# Litigation

## New Opportunities for Defendants in Securities Class Actions

*By Francis J. Menton, Jr.**

The securities class action litigation industry, known for its stability the last twenty or so years, could see some real changes soon. Several developments in the past year have given defendants opportunities previously unavailable to deliver potentially fatal blows to some of the many weak cases brought every year. These include (1) the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[1] prescribing how to apply the "strong inference of scienter" requirement of the Private Securities Litigation Reform Act of 1995 ("Reform Act"); (2) decisions from the Second and Fifth Circuits, making class certification more difficult in what could be large groups of cases; and (3) consideration by the SEC of allowing issuers to provide, in their by-laws or otherwise, for arbitration of securities disputes with shareholders.

No one of these developments is itself revolutionary, and none will represent the death knell of securities class actions as we know them. Yet each provides opportunities to defendants to attempt to win, or fatally wound, at least some of the cases that would previously have been settled. Together, these developments could represent a meaningful movement away from the situation where the large majority of securities class actions, regardless of merit, reap large settlements.

### Background: The Status of Securities Class Action Litigation in the United States up to 2006

The significance of these developments must be evaluated against the background from which they arose. Securities class action litigation over the last two decades has become a sophisticated financial game: very lucrative to its players, a net loss to its supposed beneficiaries (allegedly defrauded shareholders), and maddening to many business people caught up in its processes. Filings of securities class actions in the U.S. over this period have averaged about 200 per year. With about 12,000 publicly-traded companies in the U.S.(and giving some allowance for overlapping cases filed against the same company), this figure represents a probability of about 1.5% per company per year of drawing a class action lawsuit, or about 7.5% in five years for any given company.

Securities class actions have long been notoriously difficult to get dismissed on pre-trial motion, whether a motion to dismiss directed to the complaint or a summary judgment motion. Most federal trial and appeal courts have simply viewed it as the role of the jury, not the judge, to determine if the corporate disclosures made to shareholders met the standards of the federal securities laws. Congress' passage of the Reform Act in 1995 reflected intent to encourage the federal courts to exercise some gatekeeper function on the flow of cases, but after a decade of experience only a relatively small part of the potential of the Act has been realized. According to one study, the rate at which cases get dismissed at the pleading stage rose nationwide from 19.4% in 1991-1995 to 38.2% in 2000-2004.[2] However, the dismissal rate in the Second Circuit, which includes New York, remains at about the 20% pre-Reform Act level, a fact that just means that filings are increasingly concentrated in that jurisdiction. Moreover, once they have survived pre-trial motions, almost no securities class actions have gone to trial, and virtually all are settled. A study available on the American Bar Association's website reports that 99.5% of the cases in the 2002-2007 period were settled, meaning that of the 200 or so filed each year, only about one actually went to trial.[3]

The typical case begins with the company's stock having a significant and sudden drop in the market, generally several points on a single day. With only this to go on, several plaintiffs' law firms prepare complaints within a few days, alleging that whatever information about the company that came out that day was known to insiders for months. For companies of any substantial size and market capitalization, the damages claimed will quickly be huge. For example, if the stock dropped two points, trading averaged 500,000 shares per day, and the plaintiff alleges a class period of six months, the notional damages claim will be in the range of $150 million. Where trading is in the millions of shares per day, and class periods get to a year and more, notional damages quickly get into the many billions of dollars.

The notional damages take a step closer to reality when a court certifies a class of all shareholders who bought within an alleged class period. The numerous pre-requisites for class certification in Rule 23 of the Federal Rules of Civil Procedure may appear to make class certification a significant hurdle, but two Supreme Court decisions in the 1970s and 1980s swept away the hurdle and made most class certifications of securities actions a foregone conclusion. In *Eisen v. Carlisle & Jacquelin*, the Court made the frequently cited statement that "We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action."[4] Courts around the country applied this prescription somewhat differently, with the most heavily used forum, New York's Second Circuit, leaning strongly against allowing meaningful factual inquiry at the class certification stage. Then, in *Basic, Inc. v. Levinson*, the Supreme Court accepted the notion that there should be a "rebuttable presumption" that the reliance element in securities fraud was common to all purchasers of a security because the purchasers relied on the market price as embodying all information about the security.[5]

The availability of Directors and Officers insurance against securities claims has only strengthened the already strong incentives toward settlement of securities class actions. In most circumstances, D&O insurers will pay for the defense and settlement of securities class actions, but if the case is tried and

.......................................................................

* *Francis J. Menton, Jr. is an attorney with Willkie Farr & Gallagher, LLP.*

lost the insurers reserve their rights to refuse to pay the judgment and to seek reimbursement of legal fees already paid.

Thus, while it may seem unlikely that cases commenced on little or no investigation after a market fluctuation would have a settlement rate reported as over 99%, the dynamic is clear once one understands that classes of thousands of shareholders are almost always certified, that theoretical damages in large numbers of cases are in the hundreds of millions (and even billions) of dollars, and that insurance available for a settlement would be quite problematic to realize after a loss at trial. Indeed, while the securities class action industry has had relative stability, a problem for defendants and their insurers has been upward movement in average settlements, undoubtedly driven in part by the sense of the plaintiffs' bar that defendants cannot allow cases not to be settled. No matter how slim the chance of an adverse judgment, that result, if it occurred, would be completely ruinous to defendants, whether individual officers and directors or the corporate issuer itself.

Thus, each year we see dozens of settlements in the range from mid-seven figures ($5 million +/-) to mid eight figures, representing only a few pennies on the dollar of notional damages that could have been in the hundreds of millions or even billions. Plaintiffs' class counsel typically gets a cut of one-fifth to one-third, depending on the size of the settlement. Not uncommon are settlements where the average shareholder class member gets under $100 while plaintiffs' class counsel gets several million, or even ten million dollars, or more.

### *Tellabs*: The Supreme Court Breathes Life into the 1995 Reform Act

Of the many provisions of the 1995 Reform Act, one that appeared at first likely to result in many successful motions to dismiss was Section 21D(b)(2), 15 U.S.C. Section 78u-4, titled "Required state of mind." That section replaced the previous Federal Rule of Civil Procedure 9(b) as to the standard for alleging intent or state of mind ("intent... and other condition of mind of a person may be averred generally") with a specific pleading standard of particularity: "the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

Yet the potential for Section 21D(b)(2) to weed out frivolous cases has proved quite difficult to realize. Many courts have simply taken the view that as long as the plaintiff alleges some facts—any facts—going to scienter, then he is entitled to the usual rule of all inferences in his favor at the pleading stage. Many courts have interpreted that rule as precluding the court from weighing whether the inference of scienter is "strong" or not; if the facts alleged gave rise to *any* inference of scienter, then the plaintiff would automatically receive the presumption that the inference was "strong." As an example, the Seventh Circuit, in its decision in the *Tellabs* case, stated the standard as being whether "a reasonable person could infer [from the complaint's allegations] that the defendant acted with the required intent."[6] That standard had no element that gave any meaning at all to the statutory prescription that the inference of scienter from the facts alleged must be "strong."

With *Tellabs*,[7] the Supreme Court has now instructed the lower courts that it most definitely is their job to weigh the competing inferences as to scienter, and to allow a securities class action to proceed only if "a reasonable person would deem the inference of scienter cogent and at least as compelling as any plausible opposing inference that one could draw from the facts alleged."[8] With lower courts under explicit direction to weigh competing inferences as to scienter on a motion to dismiss, they will undoubtedly be presented with motions by defendants in most or all cases seeking to have this weighing come out in the defendant's favor.

The web sites of many defense firms have greeted the *Tellabs* decision with a degree of triumphalism, but that is premature. Until a body of case law develops, it will not be known how much the new rule moves the needle in terms of numbers of cases that will actually be dismissed. Indeed, some commentators, such as John Coffee of Columbia Law School, writing in the *New York Law Journal* of July 19, 2007, have taken the view that the shift is relatively small, and far less than the rule change advocated by the Solicitor General in the case.

Nevertheless, it is already clear that there are categories of cases that in the past routinely survived and now are in jeopardy. One such category is the case based on facts revealed to plaintiffs' counsel by alleged "confidential sources." Such unnamed sources are a common occurrence in securities class action complaints, often turning up not in the pleading filed immediately after a stock price drop, but in an amended complaint filed at a later time, such as to parry an initial motion to dismiss. Indeed, the amended complaint in the *Tellabs* case itself sought to support its inference of scienter with alleged information from some 27 confidential informants.

Following immediately upon the Supreme Court's June 2007 decision in *Tellabs*, the Seventh Circuit has ruled that information provided by alleged confidential informants will not be sufficient to provide the needed "strong inference" of scienter.[9] Affirming dismissal of the complaint, the Seventh Circuit stated:

> One upshot of the approach that Tellabs announced is that we must discount allegations that the complaint attributes to five "confidential witnesses".... Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist....
>
> Our point, rather, is that anonymity conceals information that is essential to the sort of comparative evaluation required by Tellabs.

Beyond the specific instance of confidential sources, it is fair to say that the field is now wide open. Some complaints allege specific extrinsic indicators of scienter, such as sales of stock by insiders during the class period; but many complaints lack any such extrinsic indicators of scienter, and base their alleged inference only on the allegation that the facts that ultimately came out differed from the prior disclosures. The lower courts have previously struggled to come up with some method to distinguish any one of these cases from the others. While it is not clear exactly where the new line will be drawn, it is clear that a new complaint alleging an inference of scienter from the mere fact of new disclosures differing from old ones stands a substantial chance of being in jeopardy.

## New Class Certification Decisions: Has Class Certification in Securities Class Actions Now Become Contestable in Many Cases?

Class certification is an essential element of the economics of securities class actions. In most cases involving large public companies, even the largest shareholders will own less than 1% of the securities that traded during an alleged class period; and often the very largest shareholders, such as mutual funds, will not be willing to bring a case at all. Even if there is a willing plaintiff with a 1% holding of the shares at issue, defeat of class certification will turn a potential one billion dollar claim with perhaps a $20 million settlement value into a $10 million claim with a settlement value well under $1 million—not enough to justify the time and effort of the plaintiff's lawyer.

Yet, as set forth above, a pair of Supreme Court cases in the 1970s and 1980s had made class certification almost impossible to oppose in most securities class actions, to the point where many defendants conceded the issue. Now, new cases from the Second and Fifth Circuits point to substantial categories of cases where class certification may be successfully opposed.

The Second Circuit decision is *In re Initial Public Offering Securities Litigation*.[10] The holding of the IPO Laddering Cases is that the district court on a class certification motion must make determinations that each of the Rule 23 prerequisites for class certification has been met, and that such determination can be made only if the district judge resolves factual disputes relevant to the Rule 23 requirements.[11] Based on that holding, the Second Circuit reversed class certifications granted by the district court and, in an unusual step, did not remand on this issue. The Second Circuit characterized its holding as being in accord with the Supreme Court's decision in *Eisen v. Carlisle & Jacquelin*;[12] but the holding in the IPO Laddering Cases was most definitely not in accord with the prior application of *Eisen* by many courts, who had interpreted the Supreme Court's decision as precluding extensive factual inquiry into class certification issues as a prohibited "preliminary inquiry into the merits."

The IPO Laddering Cases involved no fewer than 310 consolidated class actions, brought with respect to nearly every IPO that came out during the internet and telecommunications bubbles of 2000-2001. The complaints alleged improper conduct by the issuers and their banks, particularly in setting the pricing for the issuance and trading in the immediately following after-market. After denying motions to dismiss, the district court designated six "focus cases" for consideration of class certification, and then certified broad classes in each of the cases, with the class period covering the time immediately after the IPO. The particular fact which the Second Circuit found had not been and could not be established was the efficiency of the market for the newly issued stocks in the first weeks of trading, a fact which undermined the presumption of reliance.

As with the Supreme Court's *Tellabs* decision, the consequences of the IPO Laddering Cases are likely to be significant, but the full extent will only emerge with time. Certainly the IPO Laddering decision has an immediate impact on the 304 cases that were waiting in the wings while the Second Circuit focused on only six. Next in line will be any other cases arising from IPOs, heretofore a not insignificant portion of the securities class action universe. Also at risk will be any other cases where the trading market for the securities is less than robust—for example, stocks that are thinly traded or have had their markets disrupted for some reason.

The Fifth Circuit's decision, *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, has the potential to affect an even larger category of cases.[13] The Fifth Circuit phrases its holding in *Oscar* in relatively opaque terms: "we [require] plaintiffs invoking the fraud on the market theory to demonstrate loss causation."[14] But the practical implication could be great. In *Oscar,* the stock-price-inflating and allegedly false good news at issue were buried among various other bits of good news; and the stock-price-deflating corrective disclosure was buried among other bad news. How then could one know that the stock price inflation was caused by the particular allegedly false information as opposed to something else? Lacking an answer to that question, the Fifth Circuit ruled that plaintiff had failed to show loss causation and hence that the class could not be certified.

Factual patterns similar to that in *Oscar* are present in numerous cases. Indeed, it could well be possible for issuers to orchestrate the facts in some cases to make loss causation from any one particular disclosure more difficult to establish.

It is by no means certain that all circuits will follow the holding in *Oscar*. Indeed, there was a dissent in the case. Nonetheless, there is ample room for pushback against the notion underlying a high percentage of securities class actions, that every earnings disappointment must stem from a "fraud" that was the sole cause of a stock price inflation and subsequent drop. The *Oscar* case highlights that lack of clarity as to the unique causation of stock price deflation could defeat class certification and render much securities litigation non-viable.

## Will the SEC Permit Companies to Compel Arbitration of Securities Class Actions?

On April 16, 2007, the *Wall Street Journal* reported that the SEC has under consideration a proposal to permit issuers to require arbitration of securities class actions against them. The potential mechanism to effectuate this result could be a provision in the by-laws. By that mechanism, theoretically claims against officers and directors, in addition to those against the issuer itself, could be subject to the arbitration requirement.

Relative to the incrementalism of court decisions, such a move by the SEC has the potential to bring about something closer to a revolution of the current securities litigation landscape. Of course, this proposal faces the prospect of major opposition before adoption, not least from the plaintiffs' bar and shareholder activist groups.

Even assuming arbitration would still entail class action treatment to the same extent as currently allowed in litigation, there can be little doubt that many defendants would prefer arbitration over jury trials, if available. Despite the lack of real world experience resulting from the extraordinarily high settlement rate, most defendants regard the jury process as containing a high random component with a real potential

for runaway damages. In a world of arbitration, potentially defendants might view at least some percentage of cases as triable.

## CONCLUSION

The changes so far are incremental; the full consequences cannot yet be known. Yet new developments offer new opportunities for defendants to make motions that can actually lead to victory in more than a handful of securities class actions. Since trial is so rarely a viable option, defendants will not fail to present these motions.

### Endnotes

1 ___ U.S. ___, 127 S.Ct. 2499 (2007)("Tellabs").

2 *Available at* www.nera.com/publication.asp?p_ID:2777.

3 *Available at* www.abanet.org/buslaw/blt/2002-07-08/wagerward.html.

4 417 U.S. 156, 177 (1974).

5 485 U.S. 224, 242 (1988).

6 437 F.3d 588, 602 (7th Cir. 2006).

7 127 S.Ct. 2499.

8 *Id.* at 2510.

9 Higginbotham v. Baxter International, Inc., ____ F.3d ____, 2007 WL 2142298 (7th Cir. July 27, 2007).

10 471 F.3d 24 (2d Cir. 2006)(the "IPO Laddering Cases").

11 *Id.* at 41.

12 417 U.S. 156 (1974).

13 487 F.3d 261 (5th Cir. May 16, 2007).

14 *Id.* at 265.