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abtl REPORT

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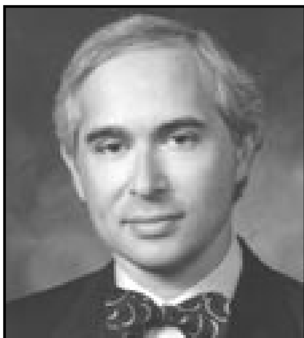
Protecting the Quarterback: How to Prepare Your CEO for Trial

Trials are seldom won or lost by the CEO. In most lawsuits, the CEO plays at most a bit part. He may provide the "face" of the corporation for the jury. But, given delegation of responsibilities and the role of the modern chief executive, he will seldom have been the principal officer involved in a dispute.

This article addresses those uncommon situations in which your CEO will be front and center at trial. As Scott Fitzgerald might say, CEOs are different from you and me. They have different strengths — and vulnerabilities — than other witnesses within the company. Preparing them for deposition and trial presents peculiar challenges. Here are some tips that have worked with my clients.



Boris Feldman

The Vulcan Mind Meld

You and your CEO must become as one. What he knows, you must know. But not necessarily vice versa! What does this mean?

At an early stage in the litigation, you must try to understand the CEO's perspective on the events and issues in the dispute. Ultimately, what he tells you during the initial

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Judicial Approval of Class Action Settlements

With more than a few public companies awash in financial scandal and executive mischief, counsel should not be surprised to find judges intensifying their scrutiny of proposed settlements of securities class action lawsuits to ensure that the proposed terms are fair, adequate and reasonable to the injured investor class. While the basic parameters of Rule 23(e) have not changed in recent years, more courts are demanding a fully developed record on which to apply the rule's fairness inquiry. A solid record containing detail and proof supporting the terms of a proposed agreement should accompany any motion for approval of a class action settlement.

Hon. Edward Infante, Ret.

Standards Under Rule 23

Under Rule 23(e) of the Federal Rules of Civil Procedure, "a class action shall not be dismissed or compromised without approval of the court." To determine whether or not to approve a settlement, a court must review the underlying record to determine whether the terms of the settlement are "fair, adequate and reasonable." The Ninth Circuit has identified the following factors that a district court must balance in assessing a settlement proposal:

- The strength of the plaintiffs' case;
- The risk, expense, complexity and likely duration of further litigation;
- The risk of maintaining class action status throughout the trial;
- The amount offered in settlement;
- The extent of discovery completed and the stage of proceedings;

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interview is likely to be what he will testify to under klieg lights. His recollection and articulation will prevail over coaching, so you better hear it in his words up front.

CEOs are usually smart. Begin by explaining the context of his testimony: the claims involved; the legal framework; the pivotal factual disputes. Who else will testify, and what are they expected to say? Where are the landmines? Often, the CEO will not have worked with you before. Make him comfortable that you understand the company's objectives in the litigation and that you have a strategy — consistent with the provable facts — to get there. At your initial meetings with the CEO, he will be evaluating you as much as you are evaluating him. The personal interplay between the two of you will be important at trial, and the judge will pick up on it. If you do not click with the CEO, submerge your ego and find someone else on the team who does.

Your initial interview of the CEO, and his first depo prep session, are often one and the same. CEOs like to talk. Let him. Don't try to reign him in with a bunch of narrowly circumscribed questions. There will be plenty of time later to acclimate him to listening and answering carefully. For now, you want to let the CEO walk you through what happened, from his perspective and in his words.

Do your homework in advance. Before the meeting, you should have collected what everyone else involved in the dispute says about the CEO: on your side, from the witness interviews; and on the other side, from discovery. Have a detailed chronology close at hand, because he is unlikely to remember all the dates or even the sequence of events. Bring the documents produced from his files, so that you can refer to his calendar and to emails and memos that he received. Remember, you are engaged in a confidence-building process. If he thinks that you are on top of the details, then he will draw strength from you.

Ignore protocol in deciding whom to bring to the interview. You do not necessarily need to include the other partners on the account. You do need someone with total mastery of the factual minutiae. If there is someone at your firm who has the CEO's trust and who makes him relax, consider including that person in the meetings, even if he isn't a litigator or wasn't involved in the transaction in question. Remember, a big part of your job is to win the CEO's trust.

Don't pollute the witness. What the CEO did not know may in some cases be as important as what he did know. For example, if the CEO was unaware at the time that a lower-level employee objected to a particular decision, you may not want to confuse him by discussing that employee's views. It is important that you hear what the CEO knows before you start feeding him facts. He may have difficulty later separating his own knowledge from information transmitted by counsel. There is no brightline rule for what you should not tell him. Obviously, you don't want him to be shocked or flustered at a deposition or at trial by a hitherto-unknown fact. But you should resist the natural (for litigators) tendency to tell him everything about the case until you have considered, item by item, whether a fact is something that he needs to know or is better off not knowing.

My preference is to schedule several shorter meetings with the CEO rather than one marathon session. He does, after all, have a business to run. After an hour or two, his attention may start to drift to other crises on his plate. Better to come back to the company often for short, productive sessions, rather than burn him out.

Neither A Gates Nor A Clinton Be

A dominant factor in how well your CEO performs at trial will be how well he performed at his deposition. If he testified well, he is likely to make a good trial witness. If he remembered nothing at the deposition, good luck putting on your case through him at trial; he will be eaten alive by impeachments.

A popular self-help book a few years back was called "Everything I Know I Learned in Kindergarten." With respect to CEO deposition conduct, a sequel might be called "Everything I Know I Learned in the Gates and Clinton Depositions." The depositions of Bill Gates in the Microsoft antitrust litigation and of Bill Clinton in the Paula Jones case will go down in history as exemplars of how not to behave at a deposition. One key lesson: don't play dumb. Gates's professed inability to understand what a "browser" was did not endear him to the trial judge. Take the time to prepare your CEO for the deposition. If he does not remember things, then try to refresh his recollection in advance of the deposition, not just at trial. People — judges and jurors — expect a CEO to know certain things (such as how much they were paid or the proceeds from their stock sales). Make certain that they know those things, rather than giving answers like "somewhere between 10 and 20 million."

A second key lesson: don't nitpick the questions. Will a student of the Clinton impeachment controversy ever forget the classic answer "it depends what you mean by 'is'"? Explain to your CEO that he cannot answer a question by applying a hypertechnical construction of the question. The judge or juror will think he was being evasive, not clever. If the question is a trick question, then he should make clear in the answer what he is addressing. He should not try to create wiggle-room for trial that might reasonably offend others.

A third lesson: remember the camera. Your CEO will almost certainly be videotaped at the deposition. Video clips of a snarling or condescending CEO will make a lasting impression on the jury during opening argument. Make sure that your CEO understands that the jury will watch the clip of *him* — not the obnoxious provocation from counsel that preceded the clip.

Two other suggestions for deposition etiquette. Make your CEO understand that he will not convert counsel for the other side. While it is true that a strong deposition performance can affect settlement discussions, it is naive to think that opposing counsel will see the error of his ways once the CEO lays out the truth. CEOs are used to persuading people. But they must understand that they

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are not likely to persuade their adversary.

With respect to your own behavior at the deposition, don't pick fights. If you have prepared the CEO well, he will do fine. If you haven't, then all the speaking objections in the world won't save him. Witnesses generally — and CEOs in particular — do not find squabbling between counsel helpful; they find it distracting and irritating. Don't make objections unless you need to in order to preserve the objection for trial. If the other side is abusive, don't respond in kind. Warn opposing counsel once, then terminate the deposition if it happens again. Do not make your CEO sit through a torture session.

Showtime!

As you prepare your CEO for trial, try to make sure he reads his deposition transcript. This will drive home how his answers look to others. It will also reduce the danger of impeachment. Be sure to update him on things that you learned since his deposition prep: what others said about him; new documents that emerged; the final contours of each side's case as they approach trial. Give him positive — but candid — feedback on how he did at the deposition. Although he cannot contradict his depo testimony at trial, he can continue to refine his testimonial techniques.

As you prepare the CEO's testimony, define your objectives precisely and narrowly. Do not make the CEO carry more water than he must. He is your quarterback; protect him in every way that you can. If someone else can make a point as effectively, make it through that person. Do not put the CEO in the position of having to testify to things that he really does not know or that are beyond his ken; he'll be dissected on cross. Don't use the CEO as the vehicle for putting all your exhibits into evidence; try to sponsor them through others who are of lesser importance to your case.

Focus the CEO on key trial themes. Let him know what your other witnesses will address. Help him understand what evidence you need from him and how it relates to the rest of your case. Let him know your greatest vulnerabilities, so that he is not surprised by them. Don't assume that, because opposing counsel did not explore a topic with him at the deposition, the counsel will skip that topic at trial.

Make sure that you have plenty of time to run the CEO through his testimony repeatedly before trial. The trick is to make sure he is adequately prepared, but not over-prepared. He should not come across as programmed or scripted. My own preference is not to provide the CEO with a list of questions and answers, since he may try to memorize them. If your CEO is having trouble making the transition to star witness, consider retaining a jury consultant to help provide feedback on presentation techniques. Try to keep the final prep sessions small – ideally, you, the CEO, and perhaps the General Counsel. This is

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Trying Securities Class Actions in the Post-Enron Era

Recent events will force major securities class actions to trial in an environment of unprecedented hostility toward defendants — particularly those accused of accounting fraud. The plaintiffs' securities bar has filed an increasing number of claims that will survive motions to dismiss. Many of the "best" cases are being pursued on behalf of institutional investors and other lead plaintiffs who are exercising real control over the litigation, and are not inclined to settle within historical parameters. These dynamics are exacerbated by the fact that the directors and officers liability insurers who fund most settlements are facing massive exposure on policies written in a softer market and less threatening times. Difficulties in valuing cases in a changing environment, and the absence of jury verdicts to provide benchmarks, make it likely that we will see a significant number of high-stakes securities class action trials in the next few years.

Robert P. Varian

Counsel will be required to chart a course through a new litigation environment that for the first time places a premium on the ability — actual and perceived — to win securities cases at trial. Because such trials have been rare, there is no reliable database of juror reactions to the fact patterns that recur in securities class actions, and no "book" on how to try them. Even if such resources existed, they would have to be updated and revised in the wake of Enron and the debacles that have followed.

Two trials in the Northern District of California — the second of which went forward in the midst of the Enron scandal — help fill this void. In addition to providing a wealth of information that should help securities litigators optimize their performance, they demonstrate that defendants can win cases in front of juries, even when the claims are based on allegations of an accounting fraud. This article attempts to provide some flavor of those trials, along with a sampling of the more important lessons learned during them.

Overview of the *Everex* Trials

The *Everex Securities Litigation* (92-3742 N.D.Cal. 1992) is believed to be the first securities class action to go to trial in the Ninth Circuit since a jury returned what amounted to a $100 million verdict in the *In re Apple Computer Securities Litigation*, in 1991. *Everex* was tried twice. The first trial ended in August of 1998, when Judge Charles A. Legge directed a defense verdict after approxi-

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Trying Securities Class Actions

mately five weeks of testimony. With the aid of an *amicus* brief filed by the SEC, plaintiffs obtained a reversal in the Ninth Circuit. (228 F.3d 1057 (9th Cir. 2001).) Judge Charles R. Breyer presided over the second trial, which went to the jury in February of 2002 and resulted in a defense verdict. The case was filed by two well-known securities class action firms, who shaped the claims and developed the underlying legal theories. Most of the trial work was handled by jury trial specialists retained by plaintiffs for that purpose.

Everex was a personal computer manufacturer that succumbed to a vicious price war initiated by Compaq Computer Corporation in the second half of 1992. The case centered on financial statements that reported modest profits in three quarters that preceded a financial collapse in which the company recorded a $100 million loss and declared bankruptcy. Playing on the inherent implausibility that Everex's financial condition had deteriorated from increasing profits to massive losses in less than six months, plaintiffs second-guessed various aspects of the company's accounting.

Everex's bankruptcy and rulings on pre-trial motions narrowed the case to claims of primary and control person liability against Steven Hui, the company's founder, Chairman and CEO. The defense strategy in the first trial successfully dismantled plaintiffs' case on the elements of scienter and control person liability, and produced a directed verdict on those grounds. When the Ninth Circuit reversed the directed verdict, it became clear that a second trial victory would require: (1) greater focus on defending the "correctness" of financial statements; (2) reliance on the company's outside auditors; and (3) the ability to counter a variety of adverse evidence designed to raise juror suspicions and impugn the integrity of Mr. Hui. Each of these objectives collided with the cascade of revelations regarding Enron, Arthur Andersen and a growing number of other companies.

Lessons Learned

Countering Juror Misconceptions About Securities Class Actions. One of the most important lessons to come out of the *Everex* trials is that jurors do not have a clear idea of what a securities class action is or how it gets filed, and harbor misconceptions that are highly prejudicial to defendants. Most believe the cases are filed by groups of injured individuals who have banded together to seek justice from corporate malefactors. Accordingly, defense counsel must contend with the image of a groundswell of angry investors hiring lawyers and accountants to investigate misconduct and pursue legal remedies. Because such misimpressions provide the filter through which the evidence will be reviewed, they must be erased at the earliest opportunity.

The basic nature of a class action can be covered within narrow limits on voir dire (if permitted), or in a preliminary instruction. These avenues — both of which were pursued in *Everex* — are not likely to be very productive. Opening statements provide the first real opportunity to dispel juror misconceptions in this area. Plaintiffs' counsel will almost certainly allude to (and embellish upon) the fact that the class representative is bringing claims on behalf of thousands and thousands of others. This point, along with the fact that accounting experts had conducted an extensive "investigation" on behalf of the class, was a prominent feature of plaintiffs' opening statements in both *Everex* trials.

Defendants will normally be permitted to tell the jury that the lawsuit was filed by an individual (or small group of individuals) acting alone — not by thousands of investors in concert. Counsel should emphasize the absence of contact between plaintiffs and other class members before the complaint was filed. In an accounting case, defendants should also note that the accountants who performed the "investigation for the class" did not communicate with any class member, and were retained by the lawyers for litigation purposes long after the lawsuit was filed. These points can then be re-emphasized through cross-examination of plaintiffs' witnesses.

Overcoming Juror Bias In Favor Of Investors. Not surprisingly, the vast majority of jurors will approach a securities class action trial with a bias in favor of investors. In the current environment this tendency will be both more pronounced and more daunting, but the *Everex* experience demonstrates that it can be overcome.

Defendants will usually control the officers, directors and lower-level employees who were involved in the transactions and events at issue, and are being accused (explicitly or implicitly) of serious wrongdoing. Jurors should be able to identify and empathize with at least some of the individuals who fall within this "target zone." Because they were on the scene at the time and know what happened, the credibility of these witnesses can be a powerful weapon that cuts through a thicket of adverse inferences, seemingly incriminating documents and testimony from paid experts. Moreover, jurors should be made to understand that they cannot render a verdict for the investors without hurting these individuals, even when they are not named as defendants. The defense can seize this opportunity to put the focus on real people, rather than a "bloodless corporation," and argue (or at least suggest) that the most important facet of the case is the reputations of decent individuals whose professional standing and ability to earn a living may depend on the verdict.

Taking the point a step further, the "real-world" damage to the individuals in the target zone can be contrasted with monetary losses suffered by disappointed investors while playing the stock market. Now more than ever, jurors understand that the stock market is risky, and that investing in individual stocks entails more risk than mutual funds or bonds. Many will have lost money themselves. While jurors will not expect investors to assume the risk of fraud, they will expect class members who testify at trial to have done their "homework," particularly when the company is in a volatile industry or market segment. The notion that the securities laws do not provide insurance for investors who took substantial risks in the hope

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Trying Securities Class Actions

of increasing their returns resonated with the jurors in both of the *Everex* trials.

Cross-Examining Class Members. Defense counsel caught up in the back-and-forth of the evidence on the key issues should not underestimate the impact of testimony from individual class members. Because such testimony will rarely be "relevant," and there is a risk of alienating jurors through aggressive examination, counsel may be tempted to forego cross-examination altogether. That would be a mistake. *Everex* demonstrated both that impressions of testifying class members play a significant role in juror deliberations, and that defendants can develop useful information on cross-examination without taking undue risks.

As noted above, the absence of prelitigation contact with other class members and the experts who "investigated on behalf of the class" can be established and highlighted in the examination of class representatives. This line of questioning can be particularly effective if plaintiffs' counsel has emphasized that the witness is in court representing a class of thousands of investors. Investors who suffered relatively small losses should be examined on that subject as well. Jurors seemed puzzled — and in some cases suspicious — about why class members who had lost so little would bother to sue. Several noted that they had, or knew people who had, suffered larger losses without resorting to litigation. Others thought it was odd that an investor continued to buy Everex stock as the price declined.

The themes surrounding investment risk can be reinforced in the middle of plaintiffs' case by displaying the most compelling risk disclosures and asking (in a low-key manner) whether class members reviewed them prior to making their investments. Plaintiffs who read such cautionary language ostensibly knew what they were getting into. Those who did not will likely alienate some members of the jury because they failed to conduct even the most rudimentary investigation before purchasing a risky stock. In either case, the witness will have to acknowledge that the defendants did not attempt to hide the facts disclosed. Other facts favorable to the defense can be underscored through "ghost" cross-examinations on topics such as whether the plaintiff "knew" that the company had received clean audit opinions, that certain insiders sold no stock, or that the company was repurchasing stock.

Winning The Battle Over The Financial Statements. The second *Everex* trial ended with the jury's "No" answer to the Special Verdict question whether plaintiffs had proven by a preponderance of the evidence that any of the three financial statements at issue was false or misleading. While the accounting issues were varied and complex, much of the dispute centered on two components — inventory valuations and accounts receivable reserves — that the accounting profession recognizes involve a considerable amount of subjective judgment. The defense was initially inclined to emphasize that Generally Accepted Accounting Principles tolerate a broad range of estimates in these two areas. The fact that reasonable accountants could disagree on the "correctness" of the numbers seemed to provide a solid foundation for countering both the claim that the financials were misstated, and the assertion that errors resulted from fraud (rather than an erroneous judgment or mistake).

This approach had to be abandoned, however, because jury research and mock trials demonstrated that lay persons would not buy it. The notion that financial statements can be "calculated" with precision appears to be deeply engrained. Defendants who challenge it risk a loss of credibility, not merely failure to persuade on a particular point. The task thus became one of demonstrating that the financial statements were "correct" as issued, and that the alternative results generated by plaintiffs' experts were "wrong." This was accomplished by: (1) winning the battle of accounting experts; (2) leaning heavily on testimony from the outside auditors; and (3) convincing the jury that the finance professionals inside the company were honest.

The battle of accounting experts must be fought with the understanding that the jury will not follow the details of the accounting dispute very far, or reach specific conclusions on the accounting issues on the basis of fine-tuned analysis. Accordingly, impressions will often be more important than substance. Experts who project confidence, avoid calculation errors, and demonstrate strong understanding of the important documents and business facts will fare better than those who stumble in these areas.

Because defendants will typically have access to company personnel who can explain transactions, ambiguous documents and the business context in which the financial statements were generated, they have a natural advantage in this arena. All other things being equal, defense experts are less likely to make mistakes, and better able to assist counsel in exposing missteps by the opposing expert. At a minimum, plaintiffs' accounting experts will have to concede that the Generally Accepted Auditing Standards (and common sense) dictate that access to a company's personnel, and an understanding of its business, are important factors in evaluating financial statements. Plaintiffs' experts will also have to admit that they would have liked the opportunity to meet with the people who ran the business and prepared the financials. Ideally, defense experts will be able to use their superior access to records and personnel to conduct accounting and audit tests that their counterparts were unable to perform. Even when such testing is not performed, however, the mere fact that the expert can testify that he has had such access will provide a basis for crediting the defense opinions over those offered by plaintiffs' experts.

Testimony from the company's auditors can be more convincing than the opinions of "paid litigation experts." Unlike the experts, the auditors were on the scene in real time. They had a professional duty to conduct a thorough examination, and a strong interest in preserving their reputations. Moreover, auditors are required to make and document contemporaneous assessments of audit risks,

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Class Action Settlements

• The experience and views of counsel;
• The reaction of class members to the proposed settlement; and
• Whether the settlement was the product of collusion among the negotiating parties.

See In re Mego Financial Corporation Securities Litigation, 213 F.3d 454, 458 (9th Cir. 2000). In addition, the Private Securities Litigation Reform Act requires judges to review factors including adequacy of class representation, limitations on damages, and content of the notice of proposed settlement terms. 15 U.S.C. sections 78u-4(a), (e).

A Solid Record Demonstrating Fairness to the Class

A record rich with detail on the dispute and history of the settlement negotiations not only supplies the trial court with a foundation for exercising its duty as a fiduciary of the class, it also reduces the possibility of reversal on appeal. An appellate court may remand a case to the trial court if a meager record fails to provide a basis for reviewing whether the district court abused its discretion in finding the settlement to be fair, adequate and reasonable.

Conclusory statements, boilerplate explanations, and unsupported assertions will be questioned. A court may probe whether the settlement was negotiated prematurely or in the absence of discovery. It may question a settlement amount substantially less than the potential recovery if the case were to be litigated. It may be necessary to submit declarations regarding damages attributable to the alleged misrepresentations, as well as the collectability of a potential verdict, including the extent of insurance coverage and the assets of the corporation and any individual officer and director defendants.

In *Reynolds v. Beneficial National Bank*, 288 F.3d 277 (7th Cir. 2002), an opinion authored by Judge Posner, the Seventh Circuit remanded a case in which the district court had approved a final settlement in a class action alleging violations of consumer finance laws, concluding that the court abused its discretion in approving the settlement. The court of appeals held that the district court lacked sufficient information to make a judgment regarding whether a $25 million settlement was fair, adequate and reasonable, given the thin record concerning the settlement negotiations, potential recovery at trial, the probabilities of various trial outcomes, and the potential sources of funding, among other things. The court stressed that district judges must exercise "the highest degree of vigilance in scrutinizing proposed settlements of class actions."

On the heels of *Reynolds*, some district judges are already probing deeper for evidence of reasonableness. For example, in *Sutton v. Bernard*, 2002 WL 1794048 (N.D. Ill. Aug. 5, 2002), the court denied plaintiffs' motion for preliminary approval of a securities class action settlement reached with the defendants' insurance carrier. The court disapproved of counsel's conclusory statement about the merits and likely outcome of the litigation and noted that the record was insufficient, under the *Reynolds* standard, to warrant approval.

Closer to home, in January 2002 U.S. District Judge William Alsup declined to grant preliminary approval of a class settlement, pointing to a variety of omissions in the record before him. *In re Critical Path, Inc. Securities Litigation* (N.D. Cal. No. C 01-00551 WHA) (unpublished decision). The case involved allegations of trumped-up predictions of future profitability and admissions of improper revenue recognition practices resulting in material misstatements of quarterly results. A $17.5 million settlement was proposed where the potential recovery reflecting the market loss was nearly $200 million and the available D&O insurance coverage was $30 million. The court questioned counsel's conclusory statement that the "risks of proving liability" justified this large discount.

Judge Alsup questioned how counsel could assess the liability risks without having taken depositions since the documentary evidence showed large fictitious product sales and false recognition of revenue followed by a restatement of the company's financial results. He also questioned counsel's bare assertion that proof of damages would be complicated, indicating that the record was devoid of any evidence relating to loss causation issues or damage analysis. Judge Alsup also questioned why the full amount of the insurance coverage was not available to fund a settlement, and sought information regarding the net worth and ongoing income of the officer and director defendants, indicating that declarations addressing these issues would be "most helpful." Further, he sought a declaration from the lead institutional plaintiff as to why it recommended a settlement of $17.5 million.

These issues led Judge Alsup to conclude that more information was required before he could determine whether the proposed settlement was ready for release to the class members. Apparently, lead plaintiffs' counsel did not anticipate a high level of judicial scrutiny at the stage of preliminary approval of the settlement, and no doubt planned on making a stronger showing at the Rule 23(e) fairness hearing. In response to the court's order, counsel submitted substantial information addressing the court's concerns, including several declarations, which led the court to grant preliminary approval of the settlement, notice to the class, and ultimately, a finding that the proposed settlement was fair, adequate, and reasonable at the Rule 23(e) fairness hearing.

Another local example of judicial scrutiny of class action settlements can be found in *In re California Micro Devices Securities Litigation*, 168 F.R.D. 257, 269-71 (N.D. Cal. 1996), in which U.S. District Judge Vaughn Walker rejected a settlement proposal, finding that "the proposed settlement has so many troubling aspects that the court is forced to conclude that it was negotiated under quasi-collusive circumstances" and that the class representatives failed to vigorously represent the interests of the class. *Id.* at 269. Judge Walker pointed to five weaknesses in the proposed settlement: (1) the settlement's small cash component while the corporate defendant retained a large

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Bill Hirsch

On SECURITIES

Throughout the 1990s, plaintiffs' lawyers were widely disparaged as greedy, selfish and dangerous — sharks who unfairly blackmail corporate America and inhibit the unparalleled prosperity enjoyed by millions of investors. None were singled out for more opprobrium than the securities lawyers who filed hundreds of cases against the great entrepreneurial engines of our day, the high tech companies and their bankers, lawyers, underwriters and accountants.

Heavily lobbied and convinced of the threat of abusive or frivolous lawsuits, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). The PSLRA was designed to erect procedural barriers to stymie the filing of securities class action cases. It included such devices as heightened pleading standards, a safe harbor for forward-looking statements, new standards for the appointment of lead plaintiff, and strict limits on early discovery, damages, and liability. In response, plaintiffs' lawyers filed waves of cases under state securities laws in state courts. Congress countered with the SLUSA, which preempted most state securities class actions.

Recently, driven by the dismal crash of the financial markets, public perceptions have begun to change. Lurid tales of corporate fraud, malfeasance and collapse fill the papers, and public faith in government enforcement of the securities laws is at a low. Some believe that the limits placed on private enforcement of the securities laws are partly to blame for the disarray in our capital markets. Plaintiffs' lawyers, so recently reviled, are seen by many as champions of the investing public, the last, best hope for recovering some tattered portion of the billions lost.

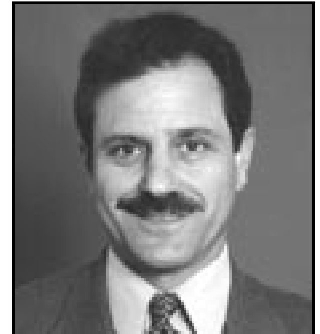
Not surprisingly, securities litigation is hot again, and many plaintiffs' firms are renewing a long-neglected practice area. Before 1995, the entry fee was low — almost anyone could file a case. While the first-to-file was inevitably appointed lead counsel, others could usually carve out a role in the case.

Under the PSLRA, things changed. Courts are now instructed to select as lead plaintiff the presumptively most adequate plaintiff, defined as the one "with the largest financial interest" in the controversy and who otherwise satisfies the adequacy and typicality requirements of Rule 23. Once such a plaintiff is identified, the PSLRA permits other plaintiffs (but not defendants) to rebut the presumption. If the presumption is rebutted, the court must begin the process anew.

One controversial response to this new regime was the court-ordered auction popularized by Judge Vaughn Walker (N.D. Cal.), in which the court requires candidates to submit bids and selects as lead plaintiff the candidate who negotiated the best fee arrangement with counsel, on the grounds that the other candidates (even the one with the largest financial stake) are not adequate representatives.

In a much-awaited decision, the Ninth Circuit recently ruled that use of such a bidding process violated the PSLRA. *In re Cavanaugh*, 2002 U.S. App. LEXIS 18846 (9th Cir. Sept. 16, 2002). The Ninth Circuit held that the PSLRA did not raise the adequacy standard for securities cases, and that courts may not determine adequacy by comparing the lawyers chosen and their fees. Instead, once the court identifies the lead plaintiff candidate with the largest financial stake, the only remaining question is whether that candidate satisfies the traditional adequacy and typicality requirements of Rule 23.

Once selected, plaintiffs' counsel still face a legal landscape heavily skewed against investors. Investors will have difficulty recovering significant amounts where the target company is in bankruptcy or dire financial straits, even if there are solvent parties who knowingly assisted its fraudulent activities. Aiders and abettors are no longer liable under Rule 10b-5 (*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)), and the PSLRA imposes proportionate liability according to fault, with no joint and several liability absent a knowing violation.



Bill Hirsch

In the Ninth Circuit investors also face a high hurdle to defeat a motion to dismiss, since the court has adopted the most rigorous pleading standard in the nation. *In re Silicon Graphics, Inc.*, 183 F. 3d 970, 974 (9th Cir. 1999), the Ninth Circuit rejected the Second Circuit's less restrictive standard, which requires that a plaintiff plead facts showing simple recklessness or a motive to commit fraud and opportunity to do so. Instead, the court held that the PSLRA requires plaintiffs to "plead, in great detail, facts that constitute strong circumstantial evidence of deliberate reckless or conscious misconduct."

And as for fees, the Third Circuit has held that while fee arrangements with the lead plaintiff are presumably reasonable, the presumption may be rebutted under the PSLRA by unforeseeable factual or legal developments or by a *prima facie* showing that the fee is excessive. *In re Cendant Corporation Litigation*, 264 F. 3d 201, 282-88 (3rd Cir. 2001).

Various strategies are available to plaintiffs' lawyers to succeed in this environment. These include avoiding the federal securities laws altogether by bringing cases in state court on behalf of pension funds (exempted from the preemptive effect of the SLUSA) or against underwriters on behalf of large individual bondholders. Those who seek to represent investor classes must court institutional investors. But, as parties continue to confront a financial world in disarray within the framework of the PSLRA, more innovative attempts to vindicate shareholder rights will no doubt emerge.

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Protecting the Quarterback

key time for the CEO, and you don't want him distracted by large crowds during the prep.

Stay out of the CEO's way during his testimony. Toast has been described as a butter-delivery system. Think of your role during the CEO's direct testimony in toast-like terms. You should be as invisible as you can. Let the CEO talk to the judge or jury. If you are pulling the words out of him, they will have less impact. If he has been well-prepared, he will take over the testimony, and the jury will conclude that he is saying what he believes. It is important that the judge and jury feel that they have a true measure of the CEO as a person, not as a packaged product.

The same is true of cross-examination. The time to protect your CEO is in preparation and in defining his direct testimony. You should put him through the most difficult mock cross-examinations you can imagine. In fact, it's often helpful to bring in the most capable cross-examiner at your firm to conduct a mock cross. You may instinctively pull your punches. You want the CEO to get used to tough questioning from someone he doesn't know. As much as possible, stay quiet during the CEO's cross. Absent unusual circumstances, you should not make many objections during his cross. You risk irritating the judge and possibly the jury. Don't create the impression that the CEO needs your help to survive cross. Let him do it on his own.

One of the complexities of putting the CEO on at trial is the existence of multiple audiences. The most important one is the judge and jury. But they are not the only audience. In a high-profile case, the CEO's performance at trial will have a major impact on public perceptions of the company. It will be watched by employees, by customers, by competitors, and by shareholders. As you define the CEO's role at trial and prepare his direct testimony, don't forget those other constituencies. Avoid the litigator's tendency to think only of the immediate trial, without considering the broader spillover effects.

Think through in advance how long you want the CEO to attend the trial. In some cases, he will need to be there throughout, as a statement of commitment to the judge and the jury. On the other hand, if he stays after his testimony, you risk having him recalled as a witness by your opponent to address issues or testimony that arose after he left the stand. If you are going to have him stay, make sure that he knows that he might be recalled and is not flustered if that occurs. Keep him up-to-date on developments during the trial so that he is not blind-sided if called back to the stand.

Conclusion

Taking the CEO through testimony at trial is a uniquely rewarding — and nerve-wracking — experience. It can be a personal career highlight and an occasion for epoxy-like bonding with a client. Or it can provide the basis for recurrent nightmares that replace the one about showing up for a college exam having skipped all the lectures. Never lose sight of the fact that the most important person at the company — someone used to being in charge and calling the shots — is at a moment of vulnerability, in a setting very different from the one in which he functions every day. He is looking to you for guidance and preparation. Don't let him down.

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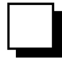

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Class Action Settlements

cash reserve; (2) counsel's apparently uncritical acceptance of the corporation's claims of imminent insolvency; (3) the unexplained exoneration of outside directors from liability; (4) apparently excessive attorneys' fees; and (5) potentially dilutive effects of the proposed settlement on retention class members. *Id.* at 269-71. Counsel later produced substantial evidence that addressed the court's concerns. *In re California Micro Devices Security Litigation*, 965 F. Supp. 1327, 1330-36 (N.D. Cal. 1997).

Recently, the Ninth Circuit issued an opinion that appears to reflect the trend toward tough judicial scrutiny of the terms of class action settlements. *Molski v. Gleich*, 2002 WL 31261156, at *12-13 (9th Cir. October 10, 2002) (reversing district court's approval of a settlement in a case brought under the Americans with Disabilities Act, concluding among other things that the settlement, which required the defendant to make charitable contributions to disability groups but provided absent class members little or no compensation, was not fair, adequate and reasonable where plaintiffs had undertaken only minimal discovery, and failed to provide evidence that proof of individual claims would be burdensome or distribution of individual damages costly).

Making the Record

In light of cases like *Reynolds, Critical Path, California Micro Devices*, and *Molski* counsel should submit a strong record with appropriate documentary evidence addressing, at a minimum, the following factors:

Risk Analysis. A risk analysis estimates the monetary value of the litigation by assessing the strengths and weaknesses of the claims and defenses and quantifying the duration and complexity of further litigation. The court need not pinpoint a single probable result, but should identify a range of possible outcomes based upon the available evidence and varying legal assumptions. Employing principles of mathematical probability, Judge Posner suggests "estimating the range of possible outcomes and ascribing a probability to each point on the range," noting however that "[a] high degree of precision cannot be expected in valuing a litigation, especially regarding the estimation of the probability of particular outcomes" without turning the fairness hearing into a trial

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JAMES YOON

On PATENTS

The first major court decision in a patent case is the *Markman* claim construction order. This order defines the scope of the claim(s) at issue and, thus, is the most important factor in determining whether the defendant's product infringes the plaintiff's patent. A product infringes a patent if one of its claims (as defined by the *Markman* order) "reads on" the product. The first rule of claim construction is that claim terms are presumed to have their ordinary meaning to the Person of Ordinary Skill in the Art ("POSITA"). Courts have explained that a POSITA is an "average" engineer who possesses the basic education, experiences and talents of individuals skilled in the field of the patent. The challenge for lawyers is to convince a court with no expertise in the field of the patent that a POSITA would interpret a claim term in the manner advocated by the lawyer. How can the lawyer do this most effectively? I have found the following rules of advocacy to be critical to success:

Understand the limitations of expert testimony. Expert testimony is usually the vehicle for providing courts with an explanation regarding how a POSITA would understand claim terms. However, merely using an expert to explain this does not increase the likelihood of success. First, the opposing side will retain an expert who will take positions contrary to your expert, resulting in a stalemate. Second, courts have a skeptical view of experts. Your job as an advocate is to present your expert's testimony in a manner that overcomes judicial skepticism and demonstrates that the expert's POSITA position is correct.

Never assert a POSITA position that is contradicted by the intrinsic evidence. Courts have ruled that expert testimony cannot be used to contradict the meaning of claim terms set forth in the "intrinsic evidence": the specifications, figures, claims and prosecution history of a patent. Taking positions that contradict the intrinsic evidence not only fails to advance a claim construction position, it undermines the credibility of the expert (and the lawyer sponsoring the expert's testimony).

Cite to text and examples from the intrinsic evidence. The Federal Circuit Court of Appeals has declared that intrinsic evidence is the most relevant claim construction evidence. Whenever possible, your expert should cite specific intrinsic evidence as support for your position regarding how a POSITA would understand the disputed claim terms. By doing so, your expert builds credibility with the court. The court will view the expert's position as consistent with the standards set forth by the Federal Circuit and will begin to develop confidence in the expert (and you). Consider the following example: "The person of ordinary skill would understand the claim phrase 'substantial pressure' to refer to pressure greater than 1000 psi. This is supported by Figure 1 that provides a range of pressure from 1000 to 9000 psi and column 2, lines 3-5 of the Patent, which states that pressures less than 1000 psi are insufficient to accomplish the goals of the invention."

Support each expert opinion regarding a POSITA with materials that were authored prior to the filing date of the patent. Patents are sparse documents that frequently fail to provide: (1) unambiguous guidance regarding the construction of disputed terms; or (2) clear support for the lawyer's construction. Patents often assume that detailed descriptions and definitions are unnecessary because the assumed reader, a POSITA, has enough expertise to understand the scope of the claims. To overcome these ambiguities, support your expert's POSITA opinions with materials that were authored prior to the filing of the patent. Commission an exhaustive search for all contemporaneous technical dictionaries, articles, text books and data sheets that support the desired claim construction. The results of this search — like the intrinsic evidence — may then be used to support each position taken by the expert witness. This shows that your expert's opinion reflects the field during the relevant time period, thereby helping to overcome judicial skepticism and persuade the court that your position reflects the understanding of a POSITA.

James Yoon

Always present arguments and POSITA positions in easy to digest segments. I call this the *USA Today* rule. Like many people, judges can be intimidated by technology and, as a result, have no desire to sit through a technical dissertation. Even if not intimidated, judges view lawyers who explain things in a clear and accessible manner as forthright and more credible. If it takes more than one to two pages (or more than three minutes) to explain a position, the argument is unlikely to be clear or persuasive. You should constantly consider whether an argument could be better illustrated through an analogy or graphic (charts, drawings, graphs, or animations) in lieu of a technical description. Each graphic or analogy should be limited to a single construction term or dispute.

The dispositive nature of the *Markman* order requires that lawyers maximize the persuasive impact of their arguments and their expert's testimony. The above rules of advocacy will help present your view of a POSITA in the most favorable light and maximize the chance for victory.

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Class Action Settlements

on the merits. *Reynolds, supra*, 288 F.3d at 285. The trial judge must make efforts to "translate his intuitions about the strength of the plaintiffs' case, the range of possible damages, and the likely duration of litigation if it was not settled now into numbers that would permit a responsible evaluation of the reasonableness of the settlement." *Id*.

Damages Analysis. Loss causation is debated in most securities cases. What caused the stock drop: declines in the stock market, overall industry weakness, or the alleged misinformation? While the PSLRA caps a plaintiffs' damages, it does not set any formula for recovery. A damages study, perhaps in the form of a declaration by an economist, should paint a picture of the loss attributable to the alleged fraud. A conservative damages study based on realistic assumptions will provide a better record for comparing the proposed settlement amount to a potential litigated recovery.

Adequacy of Legal Representation. Under *Reynolds*, inadequate representation by counsel provides an independent basis for disapproving a settlement. Counsel should prepare declarations regarding the scope of investigation and formal discovery, including depositions, document review, and expert reports. Courts want to ensure that plaintiffs' counsel is not "richly rewarded for negotiations that greatly diminish the costs of settlement" to the defendants. As a fiduciary to the class, the court must question whether the lawyers are in fact zealously negotiating on behalf of the class.

Sources of Recovery and Collectability. Counsel also should establish a record concerning the potential sources of recovery, including insurance coverage, corporate assets, and assets of the individual defendants, particularly those who may have profited from stock sales during the class period. Conversely, the record also should set out limitations on satisfying a large judgment, including insurance coverage issues, the financial condition of the corporation, and the potential for depletion of insurance proceeds by continued litigation. The record should clearly demonstrate the risks, if any, of noncollectability of a large judgment.

Settlement Process. Because courts will look for patterns demonstrating that the settlement was not the product of collusion or undertaken solely to seize upon a generous attorneys' fee award, it is helpful to submit declarations as to the history of the settlement process. For example, counsel might inform the court whether the matter was negotiated before a neutral settlement judge or mediator, whether the bargaining process involved a series of offers and counter-offers, and whether the parties engaged in a risk analysis involving evidence of liability, damages and collectability. A description of the bargaining process could provide assurance that the proposed settlement was the product of arms-length negotiations. The history should be supported by declarations from the participants in the mediation process, including the lead plaintiff.

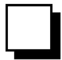
Comments of Objecting Class Members. At the final Rule 23(e) fairness hearing, counsel should supplement the record to address the reactions of class members to the proposed settlement, addressing the specific input and criticisms of objecting class members, or describing the absence of objections, as applicable.

A Note on Preliminary Approval. Initially, a court conducts a preliminary hearing to evaluate whether the terms of the proposed settlement are fair enough to warrant the time and expense of providing notice to the class. It does not delve deeply and exhaustively into the record at this point. However, judges approving preliminary settlement agreements look to see whether the terms are within, as Judge Alsup put it, a "zone of reasonableness," *i.e.*, that "reasonable minds could have honest differences of opinion as to whether or not it should be accepted or rejected." While the standard for preliminary settlements has long been whether the terms are "fair on their face," counsel should be aware that some judges are scratching beneath the surface of the record to ensure the proposed terms are sufficiently reasonable to warrant the time and effort involved with class notification.

Conclusion

While a settlement hearing should not develop into a mini trial on the merits, counsel should recognize that in order to exercise its fiduciary duty the court must have at its disposal a fully developed record demonstrating the proposed settlement is fair, adequate and reasonable to compensate class members for their losses. Crafting a solid record will facilitate an informed and thorough fairness hearing as well as reduce the possibility of reversal on appeal.

Edward Infante is a retired Chief Magistrate Judge, U.S. District Court, Northern District of California. He currently serves as a mediator at JAMS, and has successfully settled nearly 100 securities class action cases.



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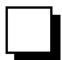
Trying Securities Class Actions

management integrity, internal controls and other factors that extend beyond the financial statements themselves. Positive assessments in these areas can add weight and credibility to the defense case. Conversely, criticisms (in areas other than management integrity) can be cited as evidence that the auditors were vigilant and doing a thorough job.

Conclusion

The *Everex* experience demonstrates that securities class actions can be taken to trial — and won — even in an increasingly hostile environment. Defense counsel have an array of weapons and strategies at their disposal, and should not hesitate to use them.

Robert P. Varian, James E. Burns, and Sara B. Brody defended the Everex *trials and are partners in the San Francisco office of Clifford Chance US LLP, practicing securities litigation. robert.varian@cliffordchance.com*



HOWARD ULLMAN

On ANTITRUST

Can competitors who do not join together to form a single legal entity nevertheless jointly set prices? The answer is almost always "No," but there is an intriguing exception to the general rule that may be considered by clients looking for more flexible business structures.

Sherman Act section 1 (15 U.S.C. section 1) broadly prohibits contracts, combinations, and conspiracies in restraint of trade. For over one hundred years, it has outlawed joint pricing agreements between or among competitors on the theory that such agreements are almost always anti-competitive and therefore deserve to be categorized as *per se* illegal. As a general rule, two or more competing firms cannot agree to set their prices jointly, no matter what their motives.

One way around the prohibition on joint pricing is merger. Competing firms can elect to merge into one legal entity. The surviving entity can then set its prices for all its products. The net result is that the firms achieve joint pricing. The antitrust laws do not object to a single firm setting its prices, because it is a cohesive and unitary legal and economic entity. (Formal joint ventures, where the parties share the profits and losses, are analyzed similarly.) The merger approach does not free the parties from antitrust scrutiny altogether; the merger itself may be subject to attack as an anti-competitive combination under the Sherman Act and the Clayton Act if it unduly concentrates the market. Once merged, however, the resulting single firm cannot be found guilty of a *per se* illegal price-fixing conspiracy.

Sometimes, however, firms do not want to merge their operations and management fully. In 1996, the Federal Trade Commission ("FTC") and the Department of Justice jointly issued Statements on healthcare antitrust that allow separate firms to engage in joint price-setting under certain limited circumstances. The Statements acknowledged that health care providers can collectively negotiate with third-party payors and engage in joint price-setting under the antitrust laws and avoid *per se* condemnation if they are sufficiently "clinically" integrated. The Statements gave some examples of sufficient clinical integration, but until this year the concepts had never been acted upon by the federal enforcement agencies.

That situation changed on February 19, 2002, when the FTC staff issued an advisory opinion to MedSouth, Inc. (http://www.ftc.gov/bc/adops/medsouth.htm). MedSouth operates an independent practice association ("IPA") of over 400 primary care physicians and specialists in Colorado. MedSouth sought the FTC staff's analysis of its proposal to engage in joint price setting on behalf of participating physicians. The IPA would negotiate price and other contract terms with third-party payors on a fee-for-service basis. However, participating physicians would also be able to negotiate independently with third-party payors outside the IPA (*i.e.*, the IPA would not be "exclusive") without sharing this non-IPA price information among each other.

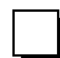
The FTC staff rejected a *per se* analysis of the proposal and concluded that the proposal was not likely to restrain competition unreasonably because the proposed joint price setting was part of a broader program of clinical integration. This integration will include: (1) the sharing of patient information via a web-based clinical data record system; (2) the development and implementation of clinical protocols; and (3) oversight and reporting of members' performance relative to established protocols and goals. Each IPA member will agree to implement a correction plan if his or her performance drops below the minimum level established by the protocols and guidelines, and will be subject to expulsion for non-compliance.

In the view of the FTC staff, the protocols and the information sharing have the potential to increase the quality and decrease the cost of medical care. The members acting independently would not likely be able to achieve these efficiencies. In addition, the proposal would make the members accountable for their performance, while sharing patient information would promote better coordination and reduce errors and duplicative procedures. The FTC concluded that the proposed joint contracting and pricing is reasonably related to the clinical integration of the members and reasonably necessary for the IPA to achieve its pro-competitive goals.

Howard Ullman

MedSouth concerns clinical integration in the health care area. It may not be applicable to manufacturers of widgets. However, it may have broader application, at least with respect to businesses that also have detailed and objective standards of performance and intensive information management requirements. For example, it might be extended to businesses engaged in computer hardware and software maintenance and repair. Such businesses might want to create a network to develop protocols, performance standards, and a comprehensive information database concerning their customers' systems. Arguably, such a network, if structured properly, could justify joint pricing. After all, there is nothing intrinsically unique about health care. Nor does the Sherman Act distinguish between different industries.

Any joint conduct among competitors affecting prices raises important antitrust issues, and should not be undertaken without careful legal review. Before structuring such a network, it may also be prudent for the parties to solicit business review by the enforcement agencies. Although it's still too early to tell, *MedSouth* may signal the FTC's willingness to expand the types of integration that will support joint pricing. Stay tuned.



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Letter From The President

Protecting Civil Liberties While Fighting Terrorism

At the 2002 ABTL Annual Seminar, California Supreme Court Justice Moreno admonished us that now, more than at any other recent time, lawyers are called upon to look beyond their own individual practices, and to consider our nation's broader legal issues. My own examination of these issues took me to Jerusalem this summer, on a trip where I sought to gain a better understanding of how the Israeli legal system is coping with the balance of civil liberties and security while its society, like ours, faces the threat of terrorism. I was able to meet with people with a range of views, holding positions both inside the government and in non-governmental organizations quite critical of government policy.

Rob Fram

In Israel, as in America, a nation's basic commitment to civil liberties is challenged during times of national threat. The Israeli experience teaches that on at least one front — the availability of judicial review over the actions of security forces — we have something to learn from other societies.

Judicial review of conditions at military detention centers. The United States government has sought to cut back on judicial review over security detainees, referring to them as "enemy combatants." Hence, there is not yet any judicial review available to detainees held, for example, in Guantanamo.

In response to the most recent Intifada, Israel established the Ofra detention center to hold terrorism suspects. A human rights organization recently filed a petition regarding the conditions at Ofra with the Israeli Supreme Court, which not only took jurisdiction of the case but issued an order providing for inspections of the facility by a representative of the petitioner. In the past, the Israeli Supreme Court has even personally inspected such detention centers, and ordered the amelioration of various conditions.

As for the detainees themselves, again in contrast with conditions in the United States, Israel's basic approach is to permit counsel to meet with detainees, and to hold a prompt administrative hearing, with judicial review of the results of that hearing.

Banning interrogation measures argued to be "indispensable to the war against terrorism." In 1999, the Israeli Supreme Court banished the use of even "moderate" physical pressure (such as shaking or the playing of loud music) in interrogations of suspected terrorists. (Violent forms of torture have long been banned under Israeli law). In banning "moderate" physical pressure, the Court had to set aside the government's contention that such methods were *"indispensable to fighting and winning the war on terrorism"* and that "[I]t is not possible to prohibit [the use of physical pressure] without seriously harming the [security service's] ability to effectively thwart deadly terrorist attacks. Its use in the past has lead to the thwarting of murderous attacks." The Israeli Supreme Court nonetheless prohibited all of the measures at issue.

Israel's human rights record is of course not perfect. But if even Israel, which faces security problems far worse than ours, can maintain the rule of law in times of security crises, then surely we can. The Israeli experience, at the very least, should make us skeptical of arguments that security requirements mandate sharp cutbacks on civil liberties.

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