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New Developments in Securities Litigation

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Compliance*

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Recent Developments in
the Use of Loss Causation
to Obtain Dismissal of
Securities Class Actions

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The financial crisis that overtook world financial markets from 2007 into 2009 has spawned a multitude of securities class actions alleging that corporate issuers, officers and directors of those issuers, underwriters, and accountants made misrepresentations and omissions of material fact in violation of Section 10(b) of the Securities Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 issued thereunder, 17 C.F.R. § 240.10b-5. With hundreds of billions or even trillions of dollars of market losses, plaintiffs have had ample incentive to scrutinize public statements for potentially inaccurate or incomplete disclosures. Yet efforts to link those specific misstatements or omissions directly to losses during a period of historic financial turbulence may prove challenging.

One significant hurdle for plaintiffs to overcome in securities class actions arising out of the financial crisis is the need to plead, and later prove, “loss causation.” Congress required securities plaintiffs to prove loss causation in the Private Securities Litigation Reform Act (PSLRA) of 1995, 15 U.S.C. § 78u-4(b)(4), and the United States Supreme Court required fact-based pleading of loss causation in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005). These respective edicts from Congress and the Supreme Court have led lower courts to review class action securities complaints very carefully to ensure that the plaintiffs have specifically alleged a factual and plausible link between defendants’ inaccurate or incomplete representations and the plaintiffs’ financial losses.

Background

The need for Section 10(b) and Rule 10b-5 class action plaintiffs to prove that the claimed misrepresentations or omissions actually caused their damages has never been controversial. Indeed, some courts, most notably the United States Court of Appeals for the Second Circuit, have held that the plaintiffs’ complaints must properly plead that the alleged misrepresentations and omissions were directly responsible for the claimed losses. In other words, even if a defendant knowingly or recklessly misstated certain facts, intervening events rather than the misrepresentations or omissions might be the more direct cause of the plaintiffs’ losses.

One early influential decision recognizing this possibility, and requiring the plaintiffs to plead specific facts to address it, arose in the context of a

Racketeering Influenced and Corrupt Organization (RICO) complaint. In *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 772 (2nd Cir. 1994), the plaintiff alleged that the defendants had induced the plaintiff to make a loan by misrepresenting the value of certain collateral. The court distinguished between “transaction causation”—that the misrepresentations had directly led the plaintiff to engage in the *transaction* at issue—and “loss causation”—that the misrepresentations had led directly to the plaintiffs’ *losses*. *Id.* at 769. A five-year interval between the loan and the lawsuit, coupled with an intervening downturn in the New York real estate market, led the court to conclude that “external factors were a substantial cause” of the losses; because plaintiff had failed to plead specific facts to show loss causation, the Second Circuit affirmed dismissal of the complaint. *Id.* at 772.

In 1995, Congress enacted the PSLRA. Among its many provisions was Section 78u-4(b)(4), 15 U.S.C. § 78u-4(b)(4), which provides:

In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

In *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2nd Cir. 2005), the Second Circuit applied its reasoning from *Gelt*, as well as Section 78u-4(b)(4), to affirm dismissal of a securities class action. The *Lentell* complaint alleged that Merrill Lynch had issued fraudulent analyst reports that touted stocks for which Merrill simultaneously served as underwriter. In its motion to dismiss, Merrill did not contest transaction causation, *Id.* at 172, but argued that plaintiffs’ complaint insufficiently alleged loss causation. The Second Circuit agreed, stating:

Loss causation is a fact-based inquiry and the degree of difficulty in pleading will be affected by circumstances, but our precedents established certain parameters. It is not enough to allege that a defendants’ misrepresentations and omissions induced a single “purchase-time value disparity” between the price paid for a security and its “true investment quality.”

Id. at 174 (quoting *Emergent Capital Inv. Management LLC v. Stonepath Group Inc.*, 343 F.3d 189, 198 (2nd Cir. 2003).) The court concluded that the complaint failed to allege that the claimed misrepresentations and omissions caused plaintiffs’ losses. *Id.* at 175, 177.

Three months after the *Lentell* decision, the Supreme Court decided *Dura Pharmaceuticals*, unanimously holding that Section 78u-4(b)(4) requires the plaintiff not only to prove loss causation at trial, but also to plead facts supporting loss causation in the complaint. The plaintiffs’ bare allegation that the alleged misrepresentations caused the purchase price to be inflated was insufficient to show that their eventual loss was caused by the alleged misrepresentations. 544 U.S. at 347. The court specifically observed that a purchaser might pay an inflated price for the securities, but then sell them at a loss before “the relevant truth begins to leak out,” in which event “the misrepresentation will not have led to any loss.” *Id.* at 342. The court also noted that a lower sales price after the truth leaks out “may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price.” *Id.* at 343. The court emphasized that, “[o]ther things being equal,” the longer the time between purchase and sale, the more likely it is that a loss is attributable to factors other than misrepresentations that led to the sale. *Id.*

Almost simultaneously with *Dura Pharmaceuticals*, the Supreme Court instructed lower courts to be more rigorous in reviewing any civil complaint when the defendant challenges it by a motion to dismiss pursuant to Rule 12(b)(6). See *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007) (plaintiff must plead “enough facts to state a claim to relief that is plausible on its face”); see also *Ashcroft v. Iqbal*, 129 S.Ct. 1937, 1949 (2009). Taken together, these precedents instruct federal district courts to conduct a searching inquiry to determine whether a class action securities complaint has adequately alleged that the claimed misrepresentations and omissions led directly to the purchase of the security at issue (transaction causation), and, just as important, whether the claimed misrepresentations and omissions led directly to the claimed financial loss (loss causation).

Loss Causation as a Basis for Dismissal of Securities Class Actions Pursuant to Rule 12(B)(6)

As a consequence of *Dura Pharmaceuticals, Twombly*, and *Iqbal*, district courts must now carefully scrutinize securities class action complaints for sufficient, fact-based allegations of proximate causation and economic loss. Especially in the context of securities claims arising during the recent period of financial turmoil, some courts have recognized that investor losses may not necessarily be correlated to misrepresentations or omissions in the sale of securities. A number of courts have recently dismissed, or affirmed dismissals of, securities claims under various provisions of the Securities Exchange Act of 1934.

With regard to Section 10(b) and Rule 10b-5, in *Luminent Mortgage Capital Inc. v. Merrill Lynch & Co.*, for example, plaintiffs alleged that they purchased mortgage-backed securities as a result of defendants' misrepresentations and omissions of material information. 652 F.Supp. 2d 576, 578 (E.D. Pa. 2009). Plaintiffs further alleged that the mortgage-backed securities carried a higher risk and might produce a lower return because of the misrepresentations and omissions. The court carefully reviewed plaintiffs' allegations of loss causation. Relying upon *Dura Pharmaceuticals, Lentell*, and *Gelt*, the court was "satisfied that the one-and-a-half year time period between the alleged misrepresentation and the injury, combined with the market downturn in the mortgage industry that developed in early- to mid-2007, is sufficient to undermine the inference of a nexus between defendants' misrepresentations and the performance of the securities." The court concluded that "plaintiffs alleged no facts to support their assertion that defendants' misrepresentations in 2005—rather than the market dislocation that occurred in 2007—caused an economic loss." *Id.* at 593. Although the court noted that it is "normally inappropriate to rule on loss causation at the pleading stage," it nevertheless found that plaintiffs' factual allegations were insufficient to meet their burden. *Id.* at 594 N.12 (citation omitted). Accordingly, the court dismissed the amended complaint "for failure to plead loss causation." *Id.* at 594.

Similarly, in *In re Security Capital Assurance Ltd. Securities Litigation*, 729 F.Supp.2d 569(S.D.N.Y. March 31, 2010), plaintiffs alleged that they purchased shares of stock in Security Capital Assurance, Ltd. (SCA) based

upon SCA's misrepresentations and omissions concerning its exposure to securities backed by subprime residential mortgages. Considering defendants' motion to dismiss pursuant to Rule 12(b)(6), the court observed that plaintiffs alleged "a slow, steady decline in SCA's securities, not a 'sharp drop' resulting from the announcement of concealed facts." Plaintiffs asserted loss causation based on an alleged course of misrepresentations during the Class Period, with a "gradual revelation of the truth, which incrementally caused the drop in stock prices, and Plaintiffs' loss." *Id.* The court rejected plaintiffs' argument, reasoning that:

plaintiffs have not with this Complaint effectively shown that it was the incremental revelation of Defendants' fraudulent misrepresentations, and not the actions of third parties or other circumstances of the market, that caused the decline in SCA's share price over the class period... Plaintiffs have not sufficiently alleged that the facts that were revealed incrementally before February 29, 2008 caused the gradual decline in SCA's stock price... In the absence of any sharp drop, plaintiffs have not demonstrated that Defendants' disclosures, and not the market failures, caused these final declines in SCA's stock.

Accordingly, the court dismissed plaintiffs' Section 10(b) and Rule 10b-5 claims as well as their Section 11 and 12(a)(2) claims. *Id.*

The United States Court of Appeals for the Ninth Circuit affirmed dismissal of a complaint for failure to plead loss causation in *New York City Employees' Retirement System v. Jobs*, 593 F.3d 1018 (9th Cir. 2010). NYCERS alleged that defendants Apple Computer, Inc. and individual defendants had issued false and misleading proxy solicitations in violation of Section 14(a) and Rule 14a-9. NYCERS asserted economic loss on the ground that its interests as a shareholder were diluted. The court rejected this theory as a matter of law, holding that "economic loss does not necessarily accompany dilution, so such conclusory assertions of loss are insufficient. Thus, NYCERS fails to adequately plead economic loss, and the district court's dismissal on this ground was proper." *Id.* at 1024. The court remanded to allow NYCERS to replead an omitted Section 10(b) claim.

Although the plaintiff's failure to plead loss causation can be fatal to a claim brought under the '34 Act, loss causation is not an element of a claim under the '33 Act and thus the plaintiff need not allege loss causation in his or her complaint. Nevertheless, the lack of loss causation is an affirmative defense to a '33 Act claim; if it appears on the face of the complaint or in public documents incorporated into the complaint that the alleged losses were *not* caused by the claimed misrepresentations, this "negative causation" will be grounds for dismissal.

Thus, in *Iowa Public Employees' Retirement System v. MF Global Ltd.*, 620 F.3d 137 (2nd Cir. 2010), the Second Circuit affirmed in part the dismissal of a class action complaint alleging that defendants had violated Sections 11(e) and 12(b) of the '33 Act. Plaintiffs alleged misrepresentations concerning MF Global's risk management measures, and that the flawed measures failed to constrain a rogue broker and compromised access to client confidential information. The court affirmed the district court's dismissal of plaintiffs' claims insofar as they alleged the risk management failures allowed access to confidential client information on the ground that the alleged misrepresentation bore no relationship to the drop in the stock price. *Id.* at 144. Thus, since the negative causation defense appeared on the face of the complaint, dismissal of the claim was appropriate.

Another recent decision to a similar effect is *Blackmoss Investments Inc. v. ACA Capital Holdings Inc.*, which dismissed a class action complaint alleging violation of Section 11 of the 1933 Act. 2010 WL 148617 (S.D.N.Y. Jan. 14, 2010). Based on allegations in the *Blackmoss* complaint and statements in ACA's public filings cited in the complaint, the court concluded that ACA's share price actually *increased* during the time ACA made corrective disclosures, thus undermining any correlation between the earlier misrepresentations and any subsequent declines in ACA's stock price.

These decisions require securities class action plaintiff's lawyers to confirm and plead fact-based loss causation before filing their complaints. Careful securities class action defense lawyers must analyze these complaints closely for fact-based loss causation. If the complaint does not plead that element sufficiently, a motion to dismiss may be appropriate.

Motion to Dismiss Denied

Of course, not all recent securities class action plaintiffs have seen their complaints dismissed. Several courts have recently found that class plaintiffs made sufficient allegations of loss causation to survive a Rule 12(b)(6) motion. For example, in *In re American International Group, Inc. 2008 Securities Litigation*, 2010 WL 3768146 (S.D.N.Y. Sept. 27, 2010), the court denied the motion to dismiss. The plaintiffs alleged that defendants misrepresented AIG’s cumulative exposure to the subprime mortgage market through its securities lending program and its credit default swap portfolio. In particular, plaintiffs alleged that AIG understated the credit risk of default, and failed to disclose the risk that AIG would be required to post collateral to cover its positions, and the valuation risk that AIG would need to mark the book value of the securities it held to a declining market. Although noting that the PSLRA and *Dura Pharmaceuticals* require a plaintiff to plead loss causation, the AIG court found the complaint “replete with allegations that AIG’s stock price fell in response to AIG’s corrective disclosures of previously undisclosed information.” The court explained that “the sharp drops of AIG’s stock price in response to certain corrective disclosures, and the relationship between the risks allegedly concealed and the risks that subsequently materialized, are sufficient to overcome” the loss causation defense at the pleading stage. *Id.* The court left open for defendants to prove on summary judgment or at trial that some or all of the plaintiffs’ losses were attributable to intervening events other than AIG’s corrective disclosures. *Id.*

Similarly, the court in *In re Countrywide Financial Corp. Securities Litigation*, 588 F.Supp. 2d 1132, 1170, 1200 (C.D. Cal. 2008), denied defendants’ motion to dismiss. In *Countrywide*, plaintiffs alleged that defendants led them to invest in Countrywide’s businesses through misrepresentations and omissions about Countrywide’s business operations, as well as its lending and loan purchasing standards, all in violation of Sections 11, 12(a)(2), and 15 of the Securities Act of 1933, 15 U.S.C. §§ 77K, 771(a)(2), 77o, and Sections 10(b), 20(a), 20A(a), and Rule 10b-5 of the Securities Exchange Act of 1934. 15 U.S.C. §§ 78j(b), 78t, 78t-1(a); 17 C.F.R. § 240.10b-5. The court held that plaintiffs had sufficiently pleaded loss causation.

With regard to the Section 11 claims, the court acknowledged that “the face of a complaint can provide a complete causation defense”—so-called negative causation—“where the vast majority of a securities’ decline cannot be attributed to an alleged corrective disclosure.” 588 F.Supp.2d at 1171. Nevertheless, the court noted that the *Countrywide* plaintiffs alleged “a complex series of misrepresentations and omissions over a long period of time” as well as “a series of partial corrective disclosures and corrective disclosures coupled with continued misrepresentations to blunt the effect of the corrections.” *Id.* at 1172-73. Thus, at least at the pleadings stage, the Section 11 claims were sufficient.

With regard to plaintiffs’ Section 10 and Rule 10b-5 claims, the court recognized that a series of corrective disclosures “make it more difficult for plaintiffs as a practical matter” to prove loss causation, but found the complaint sufficient in its allegation “that the price of Countrywide’s securities dropped as the disclosures accumulated.” *Id.* at 1200-01. The court did, however, dismiss a claim against an executive who left early in the class period on the ground that it was unlikely his statements “could have proximately caused losses almost a year later.” *Id.* at 1201. The court cautioned that a contrary ruling might “perversely encourage slow information leaks and give management a strong incentive to correct market misperceptions as slowly and ambiguously as possible.” *Id.* at 1172 n.49. Although allowing the case to proceed, the court acknowledged that “dramatic market shifts” during the financial crisis “will raise complicated questions on damages.” *Id.* at 1174.

Likewise, in *In re Ambac Financial Group Inc. Securities Litigation*, 693 F.Supp.2d 241 (S.D.N.Y. 2010), plaintiffs alleged that they acquired Ambac stock or securities based upon Ambac’s failure to disclose that it had lowered its underwriting standards, begun to write credit default swaps on closed end second mortgages,¹ and failed to value the credit default swaps accurately on its balance sheet on a mark to market basis. The court rejected defendants’ loss causation argument on the ground that the complaint specifically identified several corrective disclosures, and pled that the value of Ambac stock declined immediately after those disclosures. *Id.* at 274.

¹ “Closed-End Second Mortgages” typically cover the entire purchase price of a property, including down payment, and are considered very risky because the purchaser has no equity in the property.

Finally, in *King County, Washington v. IKB Deutsche Industriebank AG*, 708 F.Supp.2d 334, 339-40 (S.D.N.Y. 2010), the court denied motions to dismiss by Standard & Poor's and Moody's based on loss causation. The case alleged common law fraud by S&P and Moody's, among others, based on their inordinately high credit ratings on notes issued by Rhinebridge and purchased by plaintiffs. The court denied the motion to dismiss based upon allegations that the top ratings given by the ratings agencies to the Rhinebridge notes failed to take account of or disclose "billions of dollars of toxic assets" held by Rhinebridge, whereas corrective disclosures—downgraded ratings—resulted in immediate and substantial loss of value in the notes. The court rejected defendants' argument that the credit crisis rather than the materialization of the risks allegedly concealed by the ratings caused plaintiffs' losses, reasoning that "neither *Dura* nor *Lentell*... imposes on plaintiffs the heavy burden of pleading 'facts sufficient to *exclude* other non-fraud explanations.'" *Id.* at 342 (emphasis in original). Rather "[t]o hold that plaintiffs failed to plead loss causation solely because the credit crisis occurred contemporaneously with Rhinebridge's collapse would place too much weight on one single factor and would permit S&P and Moody's to blame the asset-backed securities industry when their alleged conduct plausibly caused at least some proportion of plaintiffs' losses." *Id.* at 343. Although holding that loss causation was adequately pleaded, the court allowed that the loss causation defense "may yet prevail at a later stage in this case." *Id.* at 345.

Even if plaintiffs plead loss causation sufficiently, and survive a motion to dismiss, defendants may still prevail on the issue at the summary judgment stage. As one recent example, the Ninth Circuit affirmed summary judgment on Section 10(b) and Rule 10b-5 claims *In re Oracle Corporation Securities Litigation*, 627 F.3d 376 (9th Cir. Cal., 2010). Plaintiffs claimed Oracle had made false and misleading statements about a new software product, Suite 11i, resulting in financial losses for holders of Oracle common stock. Affirming the district court's grant of summary judgment for Oracle, the Ninth Circuit held that the share price drop was related to Oracle's poor financial performance generally, including missing earnings expectations, rather than the market learning of misrepresentations by Oracle about Suite 11i. The court concluded that "plaintiffs' theory is unsupported by the record. The overwhelming evidence produced during discovery indicates the market understood Oracle's earnings miss to be a

result of several deals lost in the final weeks of the quarter due to customer concern over the declining economy. Numerous analyst reports support this conclusion.” *Id.* at 11. Because no reasonable jury could attribute the losses to misrepresentations about Suite 11i, the Section 10(b) claims failed.

Conclusion

These decisions make clear that trial courts are now scrutinizing securities class action complaints with a newfound rigor. The congressional mandate in the PSLRA for courts to enforce higher standards of pleading in securities cases, reinforced by the Supreme Court’s decisions in *Dura Pharmaceuticals* and in *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 314 (2007) (holding that securities plaintiffs must plead scienter in a way that is “cogent and at least as compelling as any opposing inference of nonfraudulent intent),” and further enhanced by the tightened pleading standards for all civil complaints mandated by *Twombly* and *Iqbal*, require careful fact-based pleading by securities law plaintiffs.

Securities class actions arising during the period of the 2007-09 financial crisis can be especially susceptible to motions to dismiss for failure adequately to plead proximate causation and economic loss. At a minimum, the complaint must plead facts showing that the alleged misrepresentations and omissions led directly to plaintiffs’ claimed losses. A lengthy temporal separation between the alleged misrepresentations and the alleged loss may jeopardize the pleading under Rule 12(b)(6). Similarly, receipt by the market of information correcting the prior misrepresentations or omissions with no material loss of value of the securities may also raise questions. Significant intervening events for the company, its industry, or the macro economy may also break the chain of causation, if more closely correlated to the loss of value than the release of corrective information.

This term, the Supreme Court will determine the degree to which lower courts must consider loss causation in connection with the decision whether to certify a case as a securities class action. On January 7, 2011, the Supreme Court granted a writ of certiorari in *Erica P. John Fund v. Halliburton Co.*, No. 09-1403, to determine “whether plaintiffs in securities fraud actions must satisfy the requirements set forth in *Basic v. Levinson* (1988) to trigger a rebuttable presumption of fraud on the market and establish loss

causation at class certification by a preponderance of the evidence without merits discovery.” If the Supreme Court affirms, loss causation will become an important issue not only to defendants’ motions to dismiss and summary judgment motions, but also to plaintiffs’ motions seeking class certification.

Although causation has always been an important element of claims brought under Section 10(b) and Rule 10b-5, the increased vigilance of courts in scrutinizing loss causation at the pleadings stage is an important development for both class action plaintiffs and defendants.

Key Takeaways

- In 1995, Congress enacted the PSLRA. Among its many provisions was Section 78u-4(b)(4), which provides: *In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.* The Supreme Court’s decision in *Dura Pharmaceuticals* extended this provision to require fact-based pleading of loss causation in the plaintiffs’ complaint.
- Following the Supreme Court’s instruction in *Dura Pharmaceuticals* that securities plaintiffs must adequately allege proximate causation and economic loss, and the recent tightening of pleading standards in *Twombly* and *Iqbal*, courts now scrutinize securities class action complaints for allegations of proximate causation and economic loss.
- With regard to the Section 11 claims, the *Countrywide* court acknowledged that “the face of a complaint can provide a complete causation defense”—so-called negative causation—“where the vast majority of a securities’ decline cannot be attributed to an alleged corrective disclosure.”
- The congressional mandate in the PSLRA for courts to enforce higher standards of pleading in securities cases, reinforced by the Supreme Court’s decisions in *Dura Pharmaceuticals* and in *Tellabs*, and further enhanced by the tightened pleading standards for all civil complaints mandated by *Twombly* and *Iqbal*, require careful fact-based pleading by plaintiffs.

- At a minimum, the complaint must plead facts showing that the alleged misrepresentations and omissions led directly to plaintiffs' claimed losses. A lengthy temporal separation between the alleged misrepresentations and the alleged loss may jeopardize the pleading under Rule 12(b)(6). Similarly, receipt by the market of information correcting the prior misrepresentations or omissions with no material loss of value of the securities may also raise questions.
- The forthcoming decision by the Supreme Court in *Erica P. John Fund v. Halliburton Co.* may shed light on what role, if any, loss causation will play in decisions whether to certify class actions in securities fraud cases.

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