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TALKINGPOINT: SECURITIES CLASS ACTIONS IN THE UNITED STATES

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TalkingPoint: Securities Class Actions In The United States

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FW moderates a discussion about securities class actions in the United States between Elaine S. Kusel at Kurtzman Carson Consultants LLC, Douglas Henkin at Milbank Tweed Hadley & McCloy LLP, and Peter B. Morrison at Skadden, Arps, Slate Meagher & Flom LLP.

FW: What trends have you seen in the volume of securities class action filings in the US over the last 12 months or so?

Kusel: Securities class action filings tend to mirror what is going on in the financial markets, and just as we have seen economic activity begin to return to pre-financial crisis levels and a coincident decline in volatility, we have seen the volume and type of securities cases filed increase. While the total number of US cases filed in 2010 was only marginally higher than the number filed in 2009, the trend towards rising numbers is evident. In the latter half of 2010, the number of securities filings was close to 25 percent greater than in the first half of the year. Another indication of an upward trend is the fact that cases are being filed far sooner after the triggering event. In 2010, the lag time between the end of the class period and the filing of a complaint on average dropped to one month from an average of six months in the latter half of 2009.

Morrison: Several organisations such as National Economic Research Associates (NERA) and the Stanford Law School Securities Class Action Clearinghouse examine trends in securities class actions. Reports from both groups are publicly available. According to these organisations, in general, the volume of securities class action filings was up at the end of 2010. For instance, NERA reported that in the second half of 2010 the pace of securities class action filings increased as compared to the first half of the year. NERA also reports that the increase at the end of 2010 occurred in spite of an overall decrease in credit-crisis related filings. Interestingly, filings in courts within the United States Court of Appeals for the Ninth Circuit, which includes Los Angeles, exceeded filings in courts within the Second Circuit, which includes New York.

Henkin: The recent volume of filings has overall been lower than in some prior years, but certain areas remain the focus of litigation and there are some new areas being targeted. Subprime-related litigations seem to be tailing off; although it may be that there has simply been a pause while plaintiffs' lawyers either identify new targets or new theories. Likewise there have been fewer filings against financial institutions than in prior years. Healthcare companies remain a significant target. Three of the most significant trends have been, first, the number of non-US companies being targeted as defendants, particularly Chinese companies, which on their own made up a very significant percentage of new filings in 2010; second, the significant leap in M&A-related cases; and third, the number of claims against for-profit education companies. The number of new filings against non-US companies is particularly significant because many of those filings occurred after the Supreme Court's decision banning 'f-cubed' claims (the Morrison decision discussed).

FW: Can you outline the predominant securities law violations that are the main subject of securities class actions at this time? What recurring factors are behind these claims, and which sectors seem to be targeted?

Morrison: In my experience, class plaintiffs predominantly allege fraud under section 10(b) of the Securities Exchange Act of 1934, and liability for a purportedly false registration statement under section 11 of the Securities Act of 1933. There has been a recent surge, however, reported by the Stanford Law School Securities Class Action Clearinghouse, in lawsuits challenging merger and acquisition transactions on the basis of proxy solicitations distributed in connection with such transactions. The increase in M&A challenges seems to have outpaced recent increases in the underlying M&A activity.

Henkin: Developments that, when announced, have significant negative impacts on stock price continue to be among the most important drivers of securities litigation. Plaintiffs will often allege that what was announced at one time was, or must have been, known earlier and so should have been disclosed sooner. Likewise, restatements have been and continue to be a significant trigger for securities class actions. Often perception of a sector-wide problem or issue will trigger a large number of filings against companies in that sector whether or not those companies are directly associated with that problem. For example, a 3 August 2010 Government Accountability Office report alleged that several for-profit education companies encouraged fraud and engaged in deceptive advertising. The report did not name specific companies. After it was issued, the share prices of many publicly traded for-profit education companies fell, and many such companies then became targets of securities class actions.

Kusel: There is a notable increase in the number of securities class action cases that assert state statutory or common law claims related to a corporate merger or acquisition. These cases generally allege that directors and officers breached their fiduciary duty to their shareholders at the time of the deal. The increase in these filings mirrored mergers and acquisitions activity, which were up 20 percent in 2010. For the last several years, a significant proportion of filings were related to specific market events including the credit crisis, options backdating and the Madoff fraud scandal. In 2010, filings related to these events declined sharply, but filings of traditional securities class actions increased nearly 70 percent.

In essence, we are seeing a return to the type of cases alleging non-disclosure of material facts that was typical before the advent of the financial crisis.

FW: Have there been any recent high-profile cases worth noting? What do they demonstrate about the market?

Henkin: US courts have begun to make much deeper analyses of when cases can be certified as class actions, and there have been denials of class certification recently on the basis that courts likely would not have addressed just a few years ago. The latter issue – when cases can be maintained as class actions – is critically important and can have a major impact on the value of a case, and the fact that courts are beginning to take a much harder look at it could be beneficial to defendants. In re Northfield Laboratories, Inc. Securities Litigation, No. 06 C 1493 (N.D Ill. May 18, 2010), *petition for leave to appeal denied,* No. 10-8020 (7th Cir. 24 August 2010) and *Berks County Employees' Retirement Fund v First American Corp.,* No. 08 Civ. 5654 (S.D.N.Y. 31

August 2010) are good examples of this, as is the recent denial of class certification in the US Imax litigation.

Kusel: The Supreme Court recently issued two decisions interpreting the Securities Exchange Act. In Merck v Reynolds, the Court found that the statute of limitations began to run at the point when plaintiffs actually discover facts constituting scienter and other elements of the violation, not at the time at which a plaintiff had acquired sufficient facts that would lead a reasonably diligent party to investigate further. In Morrison v National Australia Bank Ltd., the Court found that Section 10(b) of the Securities Exchange Act does not provide a cause of action to foreign plaintiffs suing American defendants for misconduct related to securities traded on foreign exchanges. These cases clearly demonstrate the Court's newfound focus on securities class action litigation. This term the Court will decide Janus v First Derivative Traders, in which the question is whether mutual fund advisors can be held liable as primary actors for statements in their fund's prospectuses.

Morrison: An important recent decision is the Supreme Court's ruling in Morrison v National Australia Bank, which held that section 10(b) of the Securities Exchange Act of 1934 governs only the purchase or sale of a security listed on an American stock exchange, or the purchase or sale of any other security in the US. The Morrison holding was recently applied in a high-profile class action before Judge Holwell of the Southern District of New York, involving a securities class action tried all the way to a verdict against Vivendi. Morrison was decided after the jury rendered a verdict, but the court applied the new law in ruling on post-trial motions. Because Vivendi's ordinary shares traded only on the Paris Bourse, Judge Holwell ruled that those shares are not within section 10(b)'s ambit and cannot be part of the class. Vivendi's potential exposure has been dramatically reduced as a result. In another action under section 10(b), the Supreme Court is set to decide this term a case captioned Janus Capital Group, Inc. v First Derivative Traders. In its forthcoming opinion, the Court is expected to address whether an entity that assists or participates in the drafting of an alleged misrepresentation – a so-called secondary actor – can be considered to have 'made' the misrepresentation itself under section 10(b), and, if so, in what circumstances. The Supreme Court will also decide to what extent any such alleged misrepresentation has to be affirmatively attributed to such as a secondary actor for any potential liability to even arguably attach.

FW: What considerations should be made when assessing the viability of a potential claim?

Kusel: The first consideration in assessing the viability of a claim is always to determine the strength of the particular fact pattern. Another consideration is to determine the potential exposure of the defendant, by evaluating the potential damages. Discovery, especially electronic discovery, has become expensive and time consuming. Both plaintiff and defence counsel must consider whether the potential discovery costs are reasonable in light of the potential value of the claim. Additionally, counsel should consider the risk of an adverse result, because the value of the average settlement has reached an all time high.

Morrison: Potential securities claimants and their counsel should consider a range of factors, including investigating facts that might support their theories of liability and a thorough assessment of how federal securities laws apply to those facts. Such a list of considerations is by no means exhaustive. Additionally, potential class claimants will also need to assess whether their claims are appropriate for class treatment and satisfy the requirements of Federal Rule of Civil Procedure 23. Potential claimants should also examine jurisdictional issues, as well as consider practical factors, such as their ability to recover if successful. Once a claim is filed, defendants should examine the legal sufficiency of the pleading, including determining whether the pleading has properly pleaded an alleged misstatement or omission, materiality, scienter, loss causation and damages, among other things. The defendant should further examine the pleading for any potential defences including, but not limited to, statute of limitations or statute of repose defences. A defendant might also assess the likelihood that a court would certify the class on the basis of the facts alleged in the pleading.

Henkin: One would also want to assess the potential evidence, which could include large sources of electronic information in company databases and email servers.

It is also important to consider who the plaintiffs are or are likely to be. Institutional investors choose to be involved in different cases than individuals do, and they sometimes take a larger role in the cases they become involved with. And when a complaint is based on 'confidential witness' statements, it is important to try to determine as early as possible what the sources of those statements might have been so that their accuracy can be determined and, if necessary, challenged at the earliest possible stage.

FW: Broadly speaking, what preparation, processes and procedures need to be undertaken when filing a securities class action?

Morrison: Potential plaintiffs should be certain that any factual allegations contained in the complaint have a good faith basis. Inclusion of purported facts in a complaint that later turn out to be exaggerated or without sufficient basis certainly can subject a pleading to dismissal. For example, Boeing recently won dismissal of a class action in Chicago because the complaint alleged facts learned from a so-called 'confidential informant' purported to be a Boeing engineer. The informant actually was an employee of one of Boeing's contractors, who admitted in a deposition that he had no knowledge of the alleged misconduct, and further denied information attributed to him in the pleadings. Initially, the Court denied the defendant's motion to dismiss, but later changed course and dismissed the action after learning of the confidential informant's testimony.

Henkin: Although there are probably different ways to phrase them, they all come under the heading 'investigation', and one way to think about it is the traditional 'who, what, where, when, and why' used by journalists. A plaintiff asserting a fraud claim, for example, should consider whether there are alternative explanations other than fraud – a simple mistake, for instance – because a fraud claim under the federal securities laws must include allegations that support a strong inference of fraudulent intent. And there needs to be a close focus on sources of factual allegations. Many securities class action complaints are based on 'confidential witnesses' – often former employees – and those types of complaints have recently been the focus of intense criticism by courts.

Kusel: The Private Securities Litigation Reform Act (PSLRA), which became law in 1995, imposed a heightened pleading standard for securities cases. Accordingly, in these cases, plaintiffs cannot simply allege a violation based upon information and belief and hope to gather facts through the discovery process. Instead, before filing a securities class action, class counsel must undertake a thorough investigation of the facts and circumstances surrounding the alleged wrongdoing. Among other things, this investigation usually involves research of the relevant industry, interviews with potential witnesses, analysis of relevant SEC ▸▸

filings and review of news reports. Thereafter, plaintiffs' counsel must determine which claims to file, pinpoint the appropriate defendants and decide in which federal court their action will be filed. More broadly, once counsel files, it is advantageous to engage a claims administrator early on in the process to save time and money on the settlement administration.

FW: To what extent does financial modelling and analysis play a key part in securities class actions? How difficult is it to accurately determine financial exposures and loss causation?

Henkin: This is critical and is becoming more and more important because courts have begun to allow these issues to be addressed at the motion to dismiss, class certification, and summary judgment phases of securities class actions. The analyses in securities class actions can include whether a security traded efficiently at different times, when there were statistically significant changes in price and whether those changes can be linked to alleged misstatements or omissions, and how the security traded. Some of these issues can be the subject of significant dispute between experts retained by plaintiffs and defendants – for example, plaintiffs often use market models developed specifically for securities litigation to 'calculate' how many shares of stock were affected by alleged misstatements or omissions, but those models have been excluded by several courts because they were not reliable enough to pass muster under the rules federal courts apply to expert opinions. But because so many securities class actions settle as opposed to going to trial, litigants have relatively little experience with definitive calculations of exposures. The recent spate of securities class action trials may add to litigants' experience and provide additional bases for refining experts' abilities to calculate potential damages.

Kusel: Financial modelling and analysis play a significant role in determining financial exposure. There isn't a singular model to follow as each securities case is different. From a claims administration perspective, the aspect of financial modelling and analysis that we are most commonly involved in is assisting in the creation and execution of the plan of allocation. In a securities settlement, class members' settlement amounts will be determined by the dates, during the class period, when they purchased and sold their shares. The first step in this process is to determine the class members' recognised loss and then applying a matrix based on the allegations of the complaint.

Morrison: Sometimes a lack of loss causation can appear on the face of a pleading or from judicially noticeable facts. Therefore, loss causation may be a basis on which to dismiss a complaint at times. Beyond the pleadings, however, financial modelling and analysis with respect to loss causation can be the subject of expert testimony on which parties may rely in connection with securities litigation.

FW: In terms of resolving these disputes, what are the comparative benefits of mediation, arbitration and litigation?

Kusel: In my experience, arbitration is generally not a common means of resolving a securities class action.

However, courts do routinely require the parties to consider settlement and mediation, and offer to facilitate the process. Mediation can help the parties get to a settlement sooner and has cost-saving benefits. Litigation is the most risky and transparent of the three paths. The transparency of court proceedings, and the likely public dissemination of at least some corporate documents, is itself a risk that needs to be considered by defendants. I would say, nearly all securities disputes are resolved prior to going to trial because it is typically too risky and costly to go down the path of litigation.

Morrison: Mediation sometimes can be helpful in resolving securities disputes. A number of jurisdictions may even affirmatively order parties to mediate securities disputes.

Henkin: It is difficult to compel arbitration of securities class actions because arbitration is a matter of contract. In addition, FINRA's rules do not permit FINRA to accept class claims for arbitration. So we generally don't see arbitration in the context of securities class actions in the US. In addition, the enactments of the Securities Litigation Uniform Standards Act and the Class Action Fairness Act have made federal courts the primary venue for securities class actions in the US. That said, at appropriate points in the litigation cycle, mediation is often very effective at producing settlements. Although the number of trials of securities class actions has spiked in the past year, most securities class actions are dismissed or settled, and settlement can sometimes be more easily achieved with the help of an experienced mediator.

FW: Sometimes settlement may be the preferred option. What steps are involved in calculating or estimating an appropriate settlement figure?

Morrison: The appropriate settlement figure depends on a host of factors. These factors can include, but by no means are limited to, the potential exposure of the litigants after accounting for loss causation and damages defences that may significantly limit the outer range of damages available, as well as accounting for the litigation risks faced by the plaintiff.

Henkin: Here it is critical to have assessments of the potential size of the class, how much of the drop in stock price can potentially be attributed to the misstatements or omissions the plaintiffs are claiming, what types of omissions or misstatements are alleged, who the defendants are, and whether stock price movements can be attributed to other events. The amount of D&O coverage available and who is covered under the policy is also an important part of the analysis. Usually defendants will retain testifying and consulting experts to assist in the financial and econometric analyses that are critical to the analysis of appropriate settlement ranges.

Kusel: As a claims administrator, it is not our role to determine an appropriate settlement amount. However, it is at the very time when the parties are negotiating a settlement that it is most appropriate to begin consultation with a qualified claims administrator. They can assist in formulating and testing plans of allocation of settlement proceeds as well as aid with the design of the notice and proof of claim form. We've seen record high settlements over the last several years. The main factor was high investor losses in which settlements were estimated by calculating stock fluctuations compared to stock indices. Some settlements also include non-financial agreements such as greater transparency, governance oversight or secured payments versus higher cash payments.

FW: In the event that a claim is successful, what challenges surround the process of asset recovery?

Henkin: In a certain sense this is new ground for securities class actions because so few get to the stage that a judgment would need to be enforced – when they settle, everyone knows the sources of the funds ▸▸

for settlements. One challenge is that individual defendants rarely have sufficient assets to cover a significant class action judgment, and often the only source of significant assets will be their indemnification rights from a company and/or a D&O policy. If there is a finding of fraud, it is possible that a D&O insurer might deny coverage or try to rescind the policy. Finally, there is the possibility that a non-US court might decline to enforce a US judgment against a foreign company or individual. Although these sorts of issues are often discussed during a settlement negotiation because they represent risks to a plaintiff or class, it is rare to see discussions of them in the litigation itself.

Kusel: The most obvious challenge is a defendants' actual ability to pay. One reason securities lawsuits so often settle before trial is that the magnitude of the damages alleged, if proven, could impair or even bankrupt the company. Another issue that often arises in securities litigations is the issue of whether the directors and officers liability insurance policies will pay towards the settlement. Often there are several layers of insurance coverage, and insurers have argued that the conduct alleged constituted acts which are explicitly excluded from coverage. In addition, certain insurers have required that the primary insurer exhaust its coverage before a secondary or tertiary carrier will be required to pay.

Morrison: We typically represent clients defending securities class actions. However, one factor is a corporate defendant's ability to pay. Class plaintiffs might consider whether or not a successful claim will significantly affect the corporate defendant's financial condition. ■

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Douglas has extensive experience working with complex securities and other financial products, having represented broker-dealers and securities purchasers in actions involving collateralised mortgage obligations and other mortgage-backed securities, structured notes, convertible debentures, and high-yield short-term notes. Mr Henkin represents issuers and underwriters in securities actions (both class and non-class actions) and companies and individuals in derivative litigation (including litigation relating to M&A transactions).