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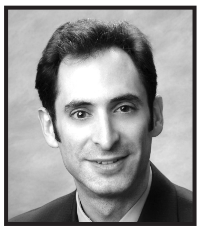
Securities Litigation Today: Striking The Right Balance

The Editor interviews ***Steven M. Hecht*** *and* ***Lawrence M. Rolnick,*** *Lowenstein Sandler PC.*



Steven M. Hecht

Lawrence M. Rolnick

Editor: Would each of you gentlemen tell our readers something about your professional experience?

Rolnick: I began my career in New York at Cravath, Swaine & Moore and came to New Jersey about fifteen years ago. My professional experience is largely focused on defending securities cases, including defending officers and directors of publicly traded companies. Following my arrival in New Jersey, I founded the New Jersey Bar Association's Section on Securities Litigation and Enforcement.

Among other things, Lowenstein has a very strong corporate practice, and for a litigator with a close connection to the business world it is essential to be in daily contact with first-rate business lawyers. That has been one of the most significant factors in the growth of our litigation practice.

Hecht: My journey is similar to Larry's. Following graduation from Harvard Law School, I spent five years with Cleary Gottlieb in New York, where I worked on class action defense, takeover litigation, and the like. My move to New Jersey was based on a desire to work in a smaller market but one with the same degree of sophistication that I had enjoyed in New York. In Lowenstein, I was fortunate to connect with what I believed then, and believe today, to be the finest firm in the state.

Let me add that two of the Lowenstein partners who interviewed me for a position here were Doug Eakeley and Larry Rolnick. They made an extraordinary impression on me, with particular reference to the quality of law I could expect to practice at the firm.

Editor: Please tell us how your practice has evolved over the course of your career?

Rolnick: My career has followed the major trends that have impacted litigation coming out of the business world over the years. In the 1980s that meant I was engaged in a great deal of hostile takeover defense work. Later in that decade I spent considerable time on insider trading issues and SEC enforcement actions. I was involved in the Resolution Trust Corporation litigation, which went on for years. Much of this involved defending directors and officers accused of negligence in connection with the savings and loan debacle. Over the years that followed we seemed to experience a series of boom-bust cycles culminating in the tech bubble, which resulted in Congress attempting to provide some protection for the technology industry with the passage of the Private Securities Litigation Reform Act. With the corporate scandals and the enactment of Sarbanes-Oxley, however, the pendulum began to swing in the other direction, and the focus on defense gave way to trying encourage investor confidence.

The area in which I practice, accordingly, has seen extraordinary changes over the course of my career, including the enactment of a great deal of new law, and it continues to be a most demanding educational experience.

Hecht: One characteristic of my practice that has changed considerably has to do with the clients we represent. The variety is astonishing, and we are no longer limited to defending large public companies, as we also represent private companies and institutional investors. I am able to interact with the executive officers of our clients, something that is difficult to do where the client is a *Fortune* 50 enterprise.

Editor: You recently moderated and spoke at the judges' panel of the securities litigation industry's conference on some of the major issues the industry faces today. What was the composition of the panel?

Rolnick: Chief Judge Garrett Brown, Jr., who is Chief Judge of the Federal District Court in New Jersey; Faith Hochberg, former U.S. Attorney for the District of New Jersey and now a Federal Court Judge, and Chris Christie, current U.S. Attorney for the District of New Jersey. Unfortunately, Chris was ill the day of the program and did not participate, but he was significantly involved in preparing our materials for the presentation.

Hecht: For legal and financial purposes, our region has evolved into a single geographic entity, so I do not think that anything should be read into the New Jersey orientation of the panel. What these people have to say is of great interest to every practitioner in the region, whether from Manhattan, Long Island, Westchester or New Jersey.

Editor: What are some of the hot issues in securities litigation today?

Please email the interviewees at shecht@lowenstein.com or lrolnick@lowenstein.com with questions about this interview.

Rolnick: The hottest issue in securities litigation today is a general tendency on the part of the courts to make it more difficult for marginal securities claims to be prosecuted. This tendency began with the passage of the PSLRA, but since its passage the courts have done a good job of really trying to give effect to the Congressional intent that produced that law.

We are also seeing a lot of activity in the damages area owing to *Dura Pharmaceuticals*. Here the United States Supreme Court addressed the issue of the measure of damages in connection with the impact of the disclosure of information on the capital markets over extended periods of time. This discussion has particular relevance for stock option backdating. As a result of the scrutiny now directed at a whole series of backdating practices, it is not unusual to see public companies restating their financial statements some ten years back to measure the impact of stock option grants. Whether that results in measurable damages from a securities litigation standpoint is very dubious. Nevertheless, the issue of loss causation from a damages perspective has not been definitively resolved, so I anticipate a great deal of litigation in this area over the next few years.

Hecht: Just two days before our conference, Chief Judge Brown issued his second ruling – 200 pages in length – in the *Intelligroup Securities Litigation,* which constitutes a very careful treatise on the evolution of securities law. What is extraordinary about the ruling is that it points out how so many of the securities issues we regard as new were, in fact, addressed by Congress and the courts 60 and 70 years ago. What was put into place with the Securities Act of 1933 and the Exchange Act of 1934 continues to effectively respond to new market conditions.

Editor: The conference spent considerable time on the subprime mortgage market meltdown. Are we past the worst, or is there more to come?

Rolnick: I think there is more to come. These loans should never have been made. However, they carried favorable interest rates, and were made in very large numbers and in an economy where real estate values were climbing rapidly and lenders were not as concerned as they should have been about the value of their collateral. What we are seeing today is the beginning of a market correction – default and foreclosure – because the economics behind these loans are no longer sensible in a flat or declining real estate market. As interest rates climb – and they will – the problem is going to be exacerbated. I reiterate that we are at the beginning of this correction. Litigation usually follows economic catastrophe by 12 to 18 months, and once we have a clear picture of those who have been injured we are going to see a significant wave of litigation.

Editor: The corporate scandals earlier this decade resulted in Sarbanes-Oxley and a whole new compliance structure in the corporate arena. Are we going to see something similar in the securities litigation area as a result of the subprime mortgage debacle?

Hecht: I am very doubtful that Congress will step in to legislate on securities litigation. Unlike the increase in accountability that resulted from Enron, WorldCom and so on, there is really no clearly identifiable or unique legislative issue here for Congress to consider. As I indicated earlier, I think the statutory framework that we already have in place is sufficient to meet the present challenge. This is especially true since the Executive Branch has now stepped in to address the subprime crisis. Secretary of the Treasury Paulson is currently meeting with the major banks to try to avoid drastic foreclosures that could result from increased interest rates. I think this represents a general consensus that people would rather mitigate their losses than try to achieve greater profits, which is simply not tenable in the present climate.

Editor: Class action litigation also received considerable scrutiny at the conference. What is underway in that arena?

Rolnick: Class certification is receiving a great deal of attention. These claims are dangerous because they offer at least a possibility of aggregating tens of thousands of claims which, together, constitute a very large exposure. In the past, class certification was almost presumed in securities litigation; however, if the defendant can show that the lead plaintiff is inappropriate – perhaps the plaintiff suffered no loss or has some conflict of interest – there may be a good chance of preventing class certification altogether.

In addition, I think we have become much more sophisticated after *Dura Pharmaceuticals* about making sure that confounding news is not transformed into damages. A company under pressure is usually going to disclose a great deal of negative news at one time – get it over with and get on with the company's affairs. Today I believe we are much more sophisticated in distinguishing market losses that are attributable to market forces and not to some alleged securities law violation. As a result, many of the large exposures are being managed down to much lower numbers.

Editor: Please tell us about the trends in internal investigations.

Rolnick: Internal investigations continue to be an important part of securities litigation, particularly in the area of derivative litigation. In order to be entitled to the protection of the business judgment rule once the courts are involved in a matter, it is important that companies do a good job of policing themselves. That means, for example, responding to a properly made demand to look into some alleged area of misconduct.

Hecht: A prime example of where the courts have shown deference to companies which have done such internal investigating following demand is in the area of stock options backdating. This is an indication that the courts really desire companies to run their own internal affairs. And, of course, where the internal investigation is run by outside counsel – and one with no prior connection to the company – the amount of deference to be given to the company's efforts is almost certainly going to be enhanced.

Editor: Is there anything that either of you would like to add?

Hecht: We have seen a great deal of activity in the past 10 years, between the passage of the PSLRA, Sarbanes-Oxley and periodic increases in staffing and funding at the SEC. I believe that this activity reflects the complete spectrum of policies that underlie our securities laws, ranging from corporate accountability to more deferential treatment of management. The issues that have been addressed within that framework have been with us for a long time. While new market forces dictate the terms of the dialogue going forward, the underlying principles remain the same. Congress and the courts will continue to sway back and forth between the goal posts of protecting investors on the one hand and shielding companies from overly expansive liability on the other.

Rolnick: The reality is that the health and integrity of the U.S. capital markets is critical to everyone. Frivolous claims cause a great deal of damage to our system. But, if the investing public does not have confidence in the integrity of the market, that is going to diminish corporate America's access to capital, an equally major concern. We need to strike the right balance.