As seen in *In-House Defense Quarterly*, Summer 2009

Preparing In-House for Investment Market-Collapse Litigation
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The chief compliance officer of your securities underwriting employer stops into your associate general counsel's office, papers in hand. She indicates that the Securities and Exchange Commission (SEC) has subpoenaed structured investment products underwriting files and seeks your response input. Your company was in the chain of distribution of mortgage loans sold to securitizers who packaged them into mortgaged-backed securities. Market collapse of the securities' values in the sub-prime debacle is well known.

A serious facial expression headlines the general counsel's anxiety as he summons you to a law department conference room. The chief executive officer of your publicly traded industrial parts manufacturing employer is also present. They discuss a 401K plan breach of fiduciary duty suit just filed in federal court by a co-employee based upon *LaRue v. DeWolff, Boberg & Associates, Inc*., 128 S. Ct. 1020 (2008). You are aware that the plan – especially the employee Stock Ownership Plan (ESOP) aspect – has performed worse than the benchmarks over the last 12 months.

The warm morning greeting by your regular barista dissipates quickly when you glance at a newspaper headline and see that your stock brokerage employer was sued in a class action alleging fraudulent distribution of securities under the Securities Exchange Act of 1934. Upon arrival at your subdued corporate counsel office a voice mail is waiting from the company's chief information officer urging a quick return call.

Lawyer jokes directed to you by CPAs at your mid-sized accounting firm are absent after lunch when news breaks that a malpractice claim was filed against the firm by customers of a collateralized debt-obligation issuer for whom the firm performed due diligence and audit investigations. The chief financial officer calls asking you to commence the investigation in-house. Where to start?

Now that the economy has left the emergency room for an in-patient floor upstairs, claimant lawyers' reactions to the enormity of the investment losses sustained in the credit crunch are now underway. In-house counsel for 401k-plan sponsors, securities dealers, accounting firms, financial planners, retirement-plan administrators, underwriters, auditors, lenders, mortgage originators, home builders, secondary-market participants, bond insurers, mortgage securitizers, commercial banks, investment banks, rating agencies, trusts, title companies, and others, including law firms, are potential targets of lawyers representing institutional and individual investors. Caught up as well in the frenzy are potential challenges to executive-compensation arrangements tying income to stock-price performance and potential coverage disputes involving directors' and officers' liability policies, professional liability policies and fiduciary liability insurance. We review here suggestions for corporate counsel as "first responders" to the surge in subprime market-collapse litigation and agency enforcement investigations.

A wide range of potential claims may arise. 401k-plan participants, beneficiaries, and the U.S. Department of Labor may challenge trustee compliance with fiduciary standards and fee reasonableness. Accounting and law firms may be sued for malpractice in auditing or product structuring, or as abettors of client issuers' malfeasance. Mutual fund account holders – already unhappy with fund performance – may allege fee excessiveness and object to revenue sharing arrangements. Investors may bring Securities Act of 1933 actions alleging that their investments were induced by false and misleading statements. The SEC may launch investigations against hedge funds, investment banks, mutual funds, auditors and officers and directors into the merits of securities offerings. Investors who bought collateralized mortgage obligations, including subprime loans, may present claims against the lenders and securitizers. Those with repurchase rights may demand that the products that they invested in be repurchased by the issuer. Shareholder derivative suits may arise against officers and directors for breach of fiduciary duty, particularly if the officers and directors sold their shares in the falling market. Borrowers may sue lenders of subprime instruments alleging fraud and predatory pricing. The list is endless. First, we must sort out the complexity.

Achieve Product, Plan and Law "Fluency"

Mastery of understanding the products involved, e.g., auction-rate securities, collateralized mortgage obligations, credit-default or total-return swaps, other derivative instruments, and even stock options (backdating claims) is vital at the outset. So is identifying the roles of all market participants involved in the chain of distribution of the product, including the role of your client. In claims involving employees, the 401k or other retirement plan documents or terms of executive compensation plans must be reviewed. Director and officer indemnification agreements should be checked. Review the applicable law, such as the current scope and limitations of ERISA fiduciary duties, fraud actions under the 1933 and 1934 acts, the Investment Company Act of 1940, the Sarbanes-Oxley Act of 2002 (SOX), the Private Securities Litigation Reform Act of 1995, professional liability common law, and corporate waste or unjust enrichment equitable remedies. Be alert for potential "whiffs" of criminal law ramifications that may arise along the way. Then get control of your company's facts.

Arrange for Immediate Document and e-Discovery Holds

Call the chair of DRI's Electronic Discovery Committee or other e-discovery professionals in your network to tap resources. Plans must be made at the outset to control the paper and e-document productions certain to come. Early attention to document retention management should keep at bay later claims of evidence spoliation that present enormous risks in litigation today – or even worse, claims of obstruction of justice. Corporate counsel should work in tandem with the IT department to prepare a document production platform. Do this as though Rules 16 and 26 of the Federal Rules of Civil Procedure apply. Careful management to control the scope of production of electronically stored information (ESI) will reduce cost, limit disruption in business unit performance, and aid privilege and scope the request evaluations as document demands are received. Paper document destruction and automatic ESI deletion and purging systems should be suspended firmwide until negotiations ensue, to reduce the scope of the production fairly. Back-up tapes or discs should also be secured.

Consideration also must be given to whether "new frontier" ESI may be in play, such as voice data, text message, hand-held device content and instant-messaging products, as they surge in popularity. Attention should also be given to methods to manage metadata production demands (allowing for review of earlier deletions or editions in any particular document), and home-computer access involving the key corporate personnel participating in the matter. Discussions involving proposed scope limits, such as date-range restrictions, key-word parameters, and business unit limitations must occur with agency or litigation adversaries. Management should also decide whether an e-discovery response vendor, record search and filtering software, or audio-search software should be acquired. When fact preservation efforts are under control, give your attention to your internal investigation.

Internal Investigation: Risks, Planning and Execution

Corporate counsel serve as gatekeepers over questions: (1) should you conduct a formal internal investigation, (2) should it be conducted in-house or by outside counsel, and (3) what should be its proper scope? Obvious reasons support initiating an internal investigation in the face of investment-loss litigation or enforcement agency inquiries. First, it allows a company to get ahead of – and not trail – fact determination important to the case. Second, early investigation ought to reveal problem areas requiring specific attention in the development of a company's defenses. Third, it demonstrates good faith with enforcement agencies and sets the stage for leniency requests in the future. Remember that under SOX §307 lawyers are obligated to report material violations of securities law up the ladder to senior management or the board, and that the SEC relies upon self-reporting by attorneys as an element of its enforcement portfolio.

On the other hand, formal internal investigations present the hazard of loss of privilege protection, making the fruit of the investigation available to adverse interests, if the decision is made to disclose the report to the agency. Public filings with administrative agencies may reveal communications within the scope of the attorney-client privilege, or mental impressions subject to the work-product doctrine. They may connect the dots to successful securities litigation against your company by claimant lawyers. In addition, investigations – particularly those launched by outside counsel – are less amenable to client control, limitations or suspensions. Overall, however, the underlying purpose of proceeding with an investigation – to formulate corrective action – generally makes the decision to proceed with the internal investigation easy.

The generic investigation protocol is straightforward. Find out what the company said about the investments. Determine the nature of disclosures the company provided to employees or investors. Identify the employees involved. Evaluate the client's representations about its lending practices. Learn whether the financial statements' representations about subprime-product valuations are supportable. Create a timeline measuring valuation representations with the timing of client acknowledgement of market and portfolio weakness and the timing of asset write-downs. Gather information helpful to substantive defenses and proof of mitigating factors. Consider the range of reasonable remedial actions, including employee discipline or victim recompense, if wrongdoing is found. Prompt action, avoidance of any scent of cover-up in the investigation, and all-in, one-time, adverse publicity when the situation is disclosed should be the goal.

Another goal should be to achieve a confidentiality agreement in negotiations with enforcement authorities preserving the attorney-client and work-product privileges applicable to the internal investigation report. This will not be easy, and precedent obstacles exist on whether "selective waiver" of privilege – waiver of privilege in disclosures to the government, while preserving the privilege respecting private litigants – is effective. Regardless, each document in internal files should be marked with the message that the document is prepared in anticipation of litigation, is privileged, and is subject to work-product protection. Documents containing adverse facts should be noted as covered under the self-critical analysis privilege, regardless of its recognition or applicability. Finally with respect to privilege, before interviewing corporate employees, counsel should announce and document the fact of disclosure that counsel does not represent the interviewee, but only the corporation. This so-called "Upjohn" warning or "Corporate *Miranda*" notice should comply with Rule 1.13 of the ABA's Model Rules of Professional Conduct and similar disciplinary standards.

The internal investigation may lead counsel to consider whether a special litigation committee should be formed to investigate or pursue derivative litigation affording the client somewhat greater influence over the situation. The board might also be inclined to appoint a special committee of disinterested directors to oversee the company's response to the claim or agency inquiry. Certainly the investigation will lead to review of the company's internal controls over financial disclosures, featuring periodic examinations and reporting, review of audit standard clarity, and whether the audit committee is adequately staffed with outside directors having accounting expertise. The board review also gives counsel an opportunity to refresh directors' familiarity with the business-judgment rule so important to the defense of actions of the type triggered by the economic collapse: if corporate governance is executed in good faith following a process in which the board is fully informed and a majority of the directors are disinterested, decisions made are presumed to be rational and thus should be respected by courts or agencies.

The internal investigation should also be conducted with a goal of discouraging adverse SEC enforcement action or Department of Justice (DOJ) prosecution decisions. The SEC's "Seaboard Report" sets forth the factors that the agency considers in evaluating enforcement action decisions. Investigation comprehensiveness, self-reporting and voluntary remediation are types of favorable factors considered in enforcement evaluations. As well, the DOJ's "McNulty Memorandum" establishes the guidelines that the department follows in evaluating stock loss prosecution decisions. Finally, inform employees likely to be interviewed by government investigators that the agents may appear without notice and that the employees have legal rights in such circumstances.

Shape the Defense Narrative

Although the goal of the internal investigation is to discover facts of a transaction or arrangement objectively, shaping the defense narrative in the course of the investigation makes sense. The generic defense to subprime market-collapse litigation is obvious in any case or enforcement inquiry relating to allegations of investment unsuitability, fiduciary imprudence, fraudulent inducement, ESOP mandates, risk understatement or financial statement errors and omissions. The generic defense is supported by these truths:

- The investment market collapse was unforeseeable
- Causation is absent: everything fell
- The lawsuit is merely a concocted hedge against well-known market volatility
- Prudent decisions and sufficient disclosures were made

Other defense elements, of course, depend upon the nature of the claims being made. In the case of 401k-plan participant litigation, proof should be gathered that mutual fund fees were reasonable, that claimants may lack standing if plan procedure exhaustion requirements are not followed, that due diligence was exercised in product vendor-selection decisions, that education and training on self-directed investment choices were provided, and best practices were followed in plan setup, fund choices, and employee disclosures. Prudence, loyalty and diversification abounded. Evidence may also be marshaled in the course of the claim handling that the claimant largely ignored the retirement plan's performance and the individual's fund allocations. As for ESOP elements of 401k plans in which participants are encouraged to invest in the employer's stock, proof that ESOP participation was voluntary, or that ERISA exceptions to fiduciary duties apply (in particular, diversification), is important. Thus, an ERISA §501(a)(2) claim for breach of fiduciary duty does not lie.

Defenses that may apply in brokerage loss accounts include proof that (1) investment recommendations were suitable, (2) misrepresentation allegations are not meritorious, deceptive acts did not occur, (3) prudent decisions were made and the broker undertook appropriate due diligence, (4) directors and officers maintained or increased their investment positions, (5) share prices to clients were comparable to competitor and industry benchmarks, (6) if misrepresentations were made, they were merely mistaken, (7) accountants employed were reliable, (8) scienter (*i.e.,* fraudulent intent) is lacking, and (9) class actions fail procedural requirements under the Reform Act and restrictive U.S. Supreme Court securities litigation jurisprudence that followed (or any event, reliance requires individual proof).

As for claims made against accountants, proof of compliance with the standard of care generally, and with generally accepted accounting principles in particular, anchors the defense preparation. Proof of compliance with internal controls attendant to the provision of services is also key. Hopefully proof can be marshaled that the accountants did not aid or abet breaches of fiduciary duty by plan fiduciaries, financial statements were not misleading, valuations noted were supportable and the financial statements did not understate losses and thereby overstate income. Look into whether the client received passing grades from Public Company Accounting Oversight Board inspections of the firm's audit history.

As for claims that may arise against those in the chain of distribution of structured subprime-loan securities from origination to securitization, proof that the practices did not run afoul of then-existing regulatory limitations is vital. Defendants must assemble evidence that the instruments were fairly valued, write-downs were taken as necessary, loan practices were consistent, extent of exposure to subprime products was appropriate, the impending collapse was not foreseeable, and quantiti8es of evidence show that scienter proof is absent. Evidence that the defendant's share price fell due to subprime concerns during the relevant period in which plaintiffs allege fraudulent non-disclosure will pose a tough causation hurdle for plaintiffs to overcome.

Consider also whether proof that the issuance of the notorious "liar's loans" was aided and abetted by federal government policy is appropriate,. Since residential real estate market values never fell for the most part over decades, legitimate and legal distribution of these products mad sense. Legitimate businesses should not be "hung by hindsight"' proof must be gathered of the open and obvious, burgeoning business in these products by prestigious, conservative underwriters and governmental organizations. In the environment then existing, the defendant's conduct was fully within the standard of care of investment professionals similarly situated. Moreover, investors in the secondary market – plaintiffs – are investment-choice and risk metric savvy.

Ongoing Corporate Counsel Responsibilities

Corporate counsel in conjunction with the board of directors will evaluate whether and when to retain outside counsel to continue defense preparations. Interviews with outside counsel candidates, and proposals for alternative fee arrangements, should be considered. When outside counsel is in place, however, in-house counsel's defense portfolio continues, as the following preparations are evaluated.

? Outreach to former employees for defense support
? Tender of claims to general liability, fiduciary liability, E & O, and D & O insurers
? Designation of the in-house portal for receipt of outside counsel communications
? Evaluation of joinder and additional parties to existing litigation
? Retention and education of a public relations consultant
? The prudence of repurchase-type "damage control" efforts
? The appropriateness of joint defense group participation
? Subpoena response-compliance oversight
? Recruitment of a forensic "best practices" compliance expert
? Management of privileged documents
? Privilege-log creation and management
? Inadvertent document production and "clawback" relief management
? Establishment of secure web-based document review sites for outside counsel
? Contract attorney retention
? Protective order planning for production of proprietary commercial information
? Preparation of the litigation budget
? Preparation of the company's narrative in public filings relating to the litigation of enforcement action
? Coordination of in-house and outside counsel task allocation
? Recruitment of a forensic accounting expert for complex calculation proof
? Development of a news article database supporting the nature and return of investments at issue at the time of i8ssuance or acquisition
? Development of a news article database showing that reliance proof fails given reporting of events signaling the iceberg ahead
? Web search investigation on litigation adversaries

- Evaluation of indemnification provisions in statutes, bylaws or director or officer agreements
- Data gathering on comparable executive compensation
- Data gathering on industry securitized product valuations at relevant times
- Planning for management of possible parallel proceedings.

Lessons Learned and Follow-up

Post-action reviews are recommended at the conclusion of proceedings to retain the experience gained from working through onslaughts of this nature. What lessons were learned? How could early response actions be improved? Is a crisis management committee worthy of creation? Was the board well advised? Are "clawback" previsions in executive compensation agreements adequately in place? Could better internal governance procedures be implemented? Are the company's audit committee and internal accounting controls functioning as they should? How could outside counsel performance improve? Don t' let valuable insights learned from the gauntlet take wing at the end.

Conclusion

"Forewarned, forearmed; to be prepared is half the victory," wrote Miguel de Cervantes Saavedra (1547-1616) in *Don Quixote*. Cervantes' famous quotation aptly describes corporate counsel's "best practices" in responding to market-collapse outcomes for those whose practices touch the investment industry. Civil, regulatory and potentially criminal outcomes of a very public nature require aggressive in-house preparation. Knowledge of the products and chain of distribution, control over fact development via document and e-discovery holds, handling the internal investigation, shaping the defense narrative and providing ongoing support to outside counsel are the way forward for in-house practitioners responding to this wave of litigation and enforcement actions.