Seven Lessons For Boards From Securities Lawsuits

by Dorothy J. Spenner & Daniel A. McLaughlin, Sidley Austin LLP

As litigators who defend lawsuits arising from stock price declines and debt downgrades and defaults, we have seen what can go wrong with securities offerings. Lawsuits can arise from legitimate corporate scandals, but also from industry-wide market events like the 2008 credit crisis. And the ground rules are constantly shifting; a pending Supreme Court case, *Omnicare*, could hold directors liable for a statement of the company's opinion (like a valuation or statement about legal compliance) even if they honestly believed it but lacked a reasonable basis. To avoid being blindsided, directors of public companies should heed these lessons from prior lawsuits:

1. **Consider Who You Do Business With:** Think of Enron and Bernie Madoff: in major financial scandals, a company's legal and business risks can come not from its own core business, but from its business partners and relationships. While the Supreme Court in 2008 set some outer limits on a third party's liability for a company's statements to its own shareholders, boards can better manage litigation risk by asking, in advance, which of the company's business relationships create potential risks and making them as transparent as possible to investors.

2. **Let Your Lawyers Handle Litigation; Don't Handle It in a Press Release:** The Supreme Court in a 2011 case, *Matrixx*, held that a company's press release contesting product liability lawsuits made it more plausible that shareholders would have wanted to know about a study of scattered complaints about the product. The Court suggested that it might have ruled differently if the company had remained silent. Corporations should be careful not to add to litigation by specifically contesting it in disclosures.

3. **Have The Key People on an Issue Review Every Disclosure:** Disclosures, and lawsuits challenging them, touch on matters known best by people in different parts of an organization. Corporations should ensure that disclosures relating to any part of their business, financial statements, or regulatory or other exposure are drafted with the input of those most knowledgeable about the issues. Boards should evaluate periodically whether disclosure committees are comprised of individuals with the appropriate breadth of knowledge.

4. **Put Fresh Eyes on Every Offering and Disclosure:** The speed of shelf offerings can make it hard to devote the same time and attention to disclosure issues as in an initial offering. But courts are skeptical of disclosures that seem to be repeated as boilerplate from one offering to the next, that don't adequately distinguish between different offerings, or that don't update risk factors in a changing market. Boards can best defend the company's interests by insisting that every disclosure (*especially* a "standard" one) is reviewed periodically, ideally offering-by-offering, and is updated as market and company-specific factors change. Even if an update makes a prior disclosure look too optimistic in hindsight, the better practice is to cut off any further risk exposure by improving disclosures as soon as possible.

5. **Examine the Incentives:** Lawsuits and regulatory actions are often triggered by some real or perceived conflict of interest – for example, suits claimed that sell-side analyst reports were too favorable to investment banking clients, that accounting firms were too favorable regarding companies that employed them as consultants, or that rating agencies were too favorable to securities when the company paid their fees. Boards also may risk losing important defenses, such as good-faith reliance on the independence of a valuation in a merger, if they rely on a party whose independence seems compromised. If a company is not comfortable fully disclosing a business relationship or payments because it is concerned about how the situation would look, that situation should be scrutinized as a legal risk.

6. **Examine Your Assumptions:** Every business plan rests on assumptions, such as, for some businesses, pre-housing/credit crisis assumptions that home prices would continue to rise or remain stable. Boards should ask whether disclosures and business plans address the risks that present the largest-sized threats to the business, even when it may not seem all that likely that those risks will come to pass and even if these risks are macro, rather than company-specific risks.

7. **Consider Whether and Where To List:** There are many reasons for U.S. and non-U.S. companies to go public and list on U.S. markets, and litigation should not be the sole driver of that decision. But the risk of U.S. securities litigation that comes with going public is greater for companies listed or trading in the U.S., because the most commonly used U.S. securities laws are limited to public offerings in the U.S., transactions on U.S. markets, and off-market transactions within the U.S., even for securities of U.S. companies.

This article first appeared in Corporate Board Member's December 2014 newsletter.

Dorothy Spenner is a partner and Dan McLaughlin a counsel in the Securities and Shareholder Litigation Practice at Sidley Austin LLP, a global law firm with 1,900 lawyers in 18 offices around the world. Ms. Spenner and Mr. McLaughlin represent financial institutions and related individuals in securities litigations and regulatory enforcement proceedings, and represent companies from a variety of industries and sectors in all aspects of complex commercial litigation. They can be contacted at DSPENNER@SIDLEY.COM or DMCLAUGHLIN@SIDLEY.COM, respectively.

This article has been prepared for informational purposes only and does not constitute legal advice. This information is not intended to create, and the receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this without seeking advice from professional advisers. The content therein does not reflect the views of the firm