

# *WHERE THERE IS SMOKE:*

## AN INSIDE LOOK INTO THE INVESTIGATIONS BEHIND FINANCIAL FRAUDS

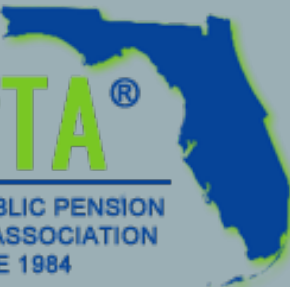


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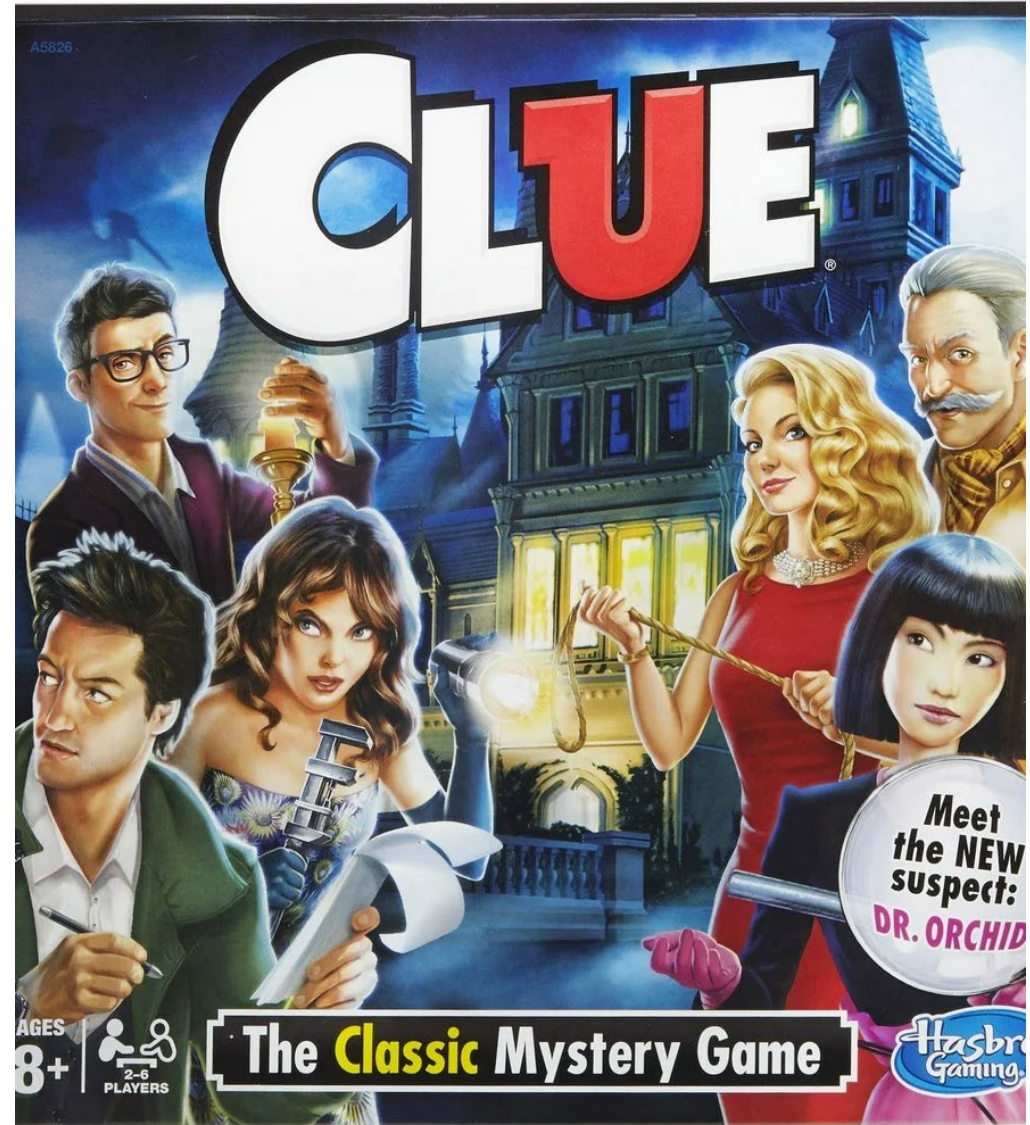
  
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**THE CONTEXT AND  
CRITICAL IMPORTANCE OF  
AN INVESTIGATION**

## PLEADING YOUR CASE: THE OPERATIVE CONSOLIDATED COMPLAINT

- Claims alleging fraud under Section 10(b) of the Securities Exchange Act of 1934 must satisfy a heightened and exacting pleading standard.
- The complaint **must**:
  - Specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation ... is made on information and belief ... state with **particularity** all facts on which that belief is formed.”
  - State with **particularity** facts giving rise to a strong inference that the defendant acted with the required state of intent.

WHO DID IT?  
WHY?  
WHEN?  
WHERE?



# PARTICULARITY: IT'S ALL IN THE DETAILS

The complaint must describe the sources of information and the “*who, what, when, where and how* of the information those sources convey.”



## PLEADING PARTICULARITY WITHOUT DISCOVERY

- There is generally no discovery at the pleading stage in securities cases.
- Under the Private Securities Litigation Reform Act of 1995, all discovery is stayed until the court rules on the motion to dismiss. Parties may move to lift the stay if: “particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.”
- Motions to lift the stay are infrequently granted but may be advisable in certain cases.

A person wearing a dark trench coat and a top hat is walking away from the camera in a dark, smoky environment. The person is centered in the frame, and the background is filled with a dense, greyish smoke or mist. The lighting is dramatic, highlighting the contours of the coat and hat against the dark background.

The “CW” ...

## USING AN INVESTIGATION TO SATISFY PARTICULARITY

- We use public sources: the Company's public filings, conference calls, social media, news, analyst reports, and FOIA requests.
- We also conduct extensive investigations and develop witnesses, who are typically former employees.
  - Often referred to as an "FE" (for former employee) or a "CW" (for confidential witness).
  - Investigation allegations are used in complaints and frequently are the key to obtaining a positive outcome on the motion to dismiss.



## WEIGHING CW INFORMATION

- To assess allegations based on CWs, courts will examine:
  - the detail provided by the confidential sources
  - the sources' basis of knowledge
  - the reliability of the sources
  - the corroborative nature of other facts alleged, including from other sources
  - the coherence and plausibility of the allegations, and similar indicia

## DETAILING THE ROLE AND KNOWLEDGE OF THE CW

- A complaint should plead information sufficient enough to explain the confidential witnesses' role, the dates they learned of the relevant information, how they had access to this information, and whether their knowledge was first or second hand.
- Each source must be described with particularity in order to pass muster.

Case 3:21-cv-00194-N Document 92  
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242.

"FE6 worked at Exxon and XTO from 2013 until February 2021, serving as an Instrument, Controls & Electrical Equipment Lead Commissioning Engineer at XTO from 2020 until 2021, and a Senior Staff Instrument Engineer at Exxon from 2018 until 2020. From May 2020 until February 2021, FE6 was working in the Delaware Basin out of Carlsbad, New Mexico, and reported to Gordan Holloway."

Case 3:21-cv-00194-N Document 92  
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224.

"FE5 was a Project Control Specialist who worked on a contract basis for XTO from January 2019 until April 2020, working in the field in Midland, Texas. FE5 was responsible for creating and presenting reports for XTO's management team, which forecasted manpower needs for construction crews on projects within the Permian. FE5 attended quarterly safety meetings in the Midland, Texas office, as well as more frequent construction team meetings, where the progress in the Permian Basin and the Delaware Basin was discussed."

# CONDUCTING THE INVESTIGATION

Securities fraud cases require extensive investigations.

Firms often have investigators with law enforcement backgrounds conduct the investigation.



**Seasoned former FBI Agent with experience investigating white collar crimes.**

- Part of a team with proprietary lead development and due diligence search engines.
- Key part of Bernie Madoff investigation - showcased on 60 Minutes.
- Provided evidentiary material to State and Federal Prosecutors when criminal cases stemmed from civil matters.

**Certified fraud examiner, who worked at the New York County District Attorney's office as an investigative analyst investigating low-level criminal activities to highly complex economic crimes.**

- Worked on some of the most significant and historic securities fraud cases over the past 25 years.
- Taught courses in Criminology and Crime and Juvenile Delinquency at both Queens College and John Jay College of Criminal Justice.

## INVESTIGATIONS OFTEN RESULT IN CASE-ALTERING ALLEGATIONS

- Investigations often provide critical facts that help get a case over the motion to dismiss pleading “hurdle.”
- Details reflecting that defendants made false or misleading statements.
- Information reflecting that defendants acted with scienter – reflecting a knowing or reckless state of mind.

# INVESTIGATIONS AND UNIQUE CASES

## THE JAMES RIVER CASE & INVESTIGATION

- The City of Miami General Employees' & Sanitation Employees' Retirement Trust and the Fort Worth Employees' Retirement Fund served as co-lead plaintiffs in the securities fraud class action against the James River Insurance Company.
- James River is an insurance company whose most important client was Uber.
- The Complaint alleged that James River materially misstated the insurance reserves and description of its reserving process that it reported to investors.

# THE JAMES RIVER CASE & INVESTIGATION

- Through our investigation, we developed statements from 15 former employees who corroborated that James River had no valid process for estimating its reserves and that it intentionally kept reserves low.
- According to the witnesses:
  - “There was no methodology for calculating reserves . . . it didn’t exist; there was nothing.”
  - The reserves process was “willy nilly” and based on a “gut feeling . . . we would guess.”
  - James River “bent the truth. They put caps on reserves irrespective of the injuries.”



## THE JAMES RIVER CASE & INVESTIGATION

- Through our investigation, we learned that the Company had massive turnover and hired inexperienced claims examiners, including Starbucks baristas.
- As one former Claims Examiner explained, ***“I could see that the place was a Titanic sinking.”***





## THE JAMES RIVER CASE & INVESTIGATION

- The accounts of these former employees were corroborated by sworn testimony from three additional James River personnel and internal James River documents obtained from a bad faith insurance litigation.
- James River’s former Vice President of Claims testified that she could not “recall” and did not “know” about any policies or procedures in place for setting Uber reserves. She also testified that “there was no training” for claims examiners.
- Other former claims personnel similarly testified that there were no procedures used to estimate loss reserves.
- Ultimately, because of the investigation, the complaint was upheld at the pleading stage and achieved a \$30 million recovery for harmed investors.

## THE EXXON CASE & INVESTIGATION

- Exxon's CEO told investors that Exxon would produce 1 million barrels of oil per day in the Permian Basin by 2024, without any basis in fact, in order to match a projection by a competitor.
- After this statement, Exxon executives scrambled to make it appear true by artificially inflating Exxon's production numbers in its Company plans.

## THE EXXON CASE & INVESTIGATION

- Two whistleblowers—Ph.D. scientists from Harvard—were directed by senior management to commit fraud by artificially inflating drilling “learning curve” times in the production plan.
- This leaked to the *Wall Street Journal*, which published a story reporting that data scientists had been directed to falsify the production numbers, and one of them had saved those false numbers in a file called “***This is a Lie.***”
- Through our investigation, we were ultimately able to interview the whistleblowers. We learned that Exxon had retaliated against them for blowing the whistle on the fraud. The whistleblowers also filed their own lawsuit against Exxon for retaliation and won.



## THE FIBROGEN FRAUD

- FibroGen, Inc. is a biopharmaceutical company whose flagship drug, Roxadustat, is an experimental pill designed to treat anemia in patients with chronic kidney disease. The current standard of care to treat anemia in CKD patients is only used in severe cases because of an increased risk of major adverse cardiac events. As a result, if FibroGen was able to demonstrate that Roxadustat was at least as effective as the current standard of care without the significant safety issues, analysts estimated a potential \$3.5 billion market for the drug—**20 times FibroGen’s total revenue for 2020.**
- FibroGen repeatedly assured investors that Roxadustat’s “robust,” “outstanding,” and “extremely clean” Phase 3 clinical trial data showed that the drug had in fact met specified objectives, and that on the strength of this very data, Roxadustat’s prospects for receiving FDA approval were “highly compelling.”

# THE FIBROGEN FRAUD

FibroGen was forced to admit, for the first time, that the Company had in fact engaged in blatant data manipulation by making “post-hoc changes to the stratification factors” in Roxadustat’s Phase 3 trial results.

Investigation uncovered that Chief Medical Officer (who was accused of manipulating the data) had stored significant amounts of evidence on a laptop which conveniently “broke” during the discovery phase—investigators spoke to computer repair shop and learned it had been intentionally destroyed.



# THE STORY BEHIND THE WILMINGTON TRUST BANK COLLAPSE

- Bank started in a parlor of a house at 915 Market Street
- Three DuPont cousins started bank to manage family fortune
- Mergers, survives Great Depression, biggest DE bank



## WILMINGTON SEEMS TO BE A PILLAR OF SAFETY DURING THE 2008 FINANCIAL CRISIS

- Due to stability and strong performance, executives receive salary bumps and performance-based bonuses in 2009.
- 2010 sold almost \$300 million in an “enormously successful” offering.
- “The proceeds will enhance our already strong capital position”.



THE  
WILMINGTON  
TRUST  
INVESTIGATION

- Spoke with nearly 100 former Wilmington Trust employees. Our investigation revealed rampant misconduct related to Wilmington Trust's loan underwriting practices, its manipulation of the asset review process, and its violations of numerous accounting practices and standards, all designed to conceal the bank's true financial state.



- Same issues plagued Delaware as rest of country.
- 2009 reported only \$10.9 million in bad loans, while “waiving” more than \$360 million.
- “Extend and pretend” SEC required disclosure of past due loans unless the Bank was in the process of extending or modifying loan terms.
- Fraudulently extended nonperforming loans worth nearly \$2 billion.
- Instructed employees not to obtain current appraisals.

PEACE OFFICERS' ANNUITY AND  
BENEFIT FUND OF  
GEORGIA V. DAVITA INC.

Case against kidney dialysis service provider DaVita following a lengthy investigation. The action alleged that DaVita engaged in an illegal scheme to steer patients eligible for and/or enrolled in Medicare and/or Medicaid away from government insurance and into high-cost commercial insurance plans so that DaVita could obtain dialysis reimbursement rates that were up **to ten times higher** than the rates paid by government plans.

Lead Plaintiff: Jacksonville Police and Fire Pension Fund





## THE DAVITA INVESTIGATION

Counsel acquired internal company documents, including, among many other materials: internal emails between high-level DaVita employees discussing the implementation and oversight of the fraud; widely circulated internal spreadsheets that documented the progress of Defendants' scheme; and internal employee training materials and PowerPoint presentations that explicitly detailed and incentivized the fraud. A former high-level employee identified and interviewed by investigation team provided documents that confirmed the company's illicit practices were being directed by DaVita corporate management.

## CHALLENGES OF SECURITIES FRAUD INVESTIGATIONS

- Non-Disclosure Agreements “NDAs”-overly broad NDAs used to silence former employees from discussing fraud that they witness.
- NDAs generally have claw-back provisions where former employees could lose their severance package.
- NDAs are used to silence employees from being whistleblowers.
- Former employees are threatened that they will never work in the industry/overly aggressive defense lawyers.



# MOST CHALLENGING SECTORS TO INVESTIGATE

- High tech companies: FANG.
- Facebook, Apple, Netflix, and Google in addition to certain chip companies.
- Extremely strict NDAs and corporate cultures that promote secrecy on a need-to-know basis.
- Example: Apple engineers must shield their work at the end of the day and not share what they are working on with other engineers not on specific projects.
- Chinese companies with a small presence in the US. - next to impossible to develop CWs in China.
- Companies that do a significant amount of contract work for the government: Lockheed Martin, Boeing, General Dynamics, and Raytheon.

SECTORS WITH  
MOST COOPERATIVE  
WITNESSES

- Healthcare service: companies that provide services to seniors, people with disabilities, and chronic illnesses such as people requiring dialysis.

Examples: DaVita

- Rent-to-Own companies that target low income and military families.

Examples: Aarons, Rent-A-Center, and Conns

- Predatory lending companies

A man in a suit and tie is shown in profile, talking on a mobile phone. He has a comically long, thin nose. The image is overlaid with a semi-transparent blue filter. A white rectangular box is centered over the man's face and nose, containing the text "THE RECANTING WITNESS" in white, bold, uppercase letters.

# THE RECANTING WITNESS



## THE PROBLEM OF THE RECOUNTING WITNESS

*In re Rayonier Inc. Securities Litigation*: the action alleged that Rayonier, one of the country's largest producers and sellers of timber, and its senior executives, misled investors regarding the Company's timber inventory and harvesting rates in the Pacific Northwest. The Company's new management ultimately issued a financial restatement because the Company had overharvested its premium Pacific Northwest timberlands by more than 40% each year for over a decade and overstated its merchantable timber by 20% in this critical region.

The "Lorax Case"



- Rayonier witness “recanted” valuable information used in the amended complaint resulting from industry pressure/Company heavy handed tactics.
- Responses were documented by counsel/investigators which confirmed that the CW had in fact provided the information to us and that agreed to the inclusion of the information in the case.
- Significant corroborating information.



# ETHICAL CONSIDERATIONS



We approach our investigations very conservatively.



Must start investigation with proper identification (who the investigator is, who they are working for).



Cannot use/obtain attorney client privileged material.



No contact with current employees of company, we only speak with former employees.



Cannot pay for information.



Cannot guarantee confidentiality or anonymity.



Always have two people speak to the witness to confirm the information the witness provided.



## ADDITIONAL CONSIDERATIONS

- Non-U.S. companies can present additional considerations and challenges:
  - Different legal considerations
  - Sometimes need to use jurisdiction-based investigators
- The sheer size of some of the companies that we investigate make it very difficult to identify the right potential witnesses
  - Huge lead lists
  - Finding witnesses that interact with executive management can be more challenging



**THANK YOU!**