Commencing a Securities Class Action: Investigating Claims

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A Practice Note examining strategies for plaintiff's counsel when investigating claims under the federal securities laws, with a focus on private actions asserting material misstatements or omissions in violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. This Note provides guidance on the initial due diligence that plaintiff's counsel should perform before making a recommendation to a client on whether to pursue a class action claim. It also provides guidance on working with confidential witnesses and independent experts or consultants to investigate a claim before drafting a complaint asserting securities fraud claims.

A plaintiff who seeks to start a lawsuit asserting a claim under the federal securities laws faces a challenging burden in pleading those claims. All plaintiffs must plead facts supporting their claims with some degree of particularity to demonstrate that the claims are plausible (*Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009); *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555 (2007)). However, those bringing federal securities claims in federal court must also comply with the Private Securities Litigation Reform Act of 1995 (PSLRA). The PSLRA provides numerous requirements for the conduct of class actions (15 U.S.C. § 78u-4(b); *In re Kingate Mgmt. Ltd. Litig.*, 784 F.3d 128, 138 (2d Cir. 2015)), including:

- A heightened pleading standard for securities fraud claims (15 U.S.C. § 78u-4(b)(3)(B)).
- The imposition of an automatic stay on all discovery until the court decides the defendant's motion to dismiss the complaint (15 U.S.C. § 77z-1(b)(1)).

Working in tandem, these provisions require plaintiffs to satisfy heightened pleading standards without the benefit of discovery. As a result, plaintiffs' counsel must conduct a robust investigation to state a claim with the requisite level of particularity. This Note provides guidance to plaintiffs' counsel on how to investigate potential claims under the federal securities laws to develop facts sufficient to satisfy their pleading obligations.

LEGAL FRAMEWORK

The Securities Act of 1933, as amended (Securities Act) and the Securities Exchange Act of 1934, as amended (Exchange Act) govern most securities litigation. Nearly all federal securities class actions alleging fraud include a claim under Exchange Act Section 10(b) and Rule 10b-5 (17 C.F.R. § 240.10b-5). Section 10 of the Exchange Act and Rule 10b-5 provide an implied private right of action to recover damages based on material misstatements or omissions and use of manipulative or deceptive devices in connection with the sale or purchase of a security. Federal courts have exclusive jurisdiction over Exchange Act claims (15 U.S.C. § 78aa(a)).

Private plaintiffs may also recover under other provisions, including, most often:

- Securities Act Sections 11 and 12(a)(2) (15 U.S.C. §§ 77k and 77l(a)(2)).
- The control person liability provisions in Securities Act Section 15 and Exchange Act Section 20 (15 U.S.C. §§ 77o(a) and 78t(a)).

The PSLRA applies to private actions asserting violations of the federal securities laws brought in federal court, including claims under both the Securities Act and the Exchange Act. It arises most often in the context of securities fraud claims filed on behalf of a putative class. Its provisions impose a unique set of standards and rules for securities fraud class actions, posing several hurdles for plaintiff to overcome.

For guidance on identifying claims under the federal securities laws, see Practice Note, Commencing a Securities Class Action: Identifying Claims (W-023-7361). To compare and contrast potential causes of actions under the federal securities laws, see Practice Note, Securities Act and Securities Exchange Act Liability Provisions: Overview (W-000-8585) and Private Actions Under US Securities Laws Chart (W-023-0624).

HEIGHTENED PLEADING STANDARDS

In contrast to the typical requirement that a complaint include "a short and plain statement of the claim" showing that the plaintiff is entitled to relief under Federal Rule of Civil Procedure (FRCP) 8(a), most elements of securities fraud claims under the Exchange Act are subject to stringent pleading requirements under FRCP 9(b) and the PSLRA.

FRCP 9(b) requires a party to state with particularity the circumstances constituting fraud or mistake. In addition, the PSLRA implemented additional requirements for private lawsuits for plaintiffs to recover in securities class action lawsuits. Under the PSLRA, a plaintiff must plead, among other things:

- Each misleading statement and the reasons why the statement was misleading (see Falsity and Materiality).
- The facts giving rise to a strong inference that the defendant acted with the required state of mind (Scienter).

(15 U.S.C. § 78u-4(b)(1), (2); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005).)

Falsity and Materiality

Plaintiffs must plead alleged false and misleading statements with particularity, meaning that they must explain why each statement was false and misleading (*Garber v. Legg Mason, Inc.*, 537 F. Supp. 2d 597, 614-15 (S.D.N.Y. 2008)). When the plaintiff bases an allegation regarding the statement or omission on information and belief, the complaint must state all facts on which the plaintiff formed that belief (15 U.S.C. § 78u-4(b)(1); FRCP 9(b)).

Although the PSLRA does not require plaintiffs to plead every single fact on which their beliefs concerning false or misleading statements are based, plaintiffs must allege facts sufficient to support a reasonable belief about the misleading nature of the statement or omission (*Novak v. Kasaks*, 216 F.3d 300, 313-14 & n.1 (2d Cir. 2000)).

Scienter

Scienter refers to a mental state embracing an intent to deceive, manipulate, or defraud and is an essential element of a securities fraud claim under Section 10(b) and Rule 10(b)-5 (*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007)). The PSLRA requires plaintiffs to establish a strong inference that the defendant acted with scienter. This means that, to survive a motion to dismiss, the complaint's factual allegations must be cogent and at least as compelling as any opposing inference of nonfraudulent intent (15 U.S.C. § 78u-4(b)(2)(A); *Tellabs*, 551 U.S. at 314).

The relevant inquiry in considering a challenge to plaintiff's pleading of scienter is whether all the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard (*Tellabs*, 551 U.S. at 322-23). If the defendant is a corporate entity, "the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter" (*In re Gentiva Sec. Litig.*, 971 F. Supp. 2d 305, 329 (E.D.N.Y. 2013) (quoting *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008))).

DISCOVERY STAY

The PSLRA expressly stays all discovery and other proceedings while a motion to dismiss is pending (15 U.S.C. §§ 77z-1(b) and 78u-4(b)(3)(B)). In other types of litigation, once an action is filed, plaintiffs have access to discovery from the defendants and relevant third parties to support their claims and any amended pleadings. However, the PSLRA's automatic discovery stay bars Exchange Act plaintiffs from taking discovery at the pleading stage.

DUE DILIGENCE TO ASSESS WHETHER TO PURSUE A CLAIM

After plaintiffs identify a potential claim under the federal securities laws, counsel generally must consider case-specific facts and circumstances to determine whether the claim is meritorious and appropriate for a client to pursue. That due diligence may include an assessment of:

- The strength of the allegations based on the available evidence.
- The size of the client's losses.
- The size of the potential aggregate damages.
- The availability of funds to pay any potential recovery, including from any:
  - applicable insurance coverage; and
  - potential third-party defendants.
- The history of potential parties in similar litigation (if any).
- Whether the company or any potential individual defendants have been or are under investigation by governmental or regulatory agencies.
- Any unique characteristics of the security at issue (for example, whether the matter involves fixed income securities that are not widely held or represented in pending actions).
- Whether other competent institutional investors are likely to assert the claim.
- The state of the law in the applicable jurisdiction.
- Any other factors related to the substantive or practical realities of any potential litigation.

Counsel's threshold due diligence generally focuses on publicly available information, and may include scrutinizing and determining the impact of:

- A company's public statements, such as:
  - a company's regulatory filings;
  - transcripts of investor calls;
  - statements or information on a company's website; and
  - press releases.
- Analyst reports.
- Government regulatory actions (if any).
- Other securities filings, including under the federal antitrust laws and state blue sky laws.
- Corporate transactions, such as mergers, executive compensation agreements, and stock option grants.

- Facts established in other lawsuits involving the company.
- Bankruptcy proceedings.
- Significant news events.

For more on identifying potential claims based on publicly available information, see Practice Note, Commencing a Securities Class Action: Identifying Claims (W-023-7361).

INITIATING AN INVESTIGATION

Once counsel decides that a claim seems meritorious and worth pursuing, they generally launch an investigation that serves as the basis of the complaint. In particular, to overcome the absence of discovery while still stating claims with the requisite specificity, plaintiffs may find it useful to:

- Identify and interview confidential witnesses who can provide information to support a pleading of scienter with the requisite level of specificity (see Working with Confidential Witnesses).
- Retain independent experts or consultants (see Working with Experts).

WORKING WITH CONFIDENTIAL WITNESSES

Confidential witnesses are generally former employees of the defendant company who were privy to relevant information that can bolster the plaintiff's allegations. Witnesses can provide insight into why the defendant engaged in securities fraud, by explaining defendants' motivation to mislead investors. This information is particularly useful where a confidential witness was a former high-level employee who interacted with the individual defendants and other C-suite executives.

Witnesses can also provide insight into individual defendants' knowledge of relevant events by describing relevant meetings that occurred, internal reports generated, and internal communications with and among the individual defendants. Armed with this information, counsel can then plead scienter with the requisite level of specificity.

IDENTIFYING WITNESSES

When commencing an investigation, it is important to locate potential confidential witnesses who are former, as opposed to current, employees.

To identify potential witnesses, counsel may rely on either:

- An in-house team of investigators and analysts (see In-House Investigations).
- Third-party vendors (see Retaining Outside Vendors).

Investigators will generate a lead list of all former employees who may have relevant information. Counsel should then evaluate this list to prioritize the individuals likely to have relevant information based on their position and tenure with the company, particularly if the number of former employees is large given the overall size of the company or recent layoffs.

High level former employees will be of particular interest, especially if they may have interacted or communicated with any of the individual defendants. Contacted witnesses may also provide names of additional former employees they believe may have relevant information.

If a confidential witness fears retaliation in a current or future job should the witness's identity be disclosed, the witness can seek a protective order from the court but must articulate a concrete basis for fear of retaliation (see *Plumbers & Pipefitters Local Union No. 630 Pension-Annuity Trust Fund v. Arbitron, Inc.*, 278 F.R.D. 335, 344 (S.D.N.Y. 2011)).

In-House Investigations

Counsel should consider relying on in-house investigators whenever possible. Utilizing an in-house team makes it easier for plaintiff's counsel to meet frequently with the investigators to monitor the status of the investigation. The in-house team can also participate in interviews with potential confidential witnesses, which can increase the likelihood of gathering complaint-worthy information. Having an in-house investigative team also ensures consistency and clarity regarding plaintiff's counsel's investigative policy.

In-house investigation and analysis also allow for real-time collaboration between plaintiff's counsel and the investigators throughout the investigation and complaint-drafting process. This collaboration is important as the case theory develops and more information about the company becomes known.

Retaining Outside Vendors

While in-house investigations are generally preferable, under certain circumstances it may be appropriate for plaintiff's counsel to engage a third-party vendor to investigate. For example, if potential witnesses are non-English speaking or located abroad, having a local investigator conduct interviews could be critical to obtaining information from these witnesses. They can provide a unique perspective into the company's overseas operations (see, for example, *In re Nu Skin Enterprises, Inc., Sec. Litig.*, 2014 WL 3351721 (D. Utah June 30, 2014)). A local investigator can also be useful in communicating with local government agencies regarding potentially relevant documents, such as necessary permits, environmental reports, or government-imposed fines.

When using a third-party vendor to investigate, plaintiff's counsel must communicate regularly with the investigators to ensure the investigation is proceeding on track. Vendors will be viewed as an extension of plaintiff's counsel, subject to the same rules and policies. Therefore, counsel must provide the outside investigators with clear directions about how to conduct and document interviews (see Strategic Considerations).

INTERVIEWING CONFIDENTIAL WITNESSES

Although courts tend to credit confidential witnesses when assessing the sufficiency of plaintiffs' pleadings, they have also raised concerns about the possible mischaracterization of confidential witness statements. Given concerns about the reliability of confidential witness allegations and the likelihood that defendants will challenge them, plaintiffs should follow certain protocols when obtaining and using this type of information in a pleading, including:

- Strategic determinations about the mechanics of witness interviews (see Strategic Considerations).
- Inquiries to ensure that the information that the witness provides can withstand judicial scrutiny (see Confidential Witness Reliability Inquiries).

- Concluding the interview with a view toward incorporating the witness's statements in a complaint (see Documents Provided by Witnesses).

Strategic Considerations

Whenever possible plaintiffs' counsel should try to conduct the investigation with the following considerations in mind:

- Have at least two individuals participate in any interviews of confidential witnesses.
- Meet the witness in person, rather than solely over the telephone.
- Memorialize the interview promptly.
- Confirm the information with the witness after determining what information will be used in the complaint.
- Explain to witnesses:
  - the purposes of the investigation;
  - the methods by which their interview is being memorialized; and
  - that any information they provide may be used in a complaint for violation of the federal securities laws.

(See *New Orleans Emps. Ret. Sys. v. Celestica, Inc.*, 455 F. App'x 10, 13–14 (2d Cir. 2011) (noting a plaintiff may rely on confidential witnesses to adequately plead securities fraud claims); *City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp.*, 875 F. Supp. 2d 359, 371 (S.D.N.Y. 2012)).

Confidential Witness Reliability Inquiries

A confidential witness interview should include inquiries directed at assessing the witness's role in the company at issue. This helps ensure that the complaint describes each confidential witness with sufficient particularity for the court to find it probable that a person in the position occupied by the source would have the information alleged (*Novak*, 216 F.3d at 314).

Most federal courts give considerable weight to confidential witness allegations when the complaint includes, for instance, job descriptions and responsibilities, and in some instances, the exact titles and reporting lines for those witnesses (see, for example, *Cutler v. Kirchner*, 696 F. App'x 809, 815 (9th Cir. 2017) (finding that confidential witness allegations about management's exposure to factual information supported a strong inference of scienter because the witness was a company president with personal recollection of quarterly executive board meetings); *In re Quality Sys., Inc. Sec. Litig.*, 865 F.3d 1130, 1145 (9th Cir. 2017); see also *Brendon v. Allegiant Travel Co.*, 2019 WL 4255051, at *6-7 (D. Nev. Sept. 9, 2019)).

Besides the nature of the confidential witness's role in the company, counsel should focus on eliciting details showing that the witness has a reasonable basis for their knowledge (see, for example, *Oklahoma Police Pension & Ret. Sys. v. LifeLock, Inc.*, 780 F. App'x 480, 484-85 & n.5 (9th Cir. 2019) (crediting a confidential witness hearsay report where the witness was "in a position to be personally knowledgeable" of the discussion reported); *Halford v. AtriCure, Inc.*, 2010 WL 8973625, at *7 (S.D. Ohio Mar. 29, 2010)). Courts have developed varying criteria for assessing the reliability of the underlying allegations, including review of:

- The level of detail provided by the witness.
- The corroborative nature of other facts alleged (including from other sources).
- The coherence and plausibility of the allegations.

(See *Institutional Inv'rs Grp. v. Avaya, Inc.*, 564 F.3d 242, 249 n.13, 261-62 (3d Cir. 2009).)

Most courts are skeptical of confidential witnesses who essentially are commenting on issues of which they have no personal knowledge.

Documents Provided by Witnesses

Former employees may have access to documents from their tenure with the defendant company. Courts have permitted the use of these documents at the pleading stage, which often provide detail and reliability regarding the former employee's statements (see, for example, *Brado v. Vocera Commc'ns, Inc.*, 14 F. Supp. 3d 1316 (2014)).

Plaintiff's counsel should take precautions against obtaining any privileged communications or truly proprietary documents such as trade secrets. Any documents provided by witnesses should be reviewed for privilege by an attorney not litigating the case, such as outside counsel or an attorney walled off from the litigation team, before plaintiff's counsel and investigators review the documents.

DISCOVERABILITY OF INVESTIGATIVE MATERIALS

In discovery, defendants may request materials the confidential witnesses may have provided to the plaintiff, as well as transcripts or memoranda of meetings with the confidential witnesses that the plaintiff's counsel or the investigator prepared. While the attorney-client privilege and work product doctrine generally protect notes, transcripts and memoranda prepared by lawyers or their investigators, plaintiffs' counsel should take note that general communications and documents provided by witnesses could be discoverable.

Courts have held that interview notes and witness summaries drafted by counsel are subject to attorney work product protection (*Hatamian v. Advanced Micro Devices, Inc.*, 2016 WL 2606830, at *3 (N.D. Cal. May 6, 2016)). Recognizing that plaintiff's counsel must often rely on investigators during litigation, courts have frequently extended the attorney-client privilege to communications between counsel and investigators (see, for example, *Gucci Am., Inc. v. Guess?, Inc.*, 271 F.R.D. 58, 74 (S.D.N.Y. 2010); *Costabile v. Cty. of Westchester*, 254 F.R.D. 160, 164 (S.D.N.Y. 2008) (protecting report prepared by private investigator acting as plaintiffs' attorney's agent)).

For more on navigating privilege and work product issues, see Attorney-Client Privilege and Work Product Doctrine Toolkit (0-501-1475).

ABILITY TO ALLEGE ADDITIONAL CONFIDENTIAL WITNESS STATEMENTS

After the filing of the complaint, the investigation should continue if plaintiff's counsel and investigators believe further relevant information about the case might exist. Although there is no obligation to amend the complaint, plaintiffs often decide to do so to ensure that the pleading is comprehensive. FRCP 15 permits a plaintiff to amend the complaint once as a matter of course without seeking leave from the court.

As the case proceeds, additional witnesses may become available if the defendant company downsizes or as people leave the company who were privy to relevant information and can further substantiate plaintiff's allegations. The addition of confidential witness statements can often add further support for plaintiff's allegations so that plaintiff's complaint overcomes a motion to dismiss (see, for example, *Dep't of Treasury of N.J. v. Cliffs Nat. Res. Inc.*, 2015 WL 6870110, at *1 (N.D. Ohio Nov. 6, 2015); *In re Rayonier Inc. Sec. Litig.*, 2016 WL 3022149, at *1 (M.D. Fla. May 20, 2016)).

WORKING WITH EXPERTS

Private lawsuits asserting damages under the federal securities laws can raise complex issues requiring substantial expertise, often in highly specialized and technical areas, requiring the parties on both sides to engage experts to establish their claims or defenses. Although counsel may retain consulting experts at any time during the case, it is best practice to involve experts as early as possible. For plaintiff's counsel, the decision whether, and when, to retain an expert or a consultant generally reflects the case-specific factual and legal issues that counsel consider during the case evaluation stage (see Due Diligence to Assess Whether to Pursue a Claim). Counsel then call on those experts when it most benefits clients, which might be well before a case is filed and to assist with the preparation of a complaint.

ISSUES FOR EXPERT REVIEW

The parties in a private federal securities fraud action generally retain corporate finance or economics experts to perform an economic and statistical analysis, known as an event study, to inform the pleading of loss causation.

In an event study, an expert determines the effect of the public disclosure of information (for example, corrective information regarding a previous misrepresentation about the subject company) on a stock price during a specified time period and isolates that effect from other potential influences. Counsel may rely on an expert to perform an event study early in the case, particularly to support a plaintiff's pleading on loss causation and with a preliminary estimate of damages. The expert can then refine the analysis during the litigation as more information becomes available, which can help counsel leverage the expert's analysis throughout the litigation.

In addition, counsel often maintain relationships with experts and specialists in other fields that are frequently used by a securities litigation practice, such as:

- Valuation experts, for instance, if the dispute requires determining the value of an asset or a right.
- Accounting experts, for instance, if the alleged violation concerns financial statement disclosures or GAAP violations.
- Experts on specific companies or industries, such as pharmaceutical, investment banking, or energy.
- Lawyers or others with knowledge of corporate governance or specific regulatory processes.
- Disclosure experts, such as lawyers or accountants, to describe the process of preparing annual or quarterly reports and the disclosure requirements of the federal securities laws.
- Experts on the underwriting process and the due diligence responsibilities of participants in a securities offering.
- Experts on issues governed by foreign law.

Counsel may also retain experts or specialists in fields that are uniquely relevant to a particular action.

SELECT AN EXPERT AS EARLY AS PRACTICABLE

When vetting potential testifying experts, counsel's preliminary examination should address:

- The financial, economic, and other relevant aspects of the subject company.
- The expert's:
  - technical skills in economic, statistical, valuation, and other relevant forms of analysis;
  - skills employed in gathering, analyzing, and weighing data; and
  - familiarity with the subject company or industry's regulatory environment and resulting constraints.

The same experts often testify for plaintiffs or defendants in several cases. Because securities litigation tends to raise similar issues from one case to the next, prior expert testimony may help counsel anticipate the expected analysis and effectively vet potential experts.

For more on the role of experts in securities class actions, see Practice Note, Exchange Act: Section 10(b) Litigation Experts (W-006-7358).

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