforms.

Then the worm turned. Or rather, a can of worms turned in the guise of Enron, WorldCom, Tyco, Adelphia and others. The pro-defense tide subsided. Plaintiffs' lawyers going into court on behalf of legitimate pension funds often reclaimed the white hat.

Until scandal struck on the other side of the aisle. The exposure of kickbacks to class representatives, and the resulting jail sentences, rocked the plaintiffs' bar. Not only were longstanding suspicions about corruption in the class process confirmed;

CONTINUED ON PAGE 3

Article REPRINT

Reprinted from the Wall Street Lawyer. Copyright © 2010 Thomson Reuters. For more information about this publication please visit www.west.thomson.com

WEST®

© 2010 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651)687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

For subscription information, please contact the publisher at: west.legalworkspublications@thomson.com

West Legalworks™ offers you more

With over 200 events annually, West Legalworks gives you more opportunities to learn from our over 2,000 world-class speakers and faculty. Choose from any one of our events covering business of law, practice of law, and other legal and business topics.

See what we have in store for you. Visit us at westlegalworks.com/events.

WEST®

Editorial Board

CHAIRMAN:

JOHN F. OLSON
Gibson, Dunn & Crutcher
Washington, DC

ADVISORY BOARD:

BRANDON BECKER
Wilmer Cutler Pickering Hale & Dorr, LLP
Washington, DC

BLAKE A. BELL
Simpson Thacher & Bartlett
New York, NY

STEVEN E. BOCHNER
Wilson Sonsini Goodrich & Rosati
Palo Alto, CA

EDWARD H. FLEISCHMAN
Linklaters
New York ,NY

ALEXANDER C. GAVIS
Vice President & Associate General Counsel
Fidelity Investments

JAY B. GOULD
Pillsbury Winthrop Shaw Pittman LLP
San Francisco, CA

PROF. JOSEPH A. GRUNDFEST
Professor of Law, Stanford Law School

MICALYN S. HARRIS
VP, General Counsel and Corporate Secretary
Winpro, Inc.

PROF. THOMAS LEE HAZEN
University of North Carolina – Chapel Hill

ALLAN HORWICH
Schiff Hardin LLP
Chicago, IL

TERESA IANNACONI
Partner, Department of Professional Practice
KPMG Peat Marwick

MICHAEL P. JAMROZ
Partner, Financial Services
Deloitte & Touche

STANLEY KELLER
Edwards Angell Palmer & Dodge LLP
Boston, MA

CARY I. KLAFTER
Vice President, Legal & Government Affairs, and Corporate Secretary
Intel Corporation

BRUCE W. LEPPLA
Lieff Cabraser Heimann & Bernstein, LLP
San Francisco, CA

SIMON M. LORNE
Vice Chairman and Chief Legal Officer at Millennium Partners, L.P.

MICHAEL D. MANN
Richards Kibbe & Orbe
Washington, DC

JOSEPH MCLAUGHLIN
Sidley Austin, LLP
New York, NY

WILLIAM MCLUCAS
Wilmer Cutler Pickering Hale & Dorr, LLP
Washington, DC

BROC ROMANEK
General Counsel, Executive Press, and Editor
TheCorporateCounsel.net

JOEL MICHAEL SCHWARZ
Attorney, U.S. Government

STEVEN W. STONE
Morgan Lewis LLP
Washington, DC

LAURA S. UNGER
Former SEC Commissioner and Acting Chairman

JOHN C. WILCOX
Senior VP, Head of Corporate Governance
TIAA-CREF

JOEL ROTHSTEIN WOLFSON
Banc of America Securities LLP

Wall Street Lawyer
West Legalworks
195 Broadway, 9th Floor
New York, NY 10007

© 2010 Thomson Reuters

One Year Subscription ■ 12 Issues ■ $564.00
(ISSN#: 1095-2985)

Please address all editorial, subscription, and other correspondence to the publishers at west.legalworksregistration@thomson.com

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

West Legalworks offers a broad range of marketing vehicles. For advertising and sponsorship related inquiries or for additional information, please contact Mike Kramer, Director of Sales. Tel: 212-337-8466. Email: mike.kramer@thomson.com.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered. However, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

but also some of the leaders in that bar who would have been most likely to lead the Counter-Reformation were in the penalty box.

Two events have tilted the table again, this time, even more dramatically: the collapse of the credit markets; and a pandemic of Ponzi schemes. Not even the most hardened defense flack can assert with a straight face that the regulatory and enforcement system worked. It did not. It failed spectacularly, with devastating impact on many lives and fortunes.

So the question is not whether Congress will enact substantial changes to the financial regulatory system. It will. Rather, the question is whether the plaintiffs' bar will be able to piggyback on those changes to undo the many salutary reforms enacted by Congress in 1995. If that comes about, what might the plaintiff bar want?

Plaintiffs' Wish List

Herewith, a defense lawyer's perspective as to where plaintiffs might profitably focus their efforts.

Aiding & Abetting

It was not the Reform Act that rejected secondary liability in private securities suits, but rather the Supreme Court in *Central Bank*.[1] Plaintiffs tried mightily to get Congress to override that decision, but they did not find a receptive audience in Washington. Plaintiffs had some success in getting lower courts to tiptoe around *Central Bank* in particularly odious cases, but the Supreme Court (in *Stoneridge*)[2] made clear that the High Court said what it meant and it meant what it said.

The climate for creating private secondary liability now, however, is ideal. The credit crisis, plus Ponzipalooza, have left many victims with no hope of recompense from the primary wrongdoers. Plaintiffs' lawyers can point to many "outsiders" who were indispensable to those schemes but are not subject to private civil liability. Those factors almost certainly will lead to legislative creation of aiding and abetting liability (as in the Specter bill, discussed below).

This is, in my opinion, the most important priority for the plaintiffs' bar. The big money is in big frauds. Those are the situations where the primary wrongdoer is usually bust. Plaintiffs must bring other pockets to the table: accounting firms; banks; law firms; rating agencies; venture capitalists and private equity funds. If those deep pockets are on the hook, then the entire recovery calculus will change. The pot will consist of more than a claim in bankruptcy and some D&O insurance policies.

The real battle will not be *whether* aiding and abetting, but rather *how* aiding and abetting. Will the pleading burden as to wrongful participation fall on plaintiffs, as part of their *prima facie* case, or on defendants, as an affirmative defense? Will the liability standard require some form of intent or merely some species of negligence? Will liability be proportionate to fault or joint and several? These are relatively nuanced topics, less subject to sound bites than "don't let Madoff's accountants escape." But it is these types of issues that will determine whether aiding and abetting liability is a measured response to the current situation or a license to subject outside advisors to *in terroram* risk.

Discovery Stay

One of the great frustrations for the plaintiffs' bar has been PSLRA's stay on discovery until plaintiffs have survived motions to dismiss—a process that often takes years. If plaintiffs are able to get even a modest quantum of documents (Board packets, weekly management updates), they are often able with the benefit of hindsight to find a red flag here or a loose thread there. They are natural storytellers.

If plaintiffs are wise, they will not mount a head-on assault on the discovery stay. Rather, they will purport to "modify" it, to make it "more balanced." There are several easy ways to do that.

The current statutory standard is that a court may only permit discovery to preserve evidence or to "prevent undue prejudice," which courts have held to be a tough test. Plaintiffs could ask Congress to change that to a "good cause" standard, which is far less demanding of plaintiffs and grants greater discretion to individual judges.

Alternatively, plaintiffs could seek to carve out from the stay documents already produced to a

governmental agency, such as the Securities and Exchange Commission, the Department of Justice, or a state Attorney General. Given that the documents have already been produced, the incremental burden of production to private plaintiffs is the time it takes to burn a CD.

Expect the defense bar and the business community to fight hard to keep the discovery stay intact. The rationale for the stay in the first place was never just burden; it was also the notion that shareholders who sue based on nothing more than a stock drop should not be allowed to traipse through a company's files. The outcome of this battle may be too close to call.

Pleading Standards

Oceans of judicial ink have been spilled interpreting the "stringent" pleading standards adopted by the Reform Act. After a decade and a half of litigating the standards, from *Silicon Graphics*[3] through *Tellabs*,[4] a fair summary is this: the facts alleged in the complaint must lay out a relatively detailed, coherent case of fraud to pass the "smell test" that is at the heart of Reform Act pleading.

The plaintiffs' bar will mount a strong attack on the pleading requirements. They will herald cases in which suits against bad guys were stymied or thrown out because of "hypertechnical" pleading requirements.

In my opinion, the smartest path for plaintiffs is to carve out areas from the PSLRA pleading requirements, rather than try to abolish them outright. For example, Congress could exclude from the pleading requirements cases in which the SEC has commenced a formal investigation of a company, on the theory that such action makes it unlikely that the case is just a strike-suit. Alternatively, Congress might ease the pleading requirements where a company has restated its prior financials because of irregularities, rather than errors (in accounting lingo, this is often the dividing line between mistakes and fraud). A more modest approach would be to limit the PSLRA Reform Act pleading requirements to class actions, but not to individual suits. This would give institutions that bring their own "opt-out" litigation greater power early in a case.

The broadest attack would be to fold securities suits back into the Rule 12(b)(6) framework. When Congress enacted PSLRA, it was a rare instance of applying distinctive pleading requirements to a particular type of claim. In recent years, however, the Supreme Court has tightened up pleading requirements generally under Rule 12(b)(6), perhaps learning from PSLRA itself. The legislative momentum to overturn the *Twombly*[5] and *Iqbal*[6] decisions is strong. If that legislation does not carve out the PSLRA, then it may be that securities cases will be restored to the lenient older pleading standards that would apply to all civil cases.

Causation

Expect the plaintiffs' bar to take a run at the Supreme Court's decision on loss causation in *Dura*.[7] The impact of *Dura* in real world cases has been mixed. In many cases, judges can't figure it out and largely ignore it. In others, they are seizing on complex causation issues at the pleading stage to cut back or even terminate securities cases.

Plaintiffs could take several approaches to undoing *Dura*. The simplest would provide that issues as to loss causation shall be addressed at summary judgment or trial, not at the pleading stage. Alternatively, plaintiffs might swing for the fences and try to adopt the causation approach in Section 11(e) of the '33 Act: namely, that lack of loss causation is an affirmative defense for defendants to plead and prove. Even without any of those changes, if plaintiffs managed to loosen the pleading standards generally, they likely would also benefit in pleading loss causation.

But not….

Lead plaintiff. Although one of the more controversial aspects of the PSLRA Reform Act was the replacement of "first to file" with "largest loss" for choosing the lead plaintiff, the plaintiffs' bar has adapted happily to their new ecosystem. Major plaintiffs firms regularly court institutional investors to serve as lead plaintiffs. Small Taft-Hartley funds in out-of-the way places have become the the post-PSLRA era's new William Weinbergers (a legendary shareholder who

 © 2010 THOMSON REUTERS

brought over 100 securities class actions). There is no incentive for the plaintiffs' bar to tinker with those provisions.

Rather, for changes in the lead plaintiff process, one must be patient and await the next tsunami of scandal: for example, if it turns out that some of these small funds were repeat players for other than eleemosynary reasons… .

Legislative Vehicles

Let me close by confessing surprise: I thought that the Counter-Reformation would have been launched a year ago, when the Forces of Change claimed Washington. In the context of TARP'ing the business world, Congress could have included some of the changes discussed above, buried inside bloated bills. For starters, the scope of the changes could have been limited: "with respect to any institution receiving TARP funds, blah blah blah." That the plaintiffs' bar missed this opportunity may well have something to do with absences in their leadership ranks in recent years.

The most likely manner in which plaintiffs will mount their assault on the Reform Act is through a group called the Financial Crisis Inquiry Commission. The Commission was created by the Fraud Enforcement and Recovery Act; perhaps it should be called the "FERAL [sic] Commission." It is to function like the 9/11 Commission: examine the causes of the recent financial meltdown and potentially recommend fixes.

The Commission has some distinguished members. It also has strong ties to the plaintiffs' securities bar among various members and staff. For example, one of the Democratic appointees has been part of the leading plaintiffs' securities firm for years.

It is a reasonable bet that the plaintiffs' bar is going to try to get some of its reforms into the recommendations of this Commission. If they can, the political pressure to adopt the Commission's recommendations will be potent.

Apart from the Commission, several bills in Congress already seek to advance portions of the Counter-Reform agenda. Prominent Members in both Houses have introduced legislation to create aiding and abetting liability. Moreover, efforts to make pleading standards generally more lenient have gained steam in Congress since *Iqbal*.

In my opinion, the prudent response on the part of the business community will not be to oppose all of the legislative initiatives head-on. The business community is not so unified as it was when it prevailed in the 1995 reforms. Moreover, key parts of the community have placed their manhood in blind trust to TARP: *i.e.,* The Government is their boss, and the current Administration may look unfavorably on efforts to lobby against the Counter-Reformation.

One strategy that may make sense is to attempt to limit the cure to the malady. For example, one sound-bite that will propel reform is: "taxpayers paid money to bailout these companies, and they should be able to recover from the wrongdoers." A potent argument indeed. The answer may be to limit the Counter-Reforms to companies that received TARP funds. This would leave the principal Reform Act measures in place, while carving out litigation against TARP'istas.

Another strategy may be to limit the new measures to companies where there is plausible external evidence of fraud, such as a formal SEC investigation. Granted, this would subject to lawsuits some companies that had really done nothing wrong. On the other hand, it would maintain in place Reform Act safeguards for many firms that had done nothing worse than miss a quarterly number.

Conclusion

For the Counter-Reformers, the electoral clock is ticking. Presumably, by the Fall of 2010, little legislative action will take place, while both sides await what happens in the mid-term Senate elections. If the majority party loses its ability to shut down a filibuster, then the odds of sweeping rollbacks of the Reform Act will diminish appreciably.

As a result, the ground war in the Counter-Reformation is likely to occur in the coming months.

NOTES

1. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver,* N.A., 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119, Fed. Sec. L. Rep. (CCH)

© 2010 THOMSON REUTERS

P 98178 (1994)*Central Bank of Denver v. First Insterstate Bank of Denver*, 511 U.S. 164, 114 S. Ct. 1439 (1994).

2. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 128 S. Ct. 761, 169 L. Ed. 2d 627, Fed. Sec. L. Rep. (CCH) P 94556 (2008)*Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S. Ct. 761 (2008).
3. *In re Silicon Graphics Inc. Securities Litigation, 183 F.3d 970, Fed. Sec. L. Rep. (CCH) P 90610, 44 Fed. R. Serv. 3d 1311 (9th Cir. 1999), as amended, (Aug. 4, 1999)Janas v. McCracken, Silicon Graphics et al.*, 183 F.3d 970 (1999).
4. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S. Ct. 2499, 168 L. Ed. 2d 179, Fed. Sec. L. Rep. (CCH) P 94335 (2007)*Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S. Ct. 2499 (2007).
5. *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955, 167 L. Ed. 2d 929, 2007-1 Trade Cas. (CCH) ¶ 75709, 68 Fed. R. Serv. 3d 661 (2007) *Bell Atlantic Corp. v. Twombly et al.*, 550 U.S. 544, 127 S. Ct. 1955 (2007).
6. *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 173 L. Ed. 2d 868, 2009-2 Trade Cas. (CCH) ¶ 76785, 73 Fed. R. Serv. 3d 837 (2009)*Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009).
7. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005)*Dura Pharmaceuticals, Inc., et al., v. Broudo et al.*, 544 U.S. 336, 125 S. Ct. 1627 (2005

© 2010 THOMSON REUTERS