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U.S. Securities Class Actions - An Overview

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A. Background

Securities fraud class action suits are the most common manner by which a large group of shareholders seeks to recover damages based upon claims of fraudulent statements made in connection with the purchase or sale of a security. These cases are routinely filed after the announcement of negative news about a company, followed by a drop in the price of the company's securities. Unfortunately, the "named plaintiffs" generally have very little to do with the lawsuit. Rather, these large suits are run by plaintiffs' law firms. To the extent that the case is not ultimately dismissed, and monies are paid by the defendants through either a judgment or a settlement, the shareholders themselves very rarely see much of the money. Rather, the plaintiffs' lawyers receive roughly 40% of any settlement or judgment, in addition to monies to cover the costs they have incurred.

Because of the expense associated with defending securities fraud class action suits, defendants often determine to settle the suits quickly. As a result, historically, the plaintiffs' bar has often instituted frivolous "strike" suits in order to extract a quick settlement. In recognition of the inappropriateness of these "strike" suits, in 1995, the U.S. Congress enacted the Private Securities Litigation Reform Act ("PSLRA"). While the PSLRA did codify certain standards of pleading that a plaintiff must meet in order to maintain a securities fraud class action suit, ultimately, the PSLRA has not been much of a deterrent against such frivolous suits.

Very few securities fraud class action suits are tried to a Judge or Jury. Rather, the cases are either (1) dismissed at an early stage of the case pursuant to a motion to dismiss; (2) dismissed when a court determines that a class cannot be properly certified; (3) dismissed as a result of a motion for summary judgment; or (4) settled.

B. Progress of a Case through the U.S. Court System

Securities fraud class action suits based upon violations of the U.S. federal securities laws must be brought in federal district court. As a general matter, the defendants in such cases include the corporation, current and former members of the Board of Directors, as well as current and former executive officers, such as CEOs and CFOs. Claims are most often made pursuant to Sections 10(b) and 20(a) of the Securities and Exchange Act of 1934, as amended, as well as Rule 10b-5 promulgated thereunder. The class action complaint(s) will include a class period, *i.e.,* dates during which the "fraud" purportedly occurred. That time period could range from a few months to several years.

One of the benefits of the PSLRA is the requirement that, if multiple federal class actions are filed in multiple courts throughout the U.S., the cases must be consolidated in one court. As

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a result of this provision of the PSLRA, it is common to have virtually identical suits filed in the same court by two or more plaintiffs. The plaintiff with the first-filed suit is then required, within 20 days, to publish, in a widely-circulated national business-oriented publication, a notice of the filing of the suit and notice of the 60-day deadline for class members to file a motion requesting to be designated as lead plaintiff.

No later than 90 days after the notice is published – so generally, 110 days after the first lawsuit is filed – the court must consider any motions requesting appointment as lead plaintiff. Importantly, the defendants have no say in that process. In other words, the defendants do not file any pleadings addressing the various motions. Once the court designates a lead plaintiff, the court will also consolidate the pending cases and, if necessary, order the lead plaintiff to file a single, consolidated complaint. The defendants then have two options: File a motion to dismiss, or file an answer.

As a matter of general practice, defendants most often choose to file a motion to dismiss. By that motion to dismiss (discussed in detail later), the defendants request dismissal of the case based on a failure to state a claim, as well as based on the lack of personal jurisdiction over non-U.S. individual defendants. A motion to dismiss gives the defendants their first opportunity of having the court determine that the lawsuit lacks merit.

Once a motion to dismiss has been filed, the plaintiff has an opportunity to file a responsive pleading, to which the defendants may file a reply brief. A district court may or may not determine to hold oral argument on the motion. There is no required deadline by which time the court must rule on the motion. Thus, the court may not rule for several months to more than a year. Once the court does rule, it may determine to dismiss the case, but give plaintiffs an opportunity to amend their complaint, dismiss certain claims, or deny the request for dismissal. While the motion to dismiss is pending, the PSLRA mandates that discovery and other proceedings are stayed. This means that the plaintiff is precluded from seeking the production of documents, issuing subpoenas, and taking depositions. Nevertheless, the defendants have an obligation to preserve all documents and information relevant to the allegations in the complaint. The plaintiff is also precluded from seeking class certification during the stay.

If the case is not dismissed, the defendants must then file a formal answer with the district court. The defendants are required to generally admit or deny each of the allegations contained in each paragraph of the complaint. In an answer, defendants are also allowed to assert affirmative defenses. Discovery may then be commenced.

Available discovery from the parties includes requests for the production of documents; interrogatories – which are written questions that must be responded to under oath; requests for admissions – which are statements to which a party is required to admit or deny; and requests for deposition (testimony). Discovery of non-parties includes subpoenas for the production of documents and for testimony. Generally, the production of documents on behalf of the defendants is a lengthy and expensive task. Although not a rule, most plaintiff's attorneys seek the production of documents prior to seeking any deposition

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testimony. The discovery process most often takes more than a year to complete. This is especially true where non-U.S. defendants are involved and information needs to be translated.

During the initial stages of discovery, defendants focus on obtaining discovery from the lead plaintiff regarding whether or not class certification is appropriate. Once that discovery is completed, and after plaintiff files a motion for class certification (discussed more fully below), defendants file a brief, with evidence, opposing class certification. There are various bases on which to oppose class certification, including arguments that the plaintiff's claims are not typical of other class members, that plaintiff and/or plaintiff's counsel cannot adequately represent the class, that individual questions of fact predominate, thereby making class certification inappropriate, and that loss causation is lacking. The court may or may not hold a hearing on the motion for class certification.

If the court denies class certification based upon substantive defects in the complaint, the lawsuit is generally dismissed or settled for a nominal sum. In certain cases, class certification may be denied with respect to a lead plaintiff, but the court may grant a substituted lead plaintiff leave to intervene in the case. If that occurs, the defendants are generally entitled to conduct additional class certification discovery of that plaintiff and, if appropriate, fight class certification once again.

After class certification, the "price" of settlement can be expected to increase, as the exposure that defendants have to a significant judgment increases exponentially. Indeed, certification of a class often forces defendants into a position where settlement is their best option in light of the risks of continuing with the litigation. While, pursuant to the U.S. Federal Rules of Civil Procedure, the defendants can file an appeal of an order granting class certification, the appellate courts have discretion whether or not to hear those appeals. As such, only about 25% of such appeals are actually heard by the appellate courts.

After extensive discovery has been obtained, the defendants may move for summary judgment on some or all of the claims presented. By a summary judgment motion, a defendant requests the court to dismiss certain causes of action or the case in its entirety based upon undisputed facts and as a matter of law. Summary judgment in these types of cases is very difficult to obtain, as there can be extensive factual issues. If summary judgment is granted as to all claims, the plaintiff's case is dismissed with prejudice to the refiling of same.

If summary judgment is denied, the parties continue their preparation for trial. Realistically, a trial cannot be expected to commence before three or more years after the case was initially filed.

C. <u>Motions to Dismiss</u>

The U.S. Constitution, the PSLRA, and the Federal Rules of Civil Procedure provide several bases on which a motion to dismiss can be filed. Importantly, the more compelling the

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arguments, the more likely that plaintiffs' counsel may wish to discuss settlement while the motion is pending. Thus, this presents the first real opportunity to have a more balanced negotiation in order to (hopefully) obtain a fairly reasonable settlement. If an insurance carrier or carriers is/are involved, they will need to be kept apprised of any settlement negotiations.

Some of the most common bases for Motions to Dismiss securities class actions are discussed below.

1. Personal Jurisdiction

In order for a U.S. court to exercise personal jurisdiction over a non-U.S. defendant, the plaintiff must establish that, pursuant to the Due Process Clause of the United States Constitution, the defendant purposefully availed himself of the benefits of the laws of the United States by establishing "minimum contacts" with the United States. The defendant's contacts with the United States must be such that the defendant should "reasonably anticipate being haled into court" in the U.S. U.S. courts generally employ a five-part test to determine whether a defendant's minimum contacts are sufficient for personal jurisdiction: (1) the nature and quality of the contacts, (2) the quantity of the contacts, (3) the relation of the cause of action to the contacts, (4) the interest of the United States in providing a forum for its residents to resolve disputes, and (5) the convenience of the parties. Personal jurisdiction can be established through two alternative theories: specific jurisdiction and general jurisdiction.

a. Specific Jurisdiction

A court has specific jurisdiction over a non-U.S. defendant when the defendant's contacts with the United States arise from, or are directly related to, the plaintiff's claims. Depending on the nature of the contact in question and the relationship of the plaintiff's claims to that contact, a single act committed in the United States can support a finding of specific jurisdiction. In any event, U.S. courts decide whether they have specific jurisdiction over foreign defendants on a case-by-case basis. By way of example, U.S. courts have found specific jurisdiction when defendants participated in "Road Shows," distributed sales material in the United States, made telephone calls and mailed allegedly fraudulent materials to the United States, partially performed a contract in the United States, and met with the plaintiff in the United States.

b. General Jurisdiction

U.S. courts may also assert personal jurisdiction over a foreign defendant if there is general jurisdiction over that defendant. A court has general jurisdiction over a non-U.S. defendant when the plaintiff's cause of action is

unrelated to the defendant's contacts with the United States but, rather, the defendant has engaged in continuous and systematic activities within the United States. In determining whether a defendant's contacts with the United States are sufficient to give rise to general jurisdiction, courts consider the longevity, continuity, volume, economic impact, physical presence, and integration of the defendant's contacts. Like with the specific jurisdiction analysis discussed above, U.S. courts determine whether they have general jurisdiction over foreign defendants on a case-by-case basis. Examples of fact patterns resulting in a finding of general jurisdiction include when a defendant maintained a temporary office and bank accounts in the United States, employed salesmen who lived in the United States, solicited business and sold products through dealers in the United States, and maintained a highly interactive Internet store which cleared sales to United States customers.

2. Failure to State a Claim/Failure to Plead Fraud with Particularity

Most defendants in a securities fraud class action suit file a motion to dismiss, arguing that the plaintiffs have failed to state a claim for relief and failed to plead fraud with particularity. As part of the PSLRA, Congress codified certain legal standards of pleading that are required to be present in a securities fraud class action. The failure to meet those pleading standards results in dismissal of the complaint – generally with an opportunity for plaintiffs to correct the defects and file an amended complaint.

In order to state a claim for violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, a plaintiff must specifically allege facts to support each of the following elements: (1) a misstatement or omission; (2) of material fact; (3) made with scienter; (4) on which the plaintiff relied; (5) that proximately caused the plaintiff's injury. Importantly, scienter, although not expressly mentioned in the text of either Section 10(b) or Rule 10b-5, is, nevertheless, an essential element of proof on a Section 10(b) claim. Scienter means "the intent to deceive, manipulate, or defraud."

The PSLRA requires a complaint to specify each false statement or misleading omission and explain why the misstatement or omission was misleading. Accordingly, a complaint must allege the "who, what, when, where, and how" of the fraud in order to satisfy the specificity requirements of the PSLRA.

In addition, the PSLRA requires that a complaint state with particularity the facts that give rise to a "strong inference" that each of the defendants acted with scienter. Allegations of negligent conduct are not sufficient to establish scienter. Thus, a court reviews a complaint to determine whether it contains facts that give a strong reason to believe that there was reckless or intentional wrongdoing. Such conduct is limited to highly unreasonable omissions or misrepresentations involving an extreme departure from the standards of

ordinary care and presenting a danger of misleading buyers or sellers, which is either known to the defendant or is so obvious that the defendant must have been aware of it.

Although "reliance" is an element of proof, reliance can be presumed. Thus, where a security is actively traded on a U.S. exchange, a court can presume that the plaintiff "relied" on the fraudulent statements. This judicially-created presumption is based on the premise that an efficient market absorbs all material information, whether or not truthful, and that information is reflected in the security's market price. If, however, the securities are not traded in an efficient market, reliance is not presumed. It is very unusual to find a case where the "inefficient market" defense is successful.

Loss causation is an element of proof required to establish a Section 10(b) claim for federal securities fraud. More specifically, Section 78u-4(b)(4) of the PSLRA provides:

> In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

Put another way, loss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.

On April 19, 2005, the U.S. Supreme Court issued the now seminal decision on loss causation, *Dura Pharmaceuticals, Inc. v. Broudo*. In that case, the Court held that proof that a company's stock price was artificially inflated (*i.e.,* priced in the market higher than it would have been had no fraud occurred) is not, without more, sufficient to prove loss causation, and further held that sales of a company's stock prior to disclosure of the "truth" fails to establish loss causation. The Court based its holding on the following reasoning:

> For one thing, as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value. Moreover the logical link between the inflated share purchase price and any later economic loss is not invariably strong . . . . [I]f, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the market place, an initially inflated purchase price *might* mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or

> other events, which taken separately or together account for some or all of that lower price.

As a result of the *Dura* decision, loss causation has become a central focus of attack by many defendants – although more effectively so at the class certification stage.

D. <u>Class Certification</u>

The battle over class certification is a tedious and expensive process. As discussed above, defendants will have the opportunity to obtain discovery from the lead plaintiff in order to determine whether the lead plaintiff can adequately represent the class. For all practical purposes, however, due to the highly-sophisticated plaintiffs' attorneys that handle these cases, it is unusual to succeed in defeating class certification based upon defects with the plaintiff or his counsel. Instead, and especially after the *Dura* case discussed above, defendants more routinely focus their attacks on loss causation.

In order to address the loss causation aspect of a case, both plaintiff and defendants retain experts. Those experts conduct various highly-sophisticated analyses in order to arrive at opinions on whether the stock price was artificially inflated. As somewhat of a corollary to this issue, the Supreme Court has recently made clear in *Halliburton Co. v. Erica P. John Fund, Inc.,* that defendants can also seek to establish that the alleged misrepresentations caused no "price impact." Again, expert analysis and testimony is required. The experts are expensive and the analyses can be complex and time-consuming.

The court has several options when ruling on class certification: (1) deny certification entirely; (2) grant certification as requested; (3) grant certification of a shortened class period; and/or (4) grant certification with sub-classes of class members.

E. <u>Motions for Summary Judgment</u>

If a class is certified, the defendants' next opportunity to obtain dismissal of the case is at the summary judgment phase. Summary judgments may be filed at any point after a reasonable opportunity for discovery. As a practical matter, however, such motions are not filed until after discovery has ended and in accordance with the court's scheduling order. Both plaintiff and defendants can file motions for summary judgment.

Due to the factual issues involved in these types of cases, it is difficult to obtain summary judgment. Thus, strategically, a defendant may want to focus his motion on one or two issues for which the highest likelihood of success is present. Summary judgment motions must be accompanied by admissible evidence such as affidavits and deposition transcripts. The affidavits serve two purposes: (1) to provide important testimony on a key issue; and (2) to prove up necessary documents.

The plaintiff will have the opportunity to file his own opposition brief with contradictory affidavits, documents, and deposition testimony. In turn, the defendants can submit reply briefs.

The court may or may not hold oral argument on the summary judgment motion(s). There is no time period by which the court must rule. If summary judgment is denied, the case continues on its path to trial.

F. Mediation

Upon court order or by agreement of the parties, the case may be mediated one or more times during the course of the litigation. Mediation is a process by which an independent person who is trained as a mediator sits down with both parties and their counsel and attempts to work out a mutually-beneficial resolution. A mediation is not binding, as the mediator does not make any determinations about the accuracy or appropriateness of the claims. He, instead, is merely a facilitator of the settlement negotiations.

Mediation of these matters can take one or two days, depending on the complexity of the issues. If insurance coverage is provided, the insurance carrier's/carriers' representative(s) will also be in attendance. If the parties reach an agreement, then they must request approval thereof from the court.

G. Settlement

Unlike other types of cases, the settlement of a securities class action suit is more complicated, although the plaintiff's counsel carries the heaviest workload during this process.

The PSLRA requires that the class members be notified of the settlement before it is approved by the court. The notification must include: (1) the amount of settlement proposed to be distributed; (2) a statement of the potential outcome of the case; (3) a statement of the attorneys' fees and costs sought by plaintiff's counsel; (4) the identification of the plaintiff's counsel that will be available to answer questions from class members; (5) a statement explaining the reasons for a settlement; and (6) any other information required by the court.

Class members are given an opportunity to file objections to the proposed settlement, and the notice will provide the date by which such objections must be filed. As a general matter, class members are provided the opportunity to opt out of the class and not participate in the settlement. Again, class members will be given a deadline by which time they can opt out. Defendants routinely obtain a provision in the settlement agreement that allows defendants to walk away from the settlement if too many people opt out.

The court will hold a hearing to determine the appropriateness of the settlement. Plaintiff's and defendants' counsel will make statements to the court supporting the settlement, and class members who object will be given the opportunity to verbally present their arguments.

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Once the court approves the settlement, an independent claims administrator will handle the distribution of the settlement monies. Defendants do not participate in this process and are not charged for the costs of the claims administrator. Thus, once approval of the settlement is finalized, the defendants are extricated from the process.

Thereafter, class members are precluded from suing defendants for conduct that occurred during the class period.

If you would like to know more about U.S. securities class actions and how they may affect your business, please contact:

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