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A Winning Strategy For Beating IPO Class Actions

Law360, New York (April 4, 2011) -- As the economy recovers from the credit crisis, initial public offerings and mergers and acquisition activity are on the rise. These transactions present fresh targets for securities class action plaintiffs' lawyers. As the volume of IPO and M&A activity accelerates, the volume of shareholder class action is likely to grow apace. Plaintiffs' lawyers are seeking new revenue streams as the litigation wave triggered by the credit crisis recedes.[1]

In responding to these lawsuits, defense counsel should take stock of lessons learned from credit-crisis-spawned securities litigation. In retrospect, 2007 was a very bad year to go public. That year, the subprime mortgage crisis began to spread to the corporate debt markets, culminating in the collapse of Lehman Brothers in September 2008. A full-blown financial crisis ensued.

Not surprisingly, class action securities lawyers were quick to file lawsuits. According to one consulting firm, "As of 12 May 2010, total writedowns and losses stemming from the credit crisis ... reached $1.8 trillion worldwide — or approximately 12.5 percent of US annual GDP — and the total number of credit crisis lawsuits ... exceeded 400."[2]

These lawsuits, several of which targeted the biggest players in the financial industry, typically alleged that the defendant company's securities filings were false and misleading because they failed to disclose adequately various credit risks that the company faced. Those risks then came to fruition during the crisis.

Many of these cases alleged violations of Section 10(b) of Securities Exchange Act of 1934 and Rule 10b-5, claiming that the defendants knowingly or recklessly made false statements in securities filings. But the weapon of choice for class action plaintiffs' lawyers is to allege, whenever possible, violations of Sections 11 and 12(a)(2) of the Securities Act of 1933 (Securities Act). These sections apply to material misstatements or omissions in connection with stock offerings.

Class action plaintiffs enjoy at least two distinct advantages in asserting claims under the Securities Act. First, the plaintiffs need not plead or prove fraud and thus do not have to comply with the onerous requirements for pleading scienter imposed by the Private Securities Litigation Reform Act of 1995 (PSLRA).[3]

Second, the plaintiffs are not required to prove loss causation under Dura Pharmaceuticals Inc. v. Broudo, 544 U.S. 336 (2005). Instead, it is the defendant's burden to show an absence of causation (so-called "negative" causation). As a result, the conventional wisdom holds that cases brought under the Securities Act are more difficult to defend than 10b-5 suits alleging fraud.

Many Securities Act cases have survived motions to dismiss and have yielded significant settlements. According to Cornerstone Research, approximately 34 percent of securities

class action settlements in 2010 involved Section 11 or Section 12(a)(2) claims, while such claims had been included in only 22 percent of cases settled through 2009.[4]

In addition, the median settlement amount for cases settled in 2010 increased to $11.3 million from $8.0 million — a year-over-year increase of more than 40 percent. That is the largest percentage increase in the median settlement amount in the last decade.[5] Median settlement amounts and median settlements as a percentage of "plaintiff-style" damages estimates also continued to be higher for cases involving Section 11 or 12(a)(2) claims as compared to cases without these claims.[6]

The Care Case

A recent case bucked this trend. Care Investment Trust Inc. is a health care-focused real estate investment trust (REIT).

Care went public through an IPO on June 22, 2007, shortly before the subprime mortgage crisis began spreading to the general corporate debt market. Care pursued so-called "warehouse" financing, which is a form of short-term financing. Representatives of Care met with several banks and selected two prospective warehouse lenders that proposed the best terms.

When Care went public, it disclosed in its IPO registration statement and prospectus that it expected to close on the warehouse facilities "soon" or "shortly" after the IPO, but warned that there was "no assurance" that would occur. By Aug. 14, 2007, market conditions had deteriorated, and Care had not closed either warehouse facility.

In a form 10-Q filed that day, Care explained that events in the subprime market "have materially impacted liquidity in the debt markets" and thus "our efforts to negotiate our warehouse facilities are taking longer than expected." Care did eventually close a warehouse facility with one lender, albeit on terms less favorable than those in lender's original term sheet. The other lender declined to provide warehouse financing in late 2007.

The plaintiffs filed a class action against Care and certain of its senior officers and directors, Briarwood v. Care Investment Trust, making multiple allegations of misstatements in Care's IPO registration statement and prospectus. At the time the lawsuit was filed, Care's stock traded for about a third less than its IPO price.

The plaintiffs brought claims solely under the Securities Act. The plaintiffs alleged that Care's IPO registration statement and prospectus failed to disclose, among other things, that certain of Care's assets were materially impaired and overvalued and that Care was experiencing difficulty in securing warehouse financing. The plaintiffs also challenged statements touting the benefits of relying on its corporate manager and the prospects for long-term financing.

Motion to Dismiss and Rule 16

The court initially denied the defendants' motion to dismiss.[7] But the court's opinion specifically addressed only the alleged misstatement regarding warehouse financing. It did not discuss several other misstatements that the plaintiffs had alleged, including those related to the valuation of Care's portfolio of assets.

At this point, some defendants would have resigned themselves to the burden and expense of discovery, class certification and protracted litigation. But Care used a series of Rule 16 scheduling hearings as an opportunity to narrow issues in the case and minimize expenses. Because the court's opinion denying the motion to dismiss discussed only one of several alleged misstatements, Care asked the plaintiffs and the court to clarify whether the other

alleged misstatements were still part of the case.

In response, the court ordered the parties to brief whether the plaintiffs had met the pleading requirements for the other alleged misstatements. After hearing arguments, the court held that the plaintiffs had failed to make the requisite showing that the other alleged statements were false or misleading and dismissed all of them from the case.

The only alleged misstatement that remained concerned the warehouse financing disclosure. That ruling alone substantially narrowed the case and saved Care from the risk and great expense of wide-ranging discovery.

Bifurcation

Care then urged the court to bifurcate discovery so that the parties would initially take discovery only on the truth or falsity of the warehouse financing disclosure. Discovery on class certification, causation and damages would be delayed until after the plaintiffs had proffered sufficient evidentiary support for their allegation that the warehouse disclosure was false and misleading.

In seeking bifurcation, Care focused its argument on a 2003 amendment to Rule 23, which replaced the requirement that the court determine whether to certify a class "as soon as practicable after commencement of an action" with the more flexible standard that such determination be made "at an early practicable time."

Care also noted Second Circuit decisions holding that, where Rule 23 requirements overlap with an issue on the merits, the district court will be "accorded considerable discretion to limit both discovery and the extent of the hearing on Rule 23 requirements" in order "[t]o avoid the risk that a Rule 23 hearing will extend into a protracted mini-trial of substantial portions of the underlying litigation."[8]

The court agreed and bifurcated discovery as requested. That ruling not only further minimized Care's expenses, but also prevented the plaintiffs from using an early class certification ruling as a bludgeon to force an expensive settlement.

Summary Judgment

During discovery, Care marshaled evidence demonstrating that — just as the registration statement and prospectus stated — Care reasonably expected to secure warehouse financing shortly after the IPO. Care's senior officers and directors so testified in their depositions. And Care assembled documents and testimony showing that the warehouse financing disclosures had been reviewed and approved by both prospective warehouse lenders, who also served as underwriters of the IPO.

The strategy worked. On Care's summary judgment motion, the court held that Care and the individual defendants could be held liable only if their statement of opinion on the expected closing of the warehouse facilities was not "genuinely and reasonably believe[d]" or had no "basis in fact."[9]

Based on the extensive evidentiary record, the court concluded that "[t]here is no genuine factual question that the defendants reasonably believed" their statements were true when made.[10] Subsequent market events in the credit markets simply led defendants' expectation not to be realized.[11]

The court also rejected the plaintiffs' attempt to create a question of fact through an expert declaration and thereby avoid summary judgment. The expert opined, in substance, that Care's stated expectation that it would close on the warehouse facilities "soon" or "shortly"

after the IPO was not "reasonable."

The court disregarded the expert's opinion, noting "the old trial lawyers' aphorism, 'One fact is worth a shipload of argument.'"[12] The court entered a judgment of dismissal with prejudice on Feb. 3.

No Appeal in Exchange for No Sanctions

Care's counsel had informed the plaintiffs and the court early in the case that, even though the plaintiffs survived a motion to dismiss, their claims lacked a factual basis and would be disproved in discovery and defendants would seek sanctions under Section 11(e) of the Securities Act.

Section 11(e) permits a party in a Section 11 case to seek its legal fees and costs "if the court believes the suit or the defense to have been without merit." The court had acknowledged during the Rule 16 hearings the availability of sanctions under Section 11(e) if the plaintiffs pursued claims that discovery revealed to be frivolous.

This standard is easier for a defendant to meet than the "frivolous" requirement of Federal Rule of Civil Procedure 11.[13] Although the standard under Rule 11 is bad faith, Section 11(e)'s "without merit" standard encompasses claims and defenses that either are brought in bad faith or "[are] utterly lacking in merit as to border on the frivolous."[14]

Thus, Section 11(e) "has been read as permitting the awarding of fees in a broader range of cases than is permissible under the ... equitable power to award such fees for claims or defenses maintained in bad faith."[15]

After the court issued its summary judgment ruling, the plaintiffs waived their right to appeal in return for Care's agreement not to seek sanctions. Care thereby avoided the risks and expense of an appeal.

By the end of the litigation, Care not only had prevailed but had saved substantial legal fees and expenses that it would have incurred had the case followed the normal course of full-blown discovery on all issues, class certification and an appeal.

The case thus highlights the importance not only of winning but of devising a viable strategy to minimize expense at every turn along the way. In today's climate of increased deal making and ensuing litigation, that lesson is as important as ever.

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Chefitz and Kratenstein served as counsel for the defendants in the case discussed in this article.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See generally John W. Moka III, 2010 a Record Year for Securities Litigation, An Advisen Quarterly Report — 2010 Review, at 14, https://www.advisen.com/downloads/sec_lit_Q42010_report.pdf.

[2] Faten Sabry, Anmol Sinha, Jesse Mark, and Sungi Lee, Credit Crisis Litigation Revisited: Litigating the Alphabet of Structured Products, NERA Insight Series, June 4, 2010, at 1.

[3] See Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007) (establishing pleading standards under the PSLRA for alleging the requisite "strong inference" of scienter).

[4] Ellen M. Ryan and Laura E. Simmons, Securities Class Action Settlements: 2010 Review and Analysis, Cornerstone Research, at 9.

[5] Id. at 2. The average settlement amount decreased slightly in 2010 from $37.2 million reported in 2009 to $36.3 million in 2010 due to a decline in "mega" settlements of over $100 million. Id.

[6] Id. at 9. A "plaintiff-style" damages estimate "is based on a modified version of a calculation method historically used by plaintiffs in securities class actions." Id. at 4.

[7] See Briarwood Inv. Inc. v. Care Inv. Trust Inc., No. 07 civ. 8159(LLS), 2009 WL 536517 (S.D.N.Y. Mar. 4, 2009).

[8] In re Initial Public Offering Sec. Litig., 471 F.3d 24, 41 (2d Cir. 2006); see also In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 486 (2d Cir. 2008).

[9] Briarwood Inv. Inc. v. Care Inv. Trust Inc., No. 07 civ. 8159(LLS), 2010 WL 5422549, at *4 (S.D.N.Y. Dec. 29, 2010).

[10] Id.

[11] Id. at *7.

[12] Id. at *7 n.3.

[13] Aizuss v. Commonwealth Equity Trust, 847 F. Supp 1482, 1491 (E.D. Cal. 1993).

[14] See Straus v. Holiday Inns Inc., 460 F. Supp. 729, 732 (S.D.N.Y. 1978).

[15] Weil v. Inv./Indicators, Research & Mgmt. Inc., 647 F. 2d 18, 22 (9th Cir. 1981).

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