COMPLIANCE WEEK

Case Shows Detail With Which Frauds Must Be Described

By Susan Schott Karr — February 1, 2005

A recent lawsuit involving the California Public Employees' Retirement System and The Chubb Corporation took an unexpected turn—one that may have implications for other public companies that become subject to civil securities fraud suits.

In 2000, CalPERS was the lead plaintiff in a class action accusing Chubb of falsely reporting the success of certain business initiatives, which in turn was purported to have led to fraudulently inflated stock prices. Chubb's alleged motive was to influence the vote on a proposed stock-for-stock purchase.

But the Third Circuit Court dismissed the allegations and decided the case in Chubb's favor.

In a written review of the case, attorneys at Wachtell, Lipton, Rosen & Katz—which represented Chubb and its directors in the case—summarized what they claimed was a "noteworthy decision interpreting the stringent pleading standards for federal securities fraud claims under Rule 9(b) and the Private Securities Litigation Reform Act of 1995."

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- Download The Opinion Of The Court (Filed Dec. 30, 2004)
- Related Update From Wachtell, Lipton, Rosen & Katz
- Original Detail, Justification On Case From CalPERS

Purpose Of The PSLRA

Prior to the PSLRA of 1995, it had been standard practice for a plaintiff's lawyer to identify companies that had experienced a precipitous drop in their stock price on the heels of negative news. The lawyer would automatically assume that the drop was the result of some form of securities fraud and, within a couple of days, head off to the courthouse with a class-action complaint in hand, hoping to beat out other plaintiffs' counsel and thereby secure the position of lead plaintiff.

When the Securities and Exchange Commission passed the PSLRA, the intent was to mitigate the ease and volume of routinely filed and insubstantial class action litigation brought under the Securities Act of 1933 and the Securities Exchange Act of 1934. The intention of the PSLRA was to introduce a series of procedural and substantive provisions to slow down this "race" to the courthouse. Among the "heightened pleading standards" introduced was Rule 9(b).

Under the federal rules of civil procedure, Rule 9(b) describes that when a fraud complaint is filed, the circumstances constituting fraud need to be described with "particularity"; it must answer the questions who, what, when, where, why and how. In other words, those bringing the suit must specify the statements the plaintiff contends were fraudulent, name the speaker, explain where and when the statements were made, and describe why they were fraudulent.

In the Chubb case, although plaintiffs filed a detailed 120-page complaint and relied upon more than a dozen confidential sources, including many former Chubb employees, the Third Circuit determined that plaintiffs had fallen short of satisfying the Rule 9(b) requirements.

The Court had been willing to do an extensive analysis of the information, also under the rubric of the standards put forth by the Second Circuit, to ensure that the information included was what people purported it to be.

Sauer

"It's reasonable for a court to demand a considerable amount of information about those allegations, such as information as established," said Richard Sauer, partner at Vinson & Elkins. "This court went through this claim with a microscope."

Conducting such a searching examination, the Court found that plaintiffs had failed to describe how or why their unnamed sources would have had access to the information they were alleged to possess, or show how much of the information alleged, when viewed in context, was inconsistent with Chubb's public statements.

In its conclusion, the Court stated that the "sheer volume of confidential sources cited cannot compensate for these inadequacies."

According to experts in the field, there is nothing new in this opinion as far as legal standards are concerned; the Third Circuit has adopted the standards set forth by the Second Circuit. What we do have here is an application of the standards in a unique setting.

Robert Bostrom, partner and head of the Financial Services Practice at Winston & Strawn, doesn't think there've been a lot of cases like this. He believes it's probably an important case in that it clearly articulates the issue and the reasoning used, and upholds Rule 9(b) as a way to deal with these suits.

Bostrom

"Clearly, the appellate court was inclined toward a strict interpretation of the pleading standards imposed by Rule 9(b) and the PSLRA," wrote Sauer in an email to Compliance Week.

A Model For Defense?

"One of the interesting things about this case—with all the attention on whistleblowers—is that the plaintiff didn't seek to get a whistleblower investigation going and use it," says Bostrom at Winston & Strawn.

Section 806 of SOX provides whistleblower protection for employees of a public company who provide evidence of fraud or securities law violations by the company. Employees could have reported violations with the knowledge that there would be no retaliation on Chubb's part. Given protection, they could have been named as sources and more fully answered the who, what, when, where, why, and how questions that the Third Circuit found to be unsatisfactorily answered.

"Given the defense of pleading with particularity, the plaintiff might have been able to use the result of the whistleblower investigation to plead the case if it was publicly disclosed," says Bostrom. "As more situations such as this one arise, that may very well be what plaintiffs in these situations consider; the plaintiffs may consider whistleblower action to get an investigation going."

Whether due to insider trading, accounting fraud violations, restatement of financials, currently, companies continue to face similar complaints.

Basically, companies have two choices: they can settle or they can fight these complaints. Usually, these companies decide to file a motion to dismiss, since it's expensive to continue, given the cost of lawyers' fees. But it's not as expensive as a trial.

One of the more exciting things about the case, says Sauer, might have to do with anonymity. In fact, plaintiffs have a heavier burden to prove they have a case at the pleading stage. The treatment of anonymous sources was more restrictive than in some other cases.

When it comes to proving frauds, says Sauer, "This is difficult for plaintiffs to do. If a court takes a view that it's a fraud claim for pleading purposes, it makes it much harder to get past the pleading claim. "It's a great tool to work with."

This case may be a model for other companies faced with civil securities law suits to follow, a model that shows that companies may get a court to agree in their favor by holding out and choosing not to settle prematurely. The idea that a suit can get dismissed at an early stage may embolden other companies to take similar action and fight this type of complaint.

"It's a good thing for public companies that these unnamed confidential sources don't allow litigation against a company to go beyond the early stages," says Bostrom.

It remains to be seen how the consequences of this decision will reverberate within the corporate world. For now, at most, perhaps we can take note. And wait.

Back