Litigation Update, With Hale and Dorr Senior Partner

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Last month, we covered a NERA survey that stated Sarbanes-Oxley has had "no statistically significant impact" on class action filings, settlement values or recovery rates. According to the research, all those key metrics have remained flat or declined, despite some fairly the massive settlements. This week, we turned to two Hale and Dorr senior partners, Jonathan Shapiro and William Paine — who is vice chairman of the firm's Corporate and Securities Litigation Group — for their insights into the research, class action trends, and the potential for controls-related litigation.

The NERA report stated that the litigation dismissal rate has fallen by as much as 30 percent post-SOX. Was that a surprise? And what does it mean?

Since mid-2002 we perceive a greater reluctance on the part the federal courts to dismiss open market fraud class actions.

That said, the 30 percent drop reported this month by NERA came as a surprise because our own dismissal rate has not fallen dramatically.

The data certainly validates our sense that it is getting even harder to solve these problems, at least at the outset on a motion to dismiss.

Have you noticed a qualitative difference in the types of class action filings post-SOX?

Although we cannot put a number on it we definitely are seeing a broader range in the quality of cases that are being brought.

There have been accounting fraud cases based on admitted mistakes — restatements — for years.

But before the aura of corporate scandal refracted the courts' response to securities cases generally, market responses to missed earnings expectations and other not necessarily predictable events were being brought less and dismissed more.

We think that plaintiffs are emboldened to pursue theories that were being rejected in the period 1995-1999, in part because there is a greater chance that a court will allow them to pursue discovery (in which case an entirely new theory may be revealed), and in part because plaintiffs hope to use the proceeds of a larger volume of relatively weak cases to smooth out their earnings in

light of the delays associated with the resolution of the much larger cases.

Does that mean the courts are open to hearing what would have been considered "frivolous" suits?

We do not conclude from a falling dismissal rate and an uptick in weaker lawsuits that the federal courts ultimately will be without skepticism of class action litigation.

We think that NERA's new data is explained to a significant extent by timing differences — courts that in the past may have thrown out a lawsuit on an early motion now are more inclined to let the case, or some small sliver of the case, proceed through some discovery.

Although litigation costs, litigation risk and therefore settlement value are increased by discovery, it doesn't necessarily follow that courts are no longer hospitable to public company defendants.

Another NERA report from November '03 stated that the annual probability of facing a securities class action lawsuit has increased 40 percent since 1995. That number seems pretty high: a 2.3 percent chance in 2002. You state it another way: the average public company faces a 9 percent probability over a five year period. How do you think that will trend over time?

There is no question that the long-term trend of increased filings has not abated since the mid-1990s, although on an annualized basis the ramp is moderate excluding one-time waves of litigation like the 300-odd IPO laddering cases and the analyst research cases.

We have been involved in more than 100 class actions over the last decade, and if the last six months are any indication, filings will continue to increase in 2004.

What types of companies will be most impacted?

There is, of course, no such thing as an average public company. So if a 9 percent probability of being sued in the next five years isn't bleak enough, that data point understates the risk in some industries. The bulk of our securities litigation clients are technology companies, and for the foreseeable future these companies will continue to face disproportionate exposure to shareholder class actions.

In the last few years we have seen a painful spike in cases against our life science and biotechnology clients; although at some point those numbers should level off, there is every indication that the SEC is stepping up its scrutiny of the space as well.

According to a recent report by ISS, a large number of shareholder litigation suits are being settled with issuers agreeing to adopt some type of corporate governance reform. Are you seeing a similar trend here?

There is nothing novel about settling shareholder litigation with non-monetary (sometimes called "prophylactic") relief. For years, it has been routine for derivative suits to be settled for other than cash consideration (except for the plaintiff's attorney's fee).

The increased prevalence of settlements requiring more than cash has something to do with the

involvement of institutional shareholders (such as state, municipal and union pension plans) in the class action process.

The Reform Act sought to empower institutional shareholders to control securities class actions. Few private institutions have answered that call. Union and governmental pension programs, however, have needs and constituencies that value therapeutic relief, and are more interested in seeking it.

A number of companies and individuals have been charged with fraud by the SEC that were actually third parties to the company at which the fraud took place. Do you get the sense that the SEC will be aggressively going after third parties that might have aided/abetted?

The SEC has made plain that they intend to make aiding and abetting liability an enforcement priority.

That comes through in public statements of the staff and the increased prevalence of enforcement actions against people that enable transactions that the SEC concludes were improper.

We've seen this new emphasis in cases of our own; and think this trend likely will continue.

Most cases alleging violations of "internal controls" provisions don't really get to the core of the alleged misconduct. Instead, they're basically an afterthought to allegations of financial fraud or false reporting. A former SEC enforcement division assistant director recently told us that all that will likely change soon and, in fact, anecdotal evidence may show the SEC staff is already addressing the internal reporting process of companies under investigation in a more comprehensive fashion. What do you foresee when it comes to enforcement & internal control provisions?

As you point out, the SEC typically brings "internal control" claims in conjunction with those alleging violations of the anti-fraud or other more weighty provisions.

There is, of course, no reason why the SEC cannot bring a civil enforcement action solely for a controls violation, and generally speaking we expect the SEC to use both its traditional and new Sarbanes-Oxley authority.

However, absent an allegation that investors were financially harmed, one could question whether a prosecution for less-than-perfect corporate process is a likely use of the SEC's expanded but still limited resources.

We would be surprised if a significant number of enforcement actions were brought that were not tethered to a substantial injury.

That makes sense. Thank you, gentlemen.

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