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ETHICAL ISSUES IN COMPLEX SECURITIES LITIGATION

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HOT TOPIC

ETHICAL ISSUES IN COMPLEX SECURITIES LITIGATION

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Keith Thomas focuses on complex and high-value commercial litigation with a particular emphasis on financial and banking disputes. He has recently led the high-profile RBS rights issue litigation to a successful conclusion on behalf of 313 major financial institutions. His expertise is in banking and financial litigation, securities litigation, multijurisdictional and international disputes, fraud and asset recovery, private client and trust disputes.

CD: Could you provide an overview of securities litigation activity over the past 12 months? What key trends have you observed in this space?

Johnson: One significant trend in securities litigation over the last 12 months has been the increase in state court actions asserting claims under the Securities Act 1933 Act following the Supreme Court's 2018 decision in *Cyan Inc. v. Beaver County Employees Retirement Fund.* In fact, the Securities Act cases filed in state court increased 40 percent last year from the prior year. Interestingly, 22 of the 49 cases filed in state court last year also had a parallel case in federal court. Another noteworthy trend was the increase in the number of securities class action filings alleging missed earnings, which came up in 30 percent of the complaints filed. By contrast, event-driven litigation asserting #MeToo claims and claims related to the opioid crisis declined dramatically from 2018, although I expect we will continue to see plaintiffs pursuing other event-driven claims, such as claims based on cyber security breaches, in 2020.

Thomas: The UK securities litigation market has experienced an increase in activity, with a lot more potential cases being evaluated by funders and law firms to determine if successful actions could be brought under the statutory regimes of section 90 or 90A of the Financial Securities and Markets Act 2000 (FSMA). *Omers Administration Corporation & Others v Tesco Plc* is the first case to be brought under section 90A FSMA, with the trial due to begin on 2 June 2020. This follows the RBS rights issue litigation which was the first case to be brought under section 90 FSMA. A further development has been the first financial antitrust cases, relating to the foreign exchange rigging scandal, to be brought under the collective action regime introduced by the Consumer Rights Act 2015 allowing opt-out class actions on the grounds of competition infringement.

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> *Skadden, Arps, Slate, Meagher & Flom LLP*

Meyer: One of the largest developments over the past year has been the Supreme Court's decision

in *Lorenzo v. SEC.* In *Lorenzo*, the court considered whether an individual could be held liable for securities fraud for disseminating false statements, even when he or she is not the 'maker' of those statements. For example, in *Lorenzo*, the Securities and Exchange Commission (SEC) had found that Francis Lorenzo had violated Rule 10b-5 by emailing investors to promote a debenture offering. Those emails contained a false statement, written and approved of by Lorenzo's boss, claiming that the company issuing the debentures had $10m in assets, when it had only around $400,000 in assets. Both the DC Circuit and the Supreme Court, on review, affirmed the SEC's decision, expanding the potential for Rule 10b-5 suits against professionals who assist in the preparation or distribution of communications to investors.

Carroll: Recent statistics show that securities fraud class action lawsuits are being filed at all-time-high levels. According to one research firm, last year saw the highest number of new class action securities filings since the 2008 financial crisis. A major contributing factor is the number of new state court filings brought under the Securities Act of 1933 in the wake of the Supreme Court's 2018 decision in *Cyan*. That decision, of course, permits state courts to adjudicate 1933 Act claims. An unprecedented number of 1933 Act claims were filed in 2019, with the majority of those cases filed in state courts, which employ less stringent pleading standards than federal courts. We are also seeing an increased number of cases being filed against pharmaceutical, healthcare and biotechnology firms as these sectors continue to face heavy regulatory scrutiny and the prospect of event-driven securities fraud lawsuits.

CD: What are some of the key ethical issues that commonly surface during securities litigation?

Thomas: An initial issue that arises for an institutional investor is whether to pursue a claim where an allegation of wrongdoing or fraud has led to significant losses on an investment. Securities litigation inevitably involves the investor in expending a certain amount of resource in evaluating an action, sourcing trade data, considering quantum, dealing with which entity is the proper claimant and, in open market cases, obtaining reliance evidence. Fund managers may be reluctant to spend time providing reliance evidence when it is not part of their core service and may be unwilling to have their decision-making process scrutinised where an investment suffered large losses, even though their conduct is not in issue. Institutional investors must weigh these issues against their fiduciary duty to protect the assets they manage and should objectively evaluate opportunities to pursue recovery of losses for the ultimate beneficiaries of the assets, putting the interests of those beneficiaries ahead of their own.

Meyer: Litigation funding is a key area where ethical concerns may arise. Class counsel may seek litigation funding to cover litigation expenses in securities cases. The extent to which the litigation funder may control the litigation, however, may be limited by ethical rules. For example, the New York Rules of Professional Conduct require lawyers to exercise independent professional judgment and preclude lawyers from representing clients where the representation may be materially limited by the lawyers' responsibilities to a third party, like a litigation funder. The rules of professional conduct are still developing in this area, but class counsel obtaining litigation funding must ensure that their judgment remains independent and that they properly address any potential conflicts of interest.

Carroll: One key ethical issue that defence counsel often face in securities litigation is how to combat allegations from so-called 'confidential witnesses'. Confidential witnesses are usually former employees of a defendant company identified by private investigators hired by plaintiffs' law firms. Plaintiffs often try to use confidential witness allegations in complaints in an attempt to meet the heightened pleading standards of the Private Securities Litigation Reform Act (PSLRA), which requires a showing of a strong inference that a company intended to deceive investors. The identities of the so-called confidential witnesses must be revealed in discovery, so using the

anonymous 'confidential witness' designation is merely a temporary ruse. There have been many instances where purported confidential witnesses are neither 'confidential' nor 'witnesses' at all. When unveiled, confidential witnesses have too often been found to lack first-hand knowledge of the allegations attributed to them. This creates an ethical issue that courts and litigants need to pay close attention to.

Johnson: As a result of the high pleading standard established by the PSLRA, plaintiff's counsel often seeks to rely on confidential informants to bolster their allegations and gain access to company documents. Ethical issues can arise where plaintiff's counsel misrepresents or 'stretches' the nature of the informant's knowledge or information in order to meet the PSLRA's high pleading bar and move into discovery. Courts have not looked favourably upon such conduct by plaintiff's counsel, which can result in sanctions and even potential dismissal of the case. For defence counsel, an important ethical issue can arise from representing a company as well as former officers and directors. It is critically important for counsel to evaluate any potential conflict of interest in such representations both early on and as the case develops to ensure that representation of all defendants in the action is consistent with counsel's ethical obligations to each client.

CD: What advice would you offer on how to approach and assess ethical issues in connection with securities litigation?

Meyer: The first and most important step is recognising when a potential ethical issue exists. Many issues can be resolved when handled properly, so spotting issues is key. Again, using litigation funding as an example, class counsel can review the funding agreement with an eye toward ethical issues and revise any portions of the agreement that would call their independence into question. In particular, the New York City Bar Association Ethics Committee (NYCBA) issued an advisory ethics opinion prohibiting lawyers from agreeing to pay a percentage of their fees in a contingency case to a litigation funder. While that opinion has been the subject of strong criticism and is unlikely the last word on the subject, lawyers should structure any litigation funding agreements to ensure their independence of judgment.

Johnson: As with every type of litigation, counsel has to ensure that, to the best of their ability, he or she has accurately represented all information provided to the court. This includes citing to binding legal authority and accurately describing case holdings, as well as accurately describing factual evidence relied upon to support arguments. Because securities litigation is an ever-evolving area of law, counsel must stay current with legal developments in order to ensure compliance with Rule 11 of the Federal Rules of Civil Procedure, which require counsel to certify every pleading, motion and paper's veracity before the court.

Carroll: Companies sued for securities fraud should act swiftly if they believe that confidential witness statements were made without a good-faith basis. Rule 11 of the Federal Rules of Civil Procedure requires that parties have a good faith basis for their pleading, and courts have permitted defendants to take early depositions of so-called confidential witnesses to determine whether the witnesses stand behind the statements attributed to them.

Thomas: Institutional funds generally hold investments through one or more intermediaries and often contract external providers for services such as fund management. Institutions should consider putting in place systems and practices to ensure that they are informed of potential litigation relating to investments they manage, it is clear which legal entity in the chain of intermediaries or the fund has the right to sue, and that any agreements with custodians and third parties, such as fund managers, require those parties to cooperate in the conduct of any litigation. In order to record and audit how they have discharged their ethical and fiduciary duties, institutional investors should document their assessment of whether to pursue litigation to recover losses on assets they manage.

CD: Has any essential guidance on ethical issues been issued by key institutions, such as the Securities and Exchange Commission (SEC), US Attorneys' Offices, the Financial Industry Regulatory Authority (FINRA) or state securities commissions?

Carroll: No guidance has been issued. State ethics rules, including related ethics opinions and case law, continue to provide the primary guidance on ethical issues arising in complex securities litigation.

Thomas: No specific guidance has been issued by the UK Financial Conduct Authority (FCA) or Serious Fraud Office (SFO), but the FCA has the power to require restitution under the FSMA if it is satisfied that a person has engaged in market abuse and that one or more persons has suffered loss as a result of the market abuse. The FCA exercised this power in respect of Tesco plc and Tesco Stores Limited (Tesco) and holders of Tesco securities were required to be offered compensation in return for releasing Tesco from any claims relating to the August 2014 trading statement, but not other trading periods covered by the litigation.

Johnson: The SEC has taken the position that attorneys practicing before the Commission are obligated to assist in enforcing securities laws. The SEC has codified 'Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer', focusing on an attorney's ethical obligation to report wrongdoing up the chain of command. When an attorney suspects wrongdoing perpetrated by the officers or directors that could substantially harm the issuer, an attorney is required to notify the issuer's chief legal officer. If the chief legal officer does not adequately respond, the attorney may report the violation to the board of directors, and in extreme circumstances, to the SEC. Violating SEC standards can subject the attorney to civil penalties and

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> *Keith Thomas, Stewarts*

result in censure or being barred from appearing or practicing before the SEC.

Meyer: Much of the key ethical guidance is published by the city and state bar association's ethics committees and in case law. The SEC and other authorities provide their own general ethical guidance as well. A common ethical issue addressed in both the rules of professional conduct and in case law is whether defendants may communicate with absent class members. Ordinarily, under Rule 4.2 of the Model Rules of Professional Conduct, lawyers may not communicate about ongoing litigation with a party whom the lawyer knows is represented by counsel. Courts generally hold, however, that prior to class certification, putative class members are not represented by the putative class counsel and, thus, counsel from both sides may communicate with them relatively free of restriction pre-certification. Of course, those communications should not be abusive in any way, and counsel should never provide false or misleading information even if communications are allowed.

CD: Could you highlight any recent securities litigation cases which showcase the intricacies of this type of dispute, particularly the ethical issues involved? What lessons can we daw from the outcome of these cases?

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> *Ada Fernandez Johnson, Debevoise & Plimpton LLP*

Thomas: The Tesco litigation has raised a number of ethical issues, including Tesco attempting to have the claims of all the claimants struck out on the basis that all the claimants held their shares through intermediaries and, while they were the economic owners of the shares, they were not the proper claimants. Given that Tesco had already paid a number of those claimants under the FCA compensation scheme and had no reservations about making such payments, the ethics of the strike out application are questionable, particularly in view of the additional costs and time incurred by the strike out application, which was dismissed by the

judge. This judgment indicates that the courts are likely to take a pragmatic approach to giving effect to the legislation underpinning securities claims.

Johnson: Case law is still developing around the treatment of information obtained from confidential informants. For example, in *In re Cabletron Systems, Inc*., the court established a multifactor test for evaluating information supplied by an anonymous source. In contrast, the Seventh Circuit decided in *Higginbotham v. Baxter Intern* that information supplied by an anonymous source is subject to automatic discounting. The court took a middle-of-the-road approach in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* finding the complaint was sufficiently plead using information from anonymous sources because the information provided about the sources, such as their occupation, made it plausible the sources would know the alleged information. As these cases demonstrate, courts continue to develop mechanisms for evaluating an informant's credibility. Courts will seek to strike a balance between trusting plaintiffs' representations and protecting defendants from frivolous claims. In these situations, counsel for each party should engage in robust, honest dialogue with the court to help it achieve an equitable and ethical outcome.

Meyer: In the class action context generally, courts may scrutinise the parties' pre-certification communications with putative class members. For example, in *Lapointe v. Target Corp*., the Southern District of New York recently considered whether it was appropriate to restrict the defendant's communications with its employees, which were putative class members in a Fair Labor Standards Act case. While the court concluded that the particular communications at issue were not abusive, it directed the defendant to make certain representations to those putative class members in its communications informing them that their statements would be used in defending a lawsuit. In a securities context, those problems could also arise if class counsel or defense counsel were to contact putative class members to gather information to help prosecute or defend the suit. Counsel on both sides should be cautious when communicating with potential parties and keep in mind that their communications are likely to be discoverable in the litigation.

Carroll: Some recent decisions illustrate the pitfalls of plaintiffs relying on confidential witnesses in securities litigation. The First Circuit in *In re Biogen Inc. Sec. Litig.* (2017) rejected plaintiffs' reliance on statements from 17 different confidential witnesses because their statements were "so lacking in connecting detail that they [could not] give rise to a strong inference of scienter". And a district court in *California in Union Asset Management Holding AG v. Sandisk LLC* (2017) denied defendants' motion to dismiss but nevertheless gave plaintiffs an option to

file an amended complaint to remove confidential witness allegations after defendants had submitted declarations from those same witnesses recanting the statements attributed to them in the complaint. The plaintiffs' securities bar continues to try to use confidential witness allegations to bolster their claims, but courts remain increasingly sceptical.

CD: What steps should parties take to ensure they comply with applicable ethical standards during complex securities litigation?

Carroll: Parties should keep robust records of their investigation and litigation activities in securities actions, including documenting interviews of current and former employees. Solid *Upjohn* warnings are critical, particularly in fact-gathering interviews conducted at the outset of the case.

Meyer: Counsel should make themselves aware of ethical rules by attending continuing legal education (CLE) courses and reading articles within the subject area of their practice. Counsel should also seek guidance when approaching a new situation – especially one that presents any type of ethical dilemma. The overarching ethical principles behind the problems I have addressed are counsel maintaining independence of judgment and avoiding improper communications with parties and putative parties to the litigation. Understanding those principles, and others, helps making judgment calls easier in the moment.

Johnson: Counsel in securities litigation should keep in mind that the PSLRA mandates sanctions if the court has found a party violated Rule 11. Unlike Rule 11, however, under the PSLRA the offending party is not given the opportunity to retract or amend their statement or pleading before sanctions are imposed. To avoid sanctions under the PSLRA or under Rule 11, counsel should ensure their claims and defences are well-founded, and are not being asserted for any improper purpose, such as to harass, cause unnecessary delay or needlessly increase the cost of litigation.

Thomas: On the claimant side, in the efforts to secure a sufficiently large number of claimants to give an action critical mass, claimant groups should ensure that their lawyers have the requisite expertise and experience, have obtained sufficient funding and protection against adverse costs to ensure that the litigation can be successfully prosecuted and investors will not have to pay adverse costs if the litigation ultimately fails. Three years after the RBS rights issue litigation settled, there are still several pieces of satellite litigation going on in relation to alleged breaches of contract by one action group entity that was formed to bring claims, adverse costs insurance which is alleged never to have existed and breached obligations

to funders. Claimants should always do full due diligence on claimant groups and be aware that the lowest cost option may not be the best in the long run.

CD: With securities litigation activity set to rise, what are some of the ethical issues you expect to dominate? In what ways might these issues impact cases?

Meyer: Ethical issues surrounding litigation funding are likely to take the forefront as securities litigation activity continues to rise. Securities litigation is notoriously complex and expensive, and litigation funding is an enormous resource for plaintiffs litigating these cases. With NYCBA Opinion 2018-5, plaintiffs' counsel must navigate some unclear ethical territory if they wish to use funding. While that opinion has not yet had a demonstrable impact on securities litigation, if other jurisdictions follow the NYCBA, plaintiffs' counsel may find themselves unable to secure funding. At the same time, Opinion 2018-5 has been widely criticised and could be modified or superseded. If the NYCBA modifies its opinion to be more approving of certain funding arrangements, or if other rule makers approve of those arrangements, plaintiffs' counsel could be more confident in seeking funding for their cases and securities litigation activity could increase even more.

Johnson: We will continue to see ethical issues arise in the use of confidential sources, particularly if it is found during discovery that the information or facts attributed to the confidential sources are not borne out. To the extent particular plaintiff's firms are found to have misrepresented – perhaps even on multiple occasions in different cases – information from confidential sources, it may result in courts' discounting allegations based on confidential sources. For defence counsel, ethical issues around multiple representations will continue to surface and will require counsel to actively evaluate potential conflicts of interest throughout the representation, to ensure compliance with the ethical obligation to vigorously represent the interests of each client.

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Thomas: The phrase 'the weaponisation of costs' has been used in relation to defendants who run up huge and often unnecessary legal costs with a view to attempting to exhaust the resources of claimants bringing securities claims or prevent those claims proceeding as insufficient adverse costs cover is available. The ethics of this tactic are questionable, not least in relation to access to justice. However, given that most securities litigation ultimately settles, it is the current shareholders of the defendant that end up paying these costs. We expect an increasingly interventionist stance from the courts by measures such as cost capping or management and greater demands for an effective class action procedure to enable claimants to access justice at a reasonable cost. The effective lack of a remedy under s90A FSMA for fraud within issuers available to index/tracker funds and funds run increasingly by algorithms and artificial intelligence may result in the courts considering concepts such as presumed reliance or indirect reliance which are well known in other jurisdictions.

Carroll: The use of third-party litigation funding raises thorny legal and ethical issues that may affect securities class action litigation. There is little public data about the use of third-party funding in securities class actions because there are presently no uniform rules requiring disclosure of funding arrangements. Courts, to date, have been reluctant to mandate disclosure. As the number of cases continue to climb, courts will be called upon for increased transparency and heightened scrutiny of potential conflicts of interest associated with third-party funding. CD