2015 Roundtable Series

Securities

Last year could have marked the end of securities litigation as we know it. Instead, the U.S. Supreme Court gave defendants another pre-class-certification opportunity to consider. The SEC charged ahead with administrative hearings rather than trials for alleged insider trading, and public companies and shareholder plaintiffs are wondering how a spate of fee-shifting corporate bylaws will be received by legislatures and the courts.

Participating in this roundtable were Joshua D. N. Hess of Dechert, Helen B. Kim of Thompson Coburn, Nicole Lavallee of Berman DeValerio, John D. Pernick of Bergeson, and Daniel J. Tyukody of Goodwin Procter. The roundtable was moderated by *California Lawyer* and reported by Cherree P. Peterson of Barkley Court Reporters.

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EXECUTIVE SUMMARY

MODERATOR: One of the most interesting decisions for public companies this year came from the Delaware Supreme Court in *ATP Tour, Inc. v. Deutscher Tennis Bund*. How does it enable fee shifting in securities litigation?

NICHOLE LAVALLEE: The court held that a Delaware corporation bylaw that requires a losing plaintiff to pay legal fees and expenses of the defendant is not presumptively invalid, assuming that the bylaw provision is not otherwise invalid. In that particular case, it was an opinion as to whether or not such a bylaw is presumptively invalid; it wasn't actually upholding the particular bylaw in that case.

HELEN B. KIM: The *ATP Tour* decision was also decided in the context of a non-stock corporation, so whether a fee-shifting bylaw in a Delaware stock corporation would be upheld as facially valid is an open question. But there was plenty of language in the opinion warning the legal community, "Just because you have a facially valid bylaw does not mean that we will enforce it. We are going to look at the circumstances in which the bylaw was enacted to see if it was enacted for an improper purpose."

JOSHUA D. N. HESS: Nothing suggested the decision wouldn't apply to stock corporations because it relied upon parts of the Delaware General Corporations Law that pointedly apply to stock corporations. Like the jurisprudence that has come down on the forum selection bylaws, this says there is a contractual relationship between a stock company and its public exchange shareholders. So, absent any equitable issues about validity in an individual case, these provisions would be upheld for stock corporations as well.

JOHN D. PERNICK: The court also disposed of two attacks that have been raised, unsuccessfully, against the forum selection bylaws. 1) The mere fact that the bylaw was enacted to make litigation against the corporation more difficult does not make it an improper purpose. 2) The fact that the bylaw was adopted after the plaintiff became a member does not mean that it is not going to apply. It still applies going forward.

On the other hand, the context of the *ATP Tour* decision is that the Third Circuit overturned the district court's ruling that the antitrust laws preempted the bylaw, instructing the district court that it needed to determine the validity of the bylaw under Delaware law before addressing the preemption issue. So that leaves the argument that the securities laws—or the policies behind the securities laws—preempt such a bylaw in class action shareholder litigation.

DANIEL J. TYUKODY: It seems pretty clear that *ATP* on its face applies to this sort of intra-corporate dispute. It is not so clear that it would apply in a securities class action where we are talking about fraud allegedly committed by the corporation.

KIM: It depends upon how broadly these fee-shifting bylaws are drafted. Thirty-four corporations have adopted fee-shifting bylaws since the *ATP Tour* decision came down. And 23 of these have language that is incredibly broad. It's not just "loser pays all." It's "you have to substantially prevail on not only the claims that you asserted, but in terms of the remedy that you sought." So if you got only 45 percent of the remedy you sought, you might still be considered a loser. And some of the fee-shifting provisions cover whistle-blower claims, administrative proceedings and investigations.

I would advise corporate clients not to be so greedy. Delaware corporations do have a legitimate interest in discouraging frivolous claims. In 2013 alone, 94 percent of mergers and acquisitions in Delaware were challenged with lawsuits. But when you make the fee-shifting provision so onerous that shareholders are deterred from bringing valid claims, the court will likely not uphold it.

TYUKODY: An issue in securities litigation generally is that some cases are frivolous. They get resolved for nominal plaintiffs fees and "corporate therapeutics" or additional disclosures that are often of dubious value. The fee-shifting provisions could help blunt that.

LAVALLEE: Many people feel this is going to have a chilling effect on meritorious litigation. And we've seen some efforts toward legislation to correct this and prevent fee-shifting provisions. At least one U.S. senator has approached the SEC about taking action to prevent such fee-shifting bylaws. I think we're going to see a lot more activity in that respect.

TYUKODY: That would be really interesting because, if you bring that up in the new Congress, you might get a very different result than the plaintiffs bar is hoping for.

PERNICK: There was an immediate look by the Delaware legislature at barring fee-shifting bylaws for stock corporations. And then right around that time there were lobbying efforts by the Chamber of Commerce, telling the legislature, "Leave *ATP* alone." And now institutional investors are lobbying the Delaware legislature and saying, "No, we do need to be protected from this bylaw."

As Helen [Kim] pointed out, if Delaware does move to bar the bylaw, that that might lead corporations away from Delaware. I read that Oklahoma allows stock corporations to have a fee-shifting bylaw.

HESS: I'll be surprised if the Delaware legislature decides to do anything. At the end of the day the Delaware Chancery Court is going to make this into a very case-by-case issue.

LAVALLEE: There's one case where there's pending litigation, and a company adopted such a bylaw, and the Chancellor really called them to task about it. So the company said it would not apply to the pending litigation.

KIM: That's the *Hemispherx* case and the company wisely chose not to make it an issue, because they had adopted the fee-shifting bylaw after the litigation had commenced. But I do think there is going to be a lot of ground shifting for the next couple of years. There will be other states that are going to use this as an opportunity to lure corporations and say, "Hey, we can be your new Delaware."

PERNICK: What else might corporations do in their bylaws to set the rules for litigation? It seems like it's an interesting trend.

HESS: General release.

KIM: They tried bylaws requiring arbitration. The SEC stepped up on that one. It's interesting that the SEC hasn't stepped up yet on the fee-shifting bylaw.

HESS: But if these bylaws expand into whistle-blower, Sarbanes-Oxley and Dodd-Frank areas, it's hard to imagine the SEC is not going to jump in very aggressively, with or without Congress. The Division of Enforcement is going to put their foot down, and most judges are going to give that a lot of deference.

With respect to intra-corporate breach of fiduciary duty cases, I think this is a reasonable effort to get back to, say, 2008 levels, where only 54 percent of mergers were followed by lawsuits.

PERNICK: It will also be interesting because of the law that, if as a result of a derivative case you bring a benefit to a company, then you can receive payment from the company based on the amount of benefit. How are these laws going to interact? If you haven't gotten all of your recovery, based on the fee-shifting bylaw you haven't met the standard and you have to pay fees. But then the court could say, "No, you actually delivered a benefit to the company." So that's another application issue. If these bylaws are allowed going forward, then the courts are going to have to balance those competing rules.

MODERATOR: From the U.S. Supreme Court, we had another decision this year in *Halliburton Co. v. Erica P. John Fund Inc.*, or "*Halliburton II*." What is the impact of this ruling?

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TYUKODY: *Halliburton II* had the potential to completely upend securities law as we know it. One question accepted for review was whether the court should reverse its 1988 decision in *Basic Inc. v. Levinson* (485 U.S. 224), which validated the fraud-on-the-market theory and made Section 10(b)(5) securities class actions possible. There have been many reasonable attacks on *Basic* both when it was decided and since, and in 2013, four Supreme Court justices in the *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds* case suggested they believe *Basic* was wrongly decided.

Nonetheless, in *Halliburton II* the court essentially said, "As a matter of *stare decisis* we're not going to change our mind, because these criticisms had been raised and rejected in *Basic* itself."

So the more modest holding of *Halliburton II* is that, at the class certification stage, a defendant can seek to affirmatively prove there was no price impact from a company's alleged fraud.

LAVALLEE: I don't think the court upheld *Basic* in *Halliburton II* based only on *stare decisis*. I think it considered the merits of the underlying arguments. When you're talking about a public company where the stock is publicly traded, the information is disseminated across the board and incorporated by the market that affects the price. Therefore, whether you actually read a particular statement is irrelevant to whether you were impacted or whether there's transaction causation. And the court acknowledged that. Proving that you read the statement is one way of proving reliance upon it, but it's not the only way.

I think the court also recognized that the principle underlying *Basic* is not an economic theory as such. The principle is a concept that information can be incorporated in the price of the stock, and that is fundamental to a publicly traded company. I don't believe there is really any legitimate argument that this basic premise is invalid. From there, the question becomes whether there was an impact, and whether it actually did impact the stock price, and whether there was loss causation. And that's a factual issue in each case.

PERNICK: So far, after *Halliburton II*, I haven't seen any case where a defendant has been able to establish lack of price impact. The courts are either saying, "We see price impact because the price went up," or, if there were other causes of the price going up, "You can't prove that it wasn't this misrepresentation, so we're going to let the case go forward."

KIM: Yes, there have been two cases decided by district courts since *Halliburton II*, and the class was certified in both. Now we'll see what happens in the *Halliburton* case itself. Judge Barbara Lynn stated from the bench that she was faced with two completely contradictory expert opinions. If she believed the plaintiffs, there was price impact. If she believed the defendants, there was no price impact. How is she going to decide? In a close case I would expect the court to take the conservative approach and allow the case to proceed.

TYUKODY: That points out a real danger here. At the class certification stage, it's the defendants' burden to prove the absence of any price impact. And the judge may decide for the other side when you've got the burden of proof. Now the burden shifts. The judge's earlier decision is not binding on his or her subsequent decision. Yet judges sometimes tend to get locked in and say, "Counsel, I've decided that issue already." So you really have to know your judge and make a very tough, calculated decision as to whether you want to raise this issue in a context where the burden is yours to disaggregate the fraudulent from the non-fraudulent causes. Later, on the merits, that's clearly the plaintiffs' burden.

HESS: I thought the gift to the defense bar here was stillborn in light of *Amgen* because, how are you going to show that there's no loss causation? You said it: you have to disaggregate fraudulent from the non-fraudulent. Well, if I'm a plaintiff, I'm going to say, "Whoa, we're starting to get into materiality issues there."

TYUKODY: You can do that. Justice Roberts' opinion in *Halliburton II* lists the four elements you have to establish. And one of them is materiality.

HESS: It seems like the courts are going to have to once again wade in there. But in terms of its actual efficacy, a lot of the discussion is, "How are the federal judges going to do this?" They are already doing this all the time in antitrust class actions over price fixing. You see economists going to war at the class certification stage to see if there are price impacts down the line. And those fights are rarely won. And here, where usually you have a stock drop issue, the price impact is graphically very present to a judge.

LAVALLEE: I agree that it is a real risk for defendants to take that on at class certification rather than reserving it for summary judgment. One reason why it's particularly dangerous is that usually there's multiple disclosures, multiple false statements. And as a practical matter, defendants cannot show that there was no price impact.

I think the people who are probably the happiest are the experts, because we are going to see a lot more in-depth analysis of the event studies at class certification and a lot more *Daubert* motions.

KIM: And a lot more discovery. It's going to get more expensive to certify a class, basically.

TYUKODY: Question for the plaintiffs: Has *Halliburton II* changed any part of your practice?

LAVALLEE: I would say no. As a practical matter, you don't want to get into a case where you don't feel that you can show loss causation and materiality. They're expensive to litigate. If you're not going to get anything at the end of the day, why bother? So it's something that we look at very carefully at the start of the case. So I don't believe it has changed how we look at cases or how we recommend cases to our clients.

KIM: But it certainly does encourage the defense bar to do their event studies much earlier than they had been doing them, just to see if there is any shot at prevailing—even though it's a narrow window, because you have to wipe out all price impact.

MODERATOR: Another case of interest for public companies is *Indiana State District Council of Laborers v. Omnicare*, which was argued before the U.S. Supreme Court on November 3, 2014.

HESS: *Omnicare* is a case dealing with Section 11 that came up from the Sixth Circuit, which broke from other circuits to say that if an opinion was expressed, and ended up being objectively false, regardless of the belief in that statement by the speaker, it could raise a Section 11 claim. There did not seem to be much appetite at the Supreme Court for the standard articulated by the Sixth Circuit, or for Omnicare's position that you have to prove both the objective falsity and the subjective state of mind of the speaker.

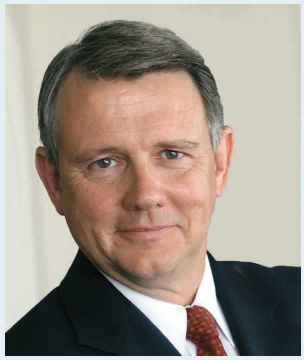
So the focus has turned to the middle ground position advocated by the Solicitor General, which is kind of a negligence or recklessness standard where the speaker had a reasonable basis for the truth of the statement when made.

TYUKODY: I think Omnicare's position has a good chance of prevailing. It seems to me the basic issue had been decided previously by the court under *Virginia Bankshares [v. Sandberg*, 501 U.S. 1083 (1991)]. You have to have made a dishonest statement of your belief in order for it to be actionable.

The other thing I would say is that a number of the justices are textualists. And a lot of the defense argument was based upon the text of Section 11. It prohibits untrue "statements of material fact." There's the strict textual argument that says, when I make a statement that "I believe X," the only fact I'm saying is that I have that belief. To put a lot of weight on what's implied by my statement and whether I had a reasonable basis for the statement is beyond Section 11's literal text. My prediction is this will be a 5-4 decision for the defense.

KIM: I don't agree. I think there is something to Chief Justice Roberts's remark that, "Wait a minute, can I turn any statement into an opinion simply by saying 'in my opinion' or 'it's my belief'? Doesn't that really upend Section 11?"

My take from this case is, first of all, anytime an issuer doesn't have to release "soft information," keep your opinions to yourself. Second, I think there is something to the Sixth Circuit argument about applying *Virginia Bankshares*, which was a Section 14(a) case, to a Section 11 case. They're very different. I agree with the government's middle ground position that it's not fair to impose Section 11 liability on a statement that turns out to be false based on some later event, that absolute objective falsity should not be the only test. You should have to look at whether there was a reasonable basis for the issuer's or speaker's statement.



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LAVALLEE: *Virginia Bankshares* is not *stare decisis*. It was a totally different claim. Section 11 is designed to look at statements made in a registration statement. And the concept is that when the company and its officers make statements in the registration statement, there is some basis for them. If there's no basis for it, they shouldn't be making the statement. The statute is designed to hold them liable for the statements made in that registration statement. That is at the heart of Section 11. So I don't believe the Supreme Court is going to apply *Virginia Bankshares*, which was an entirely different type of claim.

TYUKODY: I think *Virginia Bankshares* is directly on point. It stands for the proposition that a false statement of opinion can be actionable. But it can be actionable only if the speaker subjectively did not believe his or her statement.

PERNICK: It's even worse here, because this is in a registration statement. The company's saying, "it's our opinion"—whose opinion does it have to be to avoid liability? If the standard is you have to show subjective false opinion, then you're going to get into the question of who is actually making the statement and whose opinion counts.

HESS: I think that's what Justice Kennedy meant by saying the minute you inject any kind of subjectivity into the analysis, you get 90 percent of the way to the plaintiffs' version of events. It's an issuer saying it. And it becomes troublesome when you say "the company believes that it's compliant with foreign laws," and you have Justice Kagan saying something like, "I think a fact is being stated implicitly in that." Have I done whatever Justice Kagan thinks someone should have done to figure that out? That's very dangerous.

KIM: But at least the government proffered a test that is workable.

TYUKODY: It's not workable. The name of the game is victory on the motion to dismiss, and a "reasonableness" inquiry doesn't help achieve that.

KIM: You can actually demonstrate that there was a reasonable basis, as opposed to just going solely on a subjective analysis. I think it's appropriate.

LAVALLEE: And it's used constantly in the law. In fact, the due diligence defense gives rise to the question of whether or not they did a reasonable due diligence. Akin to that is the standard in negligence cases. It's not hard to prove. It's done all the time.

HESS: But the due diligence defense has limited application in Section 11.

LAVALLEE: Well, that proves my point in a way. How can you have the third parties liable if they failed to exercise due diligence, whereas the company, the issuer itself, won't be liable because it just didn't believe it?

MODERATOR: Okay, our final topic for today is, what are the ramifications of the SEC's move to use more administrative proceedings in insider trading cases?

PERNICK: The SEC is having difficulty with contested insider trading trials, so it is making a move to bring more insider trading claims as administrative actions. The SEC is better able to do that because the Dodd-Frank Act allowed the agency to pursue all of its available remedies in administrative actions instead of having to go to court.

From a defense standpoint, an administrative action with SEC is a very different procedure than going to court. The SEC hires the judges. And there's no discovery, no depositions. You basically get what the SEC gives you as far as evidence.

If you're a defendant facing an insider trading claim—particularly when there is already debate in the courts over what the standard should be for the knowledge essential to establish insider trading—you don't want to be in an administrative proceeding. You might have had all sorts of reasons for doing a trade, and you were going to do the trade even before someone sent you inside information. But it doesn't matter to the SEC. If you had the information, that's enough.

KIM: Judge Jed Rakoff gave a speech in which he criticized the SEC for bringing more insider trading cases in the administrative forum. As he points out, in administrative proceedings the SEC has a 100 percent success rate. Surprise! As John [Pernick] points out, in the administrative context there's no discovery, no depositions, no interrogatories. The Federal Rules of Evidence don't apply. And the SEC has carte blanche to push its more novel theories for liability. Whereas in federal district court the success rate for the last fiscal year was only 61 percent. And they had very high-profile losses, including the Obus case in New York and the Mark Cuban case in Texas.

PERNICK: And also Moshayedi.

KIM: Judge Rakoff noted that while there's technically a right of appeal from administrative decisions, deference is given to administrative law judge's rulings, whereas federal district court decisions on matters of law are reviewed *de novo* by the court of appeal.

There is far more rigorous and transparent legal analysis in the federal courts than in administrative proceedings. Judge Rakoff was correct to warn the SEC that they need to look at this from the long view. Is this really the right way to develop our securities laws? Those types of high-profile cases should be brought in federal district court.

TYUKODY: This is very dangerous ground for the SEC because right now, the agency is held in high regard. If it begins to look like a rigged game, the reputation of SEC will begin to suffer.

HESS: And they seem to already be indicating that *scienter* is going to be read out or it's going to be presumed. And if that becomes the issue, people are going to want to engage in some external reforms that the SEC won't like.

PERNICK: In my experience, if you're talking with the SEC about *scienter* and the liability of a company—it doesn't matter to the SEC. The SEC's position is that if someone within the company knew, the company is liable. Which is completely contrary to *Janus* [*Capital Group, Inc. v. First Derivative Traders*], because you actually have to show the person who made the false statement had scienter.

But when you're a company attempting to resolve a potential fraud claim with the SEC, you're generally not going to go to court to challenge the SEC on that. You're going to advocate for your position, and then negotiate the best deal you can get to settle. If you're an individual facing the SEC in court, you have the opportunity to challenge the SEC's pushing beyond *Janus* for securities fraud liability, or pushing an aggressive test for insider trading liability. In an administrative proceeding, you probably don't have that opportunity. ■