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SECURITIES CLASS ACTIONS IN THE UNITED STATES

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HOT TOPIC

SECURITIES CLASS ACTIONS IN THE UNITED STATES

PANEL EXPERTS

Jonathan Tuttle
Partner
Debevoise & Plimpton
T: +1 (202) 383 8124
E: jrtuttle@debevoise.com

Jonathan Tuttle is a partner in Debevoise & Plimpton's Litigation Department in Washington, DC. He has represented public companies, regulated institutions, boards of directors, audit/special committees of boards, and individual directors, officers and employees in regulatory enforcement investigations, as well as in securities and shareholder derivative suits and internal corporate investigations, among others. He has significant experience investigating accounting issues, and the many complicated issues that can arise in such investigations, including disclosure and reporting of accounting restatements, responding to whistleblowers and interactions with auditors.

Brian A. Herman
Partner
Morgan Lewis & Bockius LLP
T: +1 (212) 309 6909
E: bherman@morganlewis.com

Brian A. Herman counsels clients in civil and class action litigation in US state and federal court. He represents banks, broker-dealers, hedge funds, investment advisers and other complex businesses. He also advises clients facing examinations by the US Securities and Exchange Commission (SEC), self-regulatory organisations, state regulators and other regulatory agencies. Clients also turn to Mr Herman for guidance with internal examinations and enhancing their business practices.

Robert A. Fumerton
Partner
Skadden, Arps, Slate, Meagher & Flom LLP
T: +1 (212) 735 3902
E: robert.fumerton@skadden.com

Robert A. Fumerton represents a broad spectrum of US and international clients in a wide variety of complex corporate, commercial and securities litigations in federal and state courts, and US and international arbitration proceedings. Mr Fumerton was lead counsel for Yahoo! in the Southern District of New York and Second Circuit proceedings against Microsoft seeking to vacate an emergency arbitration award granted to Microsoft concerning a strategic alliance between the parties under which Yahoo! would migrate its search advertising services to Microsoft's 'Bing Ads' platform in various markets worldwide.

CD: Could you provide an overview of the current securities class actions landscape in the US? What levels of activity have you seen in the last 12 months or so?

Tuttle: After a small decline following the peak of the financial crisis cases, securities class actions seem to have returned to more normal levels, and there does not appear to be any signs that there have been any significant shifts in class action levels. The US Securities and Exchange Commission's renewed focus on accounting and financial reporting cases has, predictably, spurred greater focus in the area by companies, their auditors and investors, and, as a result, has triggered a number of securities class actions in the wake of disclosures of restatements, internal control issues or other accounting-related developments. Similarly, cases arising from cyber security breaches seem likely to add to the volume of class actions in coming years as more and more companies fall victim to attacks and more plaintiffs claim that the companies' risk and other disclosures around cyber security efforts are misleading.

Fumerton: Filing activity for securities class action litigation appears to have held steady over the past three years. We've seen predictions that the total number of new federal securities class actions filed in 2015 will be only slightly lower than the annual average of such filings seen in the years 2005 through 2014. One new trend that we've been seeing is that large shareholders, including major investment funds, are opting-out of securities class actions on a more frequent basis. One possible explanation for this trend is that it is a reaction to the Second Circuit's decision in *IndyMac*, which held that the two-year statute of repose in the Securities Act of 1933 cannot be tolled for absent class members by the commencement of a class action. We have also seen increased efforts by plaintiffs to file Securities Act claims in state court

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in order to avoid many of the hurdles imposed by the Private Securities Litigation Reform Act.

Herman: From our perspective, the securities class action landscape remains very active, with levels of new filings on par with recent years. Each year, Cornerstone Research publishes a comprehensive analysis of class action filings, and their data for 2014 confirms that the number of federal securities class action filings remains relatively unchanged, with 170 new cases in 2014. State court securities class actions challenging merger and acquisition transactions – frequently filed in the Delaware Court of Chancery and focusing on alleged breaches of fiduciary duty – also remain extremely active. Indeed, nearly every M&A deal of any size is subject to litigation.

CD: What are some of the common factors driving today's securities class actions? Have any noteworthy cases surfaced?

Herman: The initial public offering market appears to be heating up, and there have been a number of large merger and acquisition transactions announced over the past several years. We hope this trend continues, but we recognise that, as the number of transactions increases, so too does the risk of litigation. In terms of noteworthy cases, we are paying heavy attention to a number of important cases in Delaware that could shift the landscape in M&A securities litigation. In the *KKR* case, the Delaware Supreme Court clarified that, if a merger is not subject to "entire fairness" review, and a majority of fully-informed, disinterested stockholders vote in favour of the transaction, the Court will apply the business judgment rule rather than 'enhanced scrutiny' under *Revlon* and its progeny. At the same time, the Chancery Court has issued a number of decisions indicating that the courts will no longer approve class action settlements with broad releases where the benefit to the class consists of enhanced disclosure. Up until recently, such settlements were routine. Finally, there has been a noticeable uptick in the filing of appraisal actions by stockholders – including entities set up solely for the purpose of 'appraisal arbitrage' – challenging transaction consideration. Time will tell whether these decisions and trends will result in fewer securities class action lawsuits, or just a shift in approaches by the plaintiffs' bar.

Tuttle: Accounting and financial reporting issues have always been prime targets for securities class action plaintiffs and appear poised to continue that historical pattern. Increasingly, however, plaintiffs with weak accounting-related claims are having success with claims of alleged misstatements concerning internal controls over financial reporting as almost any negative corporate event can be said

to have been caused by or to reveal weaknesses in internal controls. This can be the case even when an accounting or other reporting issue itself is not material, but the uncertainties it creates lead to a more significant decline in share price when it is announced. These claims are often paired with a theory that a defendant's alleged internal control weaknesses caused it to misrepresent the risk of a negative corporate event – for example, an adverse litigation result or a significant accident – and damaged the shareholder plaintiffs when the 'true' risk was revealed by the occurrence of the event.

Fumerton: Probably the most noteworthy securities litigation decision of 2015 was *Omnicare, Inc vs. Laborers District Council Construction Industry Pension Fund*. In that case, the Supreme Court held that an issuer may be liable for opinions in a registration statement under Section 11 of the Securities Act of 1933 if it does not genuinely hold the stated opinion or a fact offered in support of the opinion is itself materially false or misleading. The Supreme Court further held that an issuer may be liable for omitting material facts about an opinion if those facts 'conflict' with what a reasonable investor would understand the opinion statement conveyed regarding how the speaker formed the opinion. This decision affects the cost/benefit analysis for issuers in deciding whether, and to what extent, matters of opinion should be included in registration statements. If an issuer does decide to include such matters in a registration statement, it is critical to understand the litigation risks of doing so and take active steps to mitigate those risks.

CD: In your opinion, what has been the legacy impact of the *Halliburton vs. Erica John Fund* case? What lessons have been learned from the outcome of this case and disputes linked to the financial crisis?

Fumerton: When the Supreme Court accepted certiorari for a second time in *Halliburton*, many wondered whether the Court was prepared to do away with the 'fraud on the market' presumption of reliance, which would have made securities class actions impossible, or nearly impossible, to bring. In the end, the Court declined to do so but it did allow securities class action defendants to introduce evidence of lack of price impact at the class certification stage in order to rebut this presumption. The *Halliburton* Court also left certain issues open – for example, what this evidentiary rebuttal should look like or which party was to bear the burden of production and persuasion in this respect. Lower courts grappled with these issues in 2015 and there is a possibility that the *Halliburton* case could make its way to the Supreme Court for a third time to provide additional guidance. In electing to challenge price impact at the class

certification stage, defendants must weigh the risk of collateral damage going forward if the court grants certification – such as a hampered ability to use similar analysis on summary judgment to defeat reliance, materiality or loss causation, or in connection with settlement talks and mediation.

On the other hand, challenging price impact at the certification stage provides an avenue for defendants to obtain early appellate review under Rule 23(f).

Tuttle: Although significant for the proposition that the basic presumption of reliance can be rebutted by defendants at the class certification stage by showing that the alleged misrepresentation had no price impact, it still remains to be seen whether the *Halliburton* case will fundamentally alter the securities litigation landscape. The district court's recent decision in the case on remand from the Supreme Court gives some hope to defendants that it will, in fact, be possible to rebut the presumption and defeat reliance at the class certification stage. However, as erected by the Supreme Court and interpreted by the lower courts thus far, the barriers to such an outcome are high. For example, at the class certification stage, courts must assume as pled both the materiality of the alleged misrepresentations and the corrective nature of alleged corrective disclosures. Defendants can really only seek to rebut the presumption by meeting their burden to prove that the alleged misrepresentations had no price impact.

Herman: While the *Halliburton* decision was much more muted than some prognosticators predicted, it still provided hope that, in some circumstances, defendants would be able to knock out cases at the class certification stage with expert evidence demonstrating a lack of connection between an alleged misrepresentation and a price drop. To date, that really has not been borne out. More time and court decisions are needed to judge the legacy of *Halliburton* and, in the near term, the Eighth Circuit's review of the class certification order in the Best Buy litigation should provide some guidance.

CD: Are participation rates in securities settlements trending higher or lower, and what are the implications?

Fumerton: There is evidence to suggest that larger shareholders are opting-out of securities class actions more frequently, and data also suggests that the chance of opt-outs increases with the value of the class action. This can have significant implications for a defendant considering settlement, as individual opt-out actions can undermine the ability to secure a 'global peace' and requires the defendant to deal with multiple plaintiffs concerned with their own economic self-interest apart from that of the class.

Tuttle: We are not aware of any new trend in participation rates, but there is increased focused on these rates and their impact on settlement values. Given that historic participation rates have typically been significantly below 50 percent, defendants and insurance companies are increasingly pointing to these low participation rates in settlement negotiations as further reasons for discounting settlement values. This leads to

discounts from modelled plaintiff-style damages both for risks associated with the plaintiffs' ability to prove liability and damages and for the fact that, even if successful at trial, the actual out-of-pocket damages that defendants will pay are almost certainly significantly below the amounts modelled with a 100 percent participation rate.

CD: What general advice would you give companies defending against regulatory and federal securities class actions in the US? Are there any particular challenges that frequently arise?

Herman: Companies should keep calm and call their lawyer, followed by their insurance broker. Experienced counsel can help with crisis management and the preservation of data, two things that need to be addressed immediately. And as far as insurance, it is critical for companies to know what coverage they have and what limits may be in place, and to provide prompt notice. After that, companies should not make the situation worse, such as reflexively issuing categorical denials or speaking to the press without first conducting an investigation. The truth is, however, that every case is different. When facing regulatory investigations, there are often strong incentives to cooperate and sometimes companies may work collaboratively with regulators, particularly if it is in a heavily regulated industry. In the class action context, you don't get any points for cooperating with the plaintiffs.

Fumerton: To be sure, there is no one-size-fits-all approach to regulatory and federal securities class actions in the US, and hiring experienced outside counsel is critical. Challenges that frequently arise include whether and how to address confidential witness allegations, issues regarding alleged insider trading by corporate executives in advance of a purported corrective disclosure, and steps to ensure preservation of attorney-client communications while advancing an advice-of-counsel defence, among many others.

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Tuttle: Companies defending securities class actions today should really adopt a two-prong strategy for evaluating and responding to the claims. On one hand, they need to mount an effective defence to the litigation, including filing as comprehensive a motion to dismiss as possible, investigating allegations purportedly made by confidential witnesses, and preparing to manage the significant discovery that accompanies these cases. On the other hand, because most of these cases settle, companies must start the process of evaluating the potential settlement value of the case, discussing settlement issues with their D&O insurance carriers, and assessing plaintiffs' likely views on the case. It is important to pursue both of these paths in parallel because they each have an effect on a company's ability to effectively purse the other.

CD: In broad terms, how should parties go about assessing potential damages and evaluating the merits of a settlement?

Tuttle: Assessment of potential damages in a securities class action really requires the services of an experienced economic consultant. Because damages arise from the purchase of securities when allegedly misleading information causes the price to be inflated, a useful estimate of potential damages exposure depends on economic modelling of those share purchases, resulting turnover in the purchased shares, and the amount of alleged inflation present in the shares at different points in the alleged class period. Although these models can provide useful information on potential exposures, defendants must keep in mind that they do not provide actual

damages estimates because the true purchases, sales and participation rates cannot be determined until after trial.

Fumerton: Generally speaking, we find that it is often helpful to enlist expert consultants to assess potential damages in the securities class action context. There are a number of ways in which trading and price data can be used to parse a securities plaintiff's claimed damages and attempt to arrive at a reliable assessment of exposure. Additionally, experts can create event studies designed to disaggregate the impact of adverse information on stock price that is unrelated to the plaintiffs' alleged fraud. This not only gives the defendant a better view of potential liability but can also arm defence counsel with effective weapons to use in settlement negotiations and at mediation.

Herman: Information is critical to making an informed decision, and the more you know, the better. Sometimes, clients ask for an assessment early on, and it can be difficult to know whether the client faces significant damages without first understanding the liability exposure. In terms of sizing the case, we frequently work with experts to analyse potential damages. Sometimes, we will work with two experts – one who we anticipate using as our trial expert and one who serves only as a consultant and whose work, prepared at the direction of counsel, is better shielded from discovery.

CD: To what extent is technology playing a part in how securities class actions are conducted? To what extent can parties benefit from time and cost efficiencies?

Herman: One of the biggest issues we face is the ever increasing amount of data that needs to be preserved and reviewed for production. We rely on technology and our data experts for critical tasks, such as preserving email, instant messages, chats, voicemails, call recordings, and so on, helping provide an early assessment of the merits of a case, giving insight into data to allow for more effective negotiations with respect to scope of discovery, and using predictive coding and technology-assisted review to identify responsive documents.

Tuttle: The most significant development that we see in the conduct of securities class actions is the development and acceptance of improved electronic discovery processes, such as predictive coding and other document search and review tools. These technological tools enable parties, particularly defendants, to more efficiently process the vast amounts of electronic data now being sought in discovery, potentially lowering the cost and the burdens of document discovery. Reducing the costs and burdens of discovery potentially removes one element of leverage that plaintiffs have in pursuit of early settlements.

Fumerton: One significant advancement has been the rise in the use of document analytics in the context of e-discovery. Investigations and litigations can involve huge amounts of documentation, and predictive coding has been gaining increased acceptance as a viable way to identify relevant documents with less manual review. This can significantly decrease document review-related time and costs. Similarly, parties can now employ computer algorithms to classify and map large document universes in order to reveal patterns that may not necessarily be apparent based on a manual review. In fact, several courts have recently concluded that predictive coding is generally more effective than keyword searches in appropriate cases. We expect these new methods to continue to gain more and more acceptance by courts and litigants.

"Alternative dispute resolution techniques have always played a large role in resolving securities class actions, and we expect that trend to continue into the future."

Robert A. Fumerton,
Skadden, Arps, Slate, Meagher & Flom LLP

CD: Are you seeing alternative dispute resolution techniques being applied more often to resolve securities class actions?

Tuttle: Over the past 10 years, alternative dispute resolution has become a more prominent part of the resolution of securities class actions. Whether court-ordered or voluntary, mediation, in particular, is now a routine development and is often a tremendous help to both sides in assessing case values and findings ways to resolve more difficult cases. The tactics and strategies of mediators tend to differ between mediators and from case to case, but we have seen the market develop to the place where mediation is a common and expected development and something that defence counsel must plan and prepare for early in the case.

Fumerton: Alternative dispute resolution techniques have always played a large role in resolving securities class actions, and we expect that trend to continue into the future. While such techniques are not right for every case, a good mediator can regularly break through stalemates that may be impeding a reasonable resolution. Mediation is also often a helpful vehicle for assessing one's own case weaknesses without the downside of a binding judicial determination.

Herman: Mediation has been an important tool in resolving class actions for a long time, and we continue to see it as a very valuable approach. A competent mediator will bring in all parties, including the insurers who are often critical to any settlement.

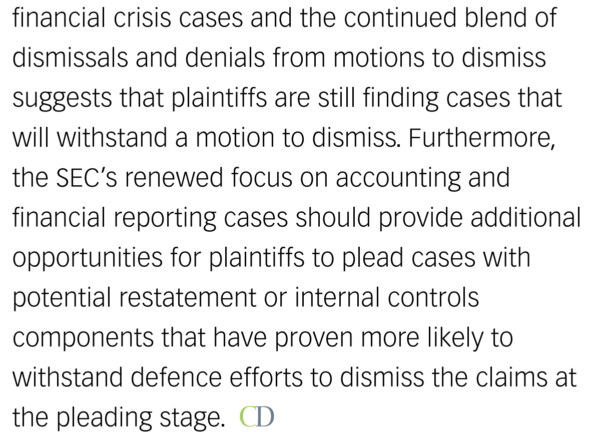
CD: Do you expect to see the number of US securities class actions increase over the next 12 months? What developments are likely to have an impact in this area?

Fumerton: We may see a general decrease in credit crisis-related securities litigation, as we have reached or are reaching the end of the statute of limitations for many such claims. In its place, we may continue to see increases in benchmark-related manipulation claims – for example, FOREX, LIBOR, US Treasury securities – and securities fraud claims regarding trend disclosure under Regulation S-K, Item 303. Additionally, recent increases in market volatility and declines in the energy sector may lead to more securities litigation activity as well. Separately, following the Supreme Court's decision in *Omnicare*, we may also see more opinion-based allegations by plaintiffs asserting securities claims.

Herman: Filings will stay stable or increase, but I am of two minds as to why that is likely to occur. One possibility is that the IPO and M&A markets

continue to heat up, and class actions tend to follow offerings and mergers. The second possibility is that the uncertainty of the world security situation, market turmoil in China, the elections or some other external factor will lead to a market correction here. When stock prices fall, class actions tend to follow.

Tuttle: We do not believe there is likely to be any significant departure from normalised levels of securities class actions in the near future. The return to these levels after the passing of the



financial crisis cases and the continued blend of dismissals and denials from motions to dismiss suggests that plaintiffs are still finding cases that will withstand a motion to dismiss. Furthermore, the SEC's renewed focus on accounting and financial reporting cases should provide additional opportunities for plaintiffs to plead cases with potential restatement or internal controls components that have proven more likely to withstand defence efforts to dismiss the claims at the pleading stage. CD