

## Recent Trends In Securities Class Actions

*Monday, Oct 29, 2007* --- Securities class action filings have decreased, whether for the short or long term. But large settlements have increased, as has the personal exposure of directors and officers.

And the litigation exposure is no longer confined to the U.S.; securities fraud enforcement has spread internationally.

Faced with the high stakes and litigation costs of these cases, courts have strengthened the defense's hand and raised the bar for plaintiffs by toughening the requirements to plead securities violations, to certify class actions and to prove loss causation.

One way or the other, the Supreme Court's expected decision this term on "scheme liability" will either reinforce or counteract this trend.

### *Overview*

#### *Fewer Filings, Larger Settlements*

##### *Record Low Filings*

2006 saw the lowest number of federal securities class actions filed since the passage of the PSLRA. The trend continued in the first six months of 2007.

Several explanations for the decline include improved corporate oversight stemming from the passage of the Sarbanes-Oxley Act of 2002, an increased focus on derivative cases in state court relating to options backdating, distractions faced by the largest plaintiffs' law firms as a result of federal indictments and investigations and, perhaps the most plausible, strong performance and low volatility in the stock market since the early 2000s.

If "it's the economy" largely, the recent trend can offer no permanent respite. In fact, as the economic fallout from the subprime lending crisis spreads to new SEC investigations of possible securities fraud in the subprime securitization market and to ensuing class action litigation, the downturn in federal securities litigation may soon be over.

##### *Record Large Settlements*

Seven of the ten largest settlements in history occurred in 2005 and 2006. Most notable of these are Enron (\$7.1 billion), Worldcom (\$6.2 billion), Tyco (\$3 billion) and AOL Time Warner (\$2.7 billion).

Notwithstanding a dramatic increase in very large settlements, the majority of settlements were for less than \$10 million, consistently with prior years.

## *Opt-Outs*

The mega-settlement cases saw an increase in opt-outs by institutional investors seeking to recover more by going at it alone.

Possibly the largest single opt-out settlement in history was announced earlier this year after the University of California had opted out of the settlement reached on behalf of the class in AOL Time Warner to pursue its claims individually.

The University estimated that its share of the \$400 million settlement for the opt-out plaintiffs would be between 16 and 24 times the amount it would have received as part of the class action settlement.

It remains to be seen whether the opt-out trend will be limited to the mega-settlement cases that originated after the market collapse of the early 2000s.

## *Derivative Litigation Is Hot*

Although plaintiffs filed fewer securities class actions, more of them were accompanied by companion derivative lawsuits. Derivative actions accompanied over 45% of the securities class actions settlement in 2006, compared with 35% in 2005.

Sometimes filed as class actions in federal court, the majority of options backdating cases are styled as derivative actions for breach of fiduciary duty and brought in state court.

NERA Economic Consulting estimates that around 20 options backdating cases were brought as securities class actions in 2006 and another 80 as derivative actions.

The trend may be short lived, on the theory that companies have largely ceased the practice of backdating.

The rise in private equity buyouts is fueling class actions challenging deal fairness.

Typical claims are for breach of fiduciary duties for unfair price and unfair inside dealing.

So called “bump cases” often seek injunctive relief to block the deal and are often settled quickly with a bump in the deal price in order to move the deal forward.

## *Evolving Legal Standards*

## *Class Certification*

### *Timing*

Timing for class certification has been pushed back, as a result of an increased focus on the merits prior to determining certification.

Before the 2003 amendments to Rule 23, district courts were required to decide whether to certify a class “as soon as practicable.” Now, the standard is “at an early practicable time.”

The Advisory Committee Notes state that the reason for the change is to comport with current practice and, “[a]lthough an evaluation of the probable outcome on the merits is not properly part of a certification decision, discovery in aid of the certification decision often includes information required to identify the nature of the issues that actually will be presented at trial.”

### *Standard*

Plaintiffs must meet the burden of satisfying the requirements of Rule 23(a) and 23(b)(3). Rule 23(a) provides that certification may only be granted if: (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the representative parties are typical of those of the class; and (4) the representative parties will fairly and adequately protect the interests of the class.

In addition to these requirements, Rule 23(b)(3) requires that questions of law or fact common to members of the class predominate over any questions affecting only individual members of the class, and that a class action must be superior to other methods of adjudication.

The major battleground has been over plaintiffs’ ability to meet the predominance requirement.

### *Merits Focus*

Erosion of an overly broad reading of *Eisen v. Carlisle & Jacquelin*, 417 U.S. 167 (1974), has led to more focus on merits at the class certification stage.

In *Eisen*, the U.S. Supreme Court held that a district court should not “conduct a preliminary inquiry into the merits of a suit in order to determine whether it be maintained as a class action” and concluded that plaintiffs only need make “some showing” that they adequately met the requirements of Rule 23.

Subsequently, the Supreme Court seemed to suggest that *Eisen* was not be read too broadly—in *Coopers & Lybrand v. Livesay*, 437 U.S. 463 (1978)

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(class questions “intimately involved with the merits”), and *General Tel. Co. of the Southwest v. Falcon*, 457 U.S. 147 (1982) (class certification requires “rigorous analysis” of Rule 23 prerequisites).

Circuit court opinions have built upon this trend, recognizing a district court’s duty to examine the Rule 23 elements carefully and to resolve conflicting evidence.

*Szabo v. Bridgeport Machines, Inc.*, 249 F.3d 672 (7th Cir. 2001). A class certification motion requires the district court to receive evidence and to resolve factual disputes over the Rule 23 elements even if they overlap with the merits.

*Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154 (3d Cir. 2001). The court followed *Szabo* and held plaintiffs’ claims failed to meet the predominance requirement of Rule 23 because plaintiffs’ expert could not show a viable methodology for calculating economic loss on a classwide basis.

*Gariety v. Grant Thornton, LLP*, 368 F.3d 356 (4th Cir. 2004). Following *Szabo*, the court specified that a district court must make findings to determine whether a plaintiff has met its burden under Rule 23.

This trend has played out in the antitrust context and has carried over to securities litigation, resulting in a number of recent pro-defense opinions in the appellate courts.

*In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006). Concluding based on *Eisen* that plaintiffs need make only “some showing” that they met the requirements of Rule 23, the district court rejected defendants’ argument that individual questions concerning reliance predominated over common questions because plaintiffs could not rely on the “fraud on the market” presumption without demonstrating an efficient market for shares of IPOs.

The Second Circuit reversed, overturning the “some showing” standard. Relying on a number of appellate decisions that had rejected such a broad reading of *Eisen*, including *Szabo* and *Gariety*, the court held that *Eisen* proscribed an inquiry into the merits only on issues unrelated to the Rule 23 requirements.

A district court may certify a class only after making a factual determination that each element of Rule 23 has been met, including elements overlapping with merits issues.

Plaintiffs could not satisfy their burden on predominance because the pleadings and evidence demonstrated the lack of an efficient market for IPOs.

*Regents of the University of California v. Credit Suisse First Boston*, 482 F.3d

372 (5th Cir. 2007). Reversing certification of a class of shareholders claiming against three investment banks for allegedly participating in fraud that led to Enron's collapse, the Fifth Circuit rejected plaintiff's underlying theory of scheme liability as inconsistent with the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank*, 511 U.S. 164 (1994) (no aiding and abetting liability under §10(b)).

Further, in light of Supreme Court precedent that plaintiffs are entitled to a presumption of reliance on an omission only when defendants owe a duty to disclose, the court held plaintiffs were not entitled to a class presumption of reliance since the banks owed no such duty.

Plaintiffs' petition for certiorari with the Supreme Court remains pending.

*Oscar Private Equity Investments v. Allegiance Telecom*, 487 F.3d 261 (5th Cir. 2007). Again questioning plaintiffs' entitlement to the fraud on the market presumption of reliance, the Fifth Circuit reversed class certification and held that Rule 23 "mandates a complete analysis of fraud-on-the-market indicators," including a showing of loss causation.

These cases demonstrate an increased willingness of the appellate courts to question underlying theories of liability via interlocutory review of a class certification order.

### *Scheme Liability*

The circuits have split over the viability of "scheme liability" under §10(b).

In *In re Charter Communications, Inc. Securities Litigation*, 443 F.3d 987 (8th Cir. 2006), the Eighth Circuit ruled that "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5."

Thus a party cannot be held liable under §10(b) for engaging in a "scheme" to defraud. This was the same approach taken by the Fifth Circuit in *Regents*.

In stark contrast, the Ninth Circuit has embraced scheme liability in *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006).

There, the court held that a defendant may be held liable "as a primary violator of § 10(b) for participation in a 'scheme to defraud'" if the defendant "engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme."

The Supreme court has heard argument in *Charter* and is expected to decide this term whether secondary actors can be held liable to shareholders under a "scheme liability" theory.

## *Pleading Standards*

A string of recent Supreme Court cases has heightened the pleading requirements for §10(b) and other federal court claims.

*Dura Pharm. Inc. v. Broudo*, 544 U.S. 336 (2005). The Supreme Court held a securities plaintiff may not satisfy the element of loss causation simply by alleging and proving that the price of the security was inflated on the date of purchase because of the misrepresentation. Rather, the specific misrepresentation at issue, not other factors, must actually cause a loss.

*Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006). A unanimous Court ruled that statutory preemption precludes “holder” claims—those brought by plaintiffs whose purported injury stems from their decision to retain, rather than purchase or sell, their allegedly overvalued securities.

*Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499 (2007). At issue in *Tellabs* was the extent to which a court must weigh competing factual inferences in determining whether the requisite “strong inference” of scienter has been pled.

Under *Tellabs*, courts must view the factual allegations holistically, and “the inference of scienter must be more than merely ‘reasonable’ or ‘permissible’ – it must be cogent and compelling, thus strong in light of other explanations. . . . and at least as compelling as any opposing inference one could draw from the facts alleged.”

Further, “omissions and ambiguities count against inferring scienter,” due to the particularity requirement of the PSLRA.

*Bell Atlantic Corp. v. Twombly*, 127 S.Ct. 1955 (2007). In a similar vein, the Supreme Court recently toughened the pleading standards for antitrust and likely all other claims filed in federal courts.

*Twombly* held that the factual allegations in a complaint subject to Rule 8 of the Federal Rules of Civil Procedure must establish that the entitlement to relief is “plausible,” not just possible.

## *Director Exposure*

### *Direct Payments from Individuals*

Historically, individual out-of-pocket contributions toward settlements have been unusual and rare. But significant recent cases have required such contributions, indicating an increase in director and officer exposure.

In *Worldcom*, 12 former directors agreed to pay a total of \$24.75 million to settle allegations that they failed to detect fraud. The settlement amount was

arrived at after taking into account the outside-director-defendants' net worth; the settlement represented approximately 20% of their net worth.

In Enron, 10 former directors agreed to pay \$13 million, in addition to a \$168 million contribution from D&O insurance, after coverage limits had been exhausted.

Earlier this year, a U.S. bankruptcy judge approved an \$82 million settlement in which five outside directors contributed \$41.5 million.

The case arose out of the 1999 collapse and bankruptcy of Just for Feet, in which three of its former executives pled guilty to crimes relating to securities fraud.

The bankruptcy trustee sued the outside directors, alleging, among other things, conflicts of interest, misrepresentations, breach of fiduciary duty and bad faith.

The insolvency of the company and the exhaustion of the D&O liability policy from the securities litigation left the directors exposed to the trustee's claims.

### *Individual D&O Insurance Coverage*

This increased exposure has caused a corresponding increase in demand for and availability of personal coverage for individual directors and officers.

More organizations are buying Side-A policies providing expanded D&O coverage for executives, including when they are denied corporate indemnification or coverage under the underlying corporate policy.

In addition, as U.S.-style securities fraud suits are exported to other countries, executive exposure expands internationally.

D&O policies issued in the United States may not provide effective global coverage, and insurers are filling the gap with worldwide policies.

### *Conclusion*

While class action filings are down at least temporarily, large settlements and personal exposure of directors and officers are up. Both the stakes and costs of litigation remain high. Responding to the in terrorem pressure on defendants to settle even meritless suits, the courts have toughened the standards for certifying classes, pleading violations and proving causation.

--By Joel G. Chefitz, Shawn M. Harpen and Travis S. Biffar, McDermott Will & Emery LLP

Joel Chefitz and Shawn Harpen are partners, and Travis Biffar an associate with McDermott.