THE MERITS MATTER MOST AND OBSERVATIONS ON A CHANGING LANDSCAPE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

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I. THE MERITS MATTER ENORMOUSLY TO THE SIZE OF RECOVERY IN SECURITIES CLASS ACTIONS

Statistics varying all over the lot have been presented in the debate over the value of securities class actions and whether they genuinely compensate victims. Some say settlements represent in most instances less than 10% of damages. Others demonstrate numbers of over 25% up to 60% on average. Those pointing to the low percentages conclude that "the merits don't matter" and imply or state that only the class action plaintiffs' lawyers are well compensated. As a practitioner of more than twenty years in the field representing investors and investor classes, the merits matter enormously. As a participant in hundreds of settlement meetings, mediations and other conferences convened for the purpose of trying the resolve a securities class action, it is obvious that the merits not only matter, but are largely determinative of the size of a settlement, assuming an ability to fund a settlement.

Assuming a viable funding source (i.e. a solvent defendant and/or adequate insurance coverage), the most important factor affecting the size of the outcome is the strength of the factual claims. To properly analyze whether victims are being compensated reasonably in securities class actions, the most meaningful analysis is to look into the facts of the cases, not just statistics of results (settlement amounts) versus claimed damages.The biggest *legal* factor affecting the size of a settlement for relative damages is whether the claim is a § 11 claim requiring proof of only negligence or whether the claim is a § 10b claim and requires proof of scienter. Even a § 11 claim's result will turn largely on the factual strength of the case.

Once the motion to dismiss hurdle is passed by the plaintiffs, the parties are constantly assessing the impact of the facts on a potential jury. Questions being considered by the plaintiffs' lawyer are: Why did the defendants do it? Why did they issue the false or misleading statements? Defense counsel undoubtedly raise the same

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questions.

Cases in which there is an apparent motive for wrongdoing such as: (1) insider selling; (2) use of stock at inflated levels to acquire other companies; or (3) maintaining the illusion of success in order to attract new capital through public offerings or venture capital, are inherently viewed as stronger and will command higher settlement amounts absolutely and relative to assessed damages, assuming ability to pay. Cases where there is the lack of an apparent motive, other than receipt of fees by professionals, like accountants or underwriters, are generally more difficult to settle for significant amounts. The cases against accountants where there is lack of an apparent motive are difficult even where it can be demonstrated that audit work is shoddy or reckless and violates Generally Accepted Auditing Standards (GAAS) or Generally Accepted Accounting Principals (GAAP). Even § 11 claims, particularly against professionals like auditors and underwriters, are difficult to settle for significant sums without proof of an apparent motive.

Many cases turn on what the corporate executive officers really knew about the company's financial position during the fraud period. Where plaintiffs can demonstrate through documentation a knowledge of corporate problems and a divergence between what individual officers knew and what the corporation publicly said, plaintiffs will be able to negotiate a greater settlement relative to damages. Knowledge can sometimes be shown through a "smoking gun," but more often will be demonstrated through regularly generated corporate reports which numerically or textually show a negative trend different from what has been publicly portrayed. This again shows that the merits do matter in the relative size of the settlement, even where no motive is apparent except the psychological one of wanting to make one's self or one's company look better to the public, or covering up a personal or corporate disappointment.

The psychology of the plaintiffs' lawyer must be taken into account in evaluating the question of whether the merits matter in the size of a settlement relative to claimed damages. When the plaintiffs' lawyer knows he or she "has the goods," he will negotiate harder, hold out longer, and will go through all pretrial proceedings or trial if necessary to get a higher proportionate recovery relative to the damage evaluation. Conversely, sophisticated defense lawyers will usually know when plaintiffs don't "have the goods." There is always a certain amount of bluffing and posturing on both sides in connection with settlement negotiations, but how much to take and when to fold is definitely influenced by the perceived strength or weakness of the merits.

An increasingly popular technique currently being used by securities class action practitioners on both sides is the use of jury focus groups. Use of focus group exercises is another empirical example of the fact that the merits matter enormously to case resolution. These exercises are very expensive, ranging, depending on the scope of the project, from $20,000–$50,000. They are especially expensive for the plaintiffs' securities practitioners, who are operating on a contingent fee basis. These exercises are being used at the final pretrial stages not only to hone a trial strategy, but to realistically condition a settlement posture and strategy. The exercises are conducted by enactments of truncated presentations of plaintiffs' and defendant's cases to panels of individuals (the mock jurors) designed to reflect the applicable jury pool in the forum where the case would be tried. They are entirely merits-oriented.

Evaluation of damages versus settlement amounts is highly flawed as a means of criticizing securities class action settlements and evaluating the validity of securities class actions in compensating defrauded investors. As noted above, litigation risk, i.e., the evaluation of liability, is usually the biggest factor driving the settlement, assuming no ability to pay issues. Moreover, statistics used for claimed damages are highly suspect. The numbers used are either a market loss number and not a real damage number (which is normally substantially less) and are *the plaintiffs'* most optimistic figure. If the same studies took *defendant's* damage analyses, recoveries in class actions would appear to be huge percentages of loss. Defendants' damage analyses range from zero, where defendants claim even if liability exists there is no damage since there is no causation, to small fractions of what plaintiffs claim. Defendants use variants of a regression- type analysis in which it is claimed that a myriad of factors affect the price of the stock in question and have caused the decline in the stock price which marks the end of the class period. In defendants' analyses, when one eliminates the amount of price decline that purportedly comes from every other factor but fraud, the fraud induced damages are minuscule.

Experience has also shown that a large percentage of claimants, perhaps one third to one half, do not file claims, and thus the recovery amounts to investors who do file claims are greater than a straight comparison of damages to settlement. Finally, it is well known in private litigation that no one ever settles for 100 cents on the dollar or even close to it. If that were the norm, there would be few settlements. Securities class action plaintiffs' counsel are held to a higher standard than litigants in private cases, even though securities cases are more complex factually and legally than most other cases.

Regarding criticism on the observation that settlement size is almost always within the insurance coverage limits, if the defendant company is not particularly solvent, this is often the case. In such instances, plaintiffs will attempt to obtain an settlement ownership in the corporate defendant through some form of stock or security interest in addition to insurance funds. Where the corporate defendant is solvent, in most instances it contributes to a settlement anywhere from 10–50% of the ultimate amount agreed to, usually at the insistence of the insurance carrier. In the case of a solvent corporate defendant and a strong plaintiffs' case, the total settlement often goes above any coverage limits. Plaintiffs' counsel normally do not get into the allocation debate between company and carrier, since plaintiffs' concern is a global resolution at a targeted amount. This is often one of the thorniest issues in a negotiated settlement, and it sometimes rages on between corporate defendant and the officer and director insurance carrier even after a settlement has been agreed to with plaintiffs.

Size of insurance coverage does usually shape the final size of a settlement. Plaintiffs' counsel will often settle with officer and director defendants who are usually the most culpable defendants within policy limits because there is little incentive to refuse a bird in the hand and go outside policy limits. Even if individual defendants are very wealthy, the prospects for a plaintiff class action attorney of chasing down an individual's assets, especially where most property is owned jointly with a spouse, is in a foreign country, or is protected by a homestead law, is highly unappetizing. Often the wealthiest defendants are the venture capitalists who may be on the corporate board representing the venture capital source. Those defendants are the most removed from the day to day corporate activity and therefore might be the most difficult targets against whom to establish liability.

As Cox points out, insurance settlements are not to be discredited because: (1) innocent current corporate owners do not bear the liability burden; (2) insurance companies who pay are in the business of evaluating their risk levels when they sell premiums; (3) corporations who buy insurance are also evaluating their entity risk; and (4) the existence of insurance facilitates settlement to injured victims and shortens the life of a case which might otherwise be devoted to a multi-year search for a culpable individual's unencumbered assets.

II. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 HAS SIGNIFICANTLY CHANGED THE LANDSCAPE, BUT MERITORIOUS SECURITIES CLASS ACTIONS APPEAR TO BE ALIVE AND WELL

The procedural landscape has been dramatically changed by the Securities Litigation Reform Act of 1995 ("Reform Act").[1] The Reform Act has engendered both positive and negative changes. No cases have played out yet on the merits, since the Reform Act was passed just over a year ago, on December 22, 1995, but the author believes the stronger cases will be alive and well under the Reform Act. Set forth below are a practitioner's views on both the positive and negative aspects of the Reform Act and some observations of what has occurred during the early phases of its existence.

1. **The "race to the courthouse" has largely ended.** More time is being taken by counsel to investigate before filing and better complaints are being drafted. The *Wall Street Journal* of November 12, 1996 reports on a NERA (National Economic Research Associates, Inc.) study finding that in 1996 the average suit was filed sixty-three days after a company's stock dropped, versus forty-nine days during the same period in 1995.[2] However, some still perceive it advantageous to file the first case in federal court because of the Reform Act's twenty-day notice requirement, which is designed to provide investors with additional information about the litigation. The first plaintiff to file a securities class action is obligated under the Reform Act to disseminate to members of the proposed class a notice of the lawsuit informing potential class members that, within sixty days, they may move to serve as lead plaintiff.[3] Because the Reform Act creates a presumption that the person or group of

1. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67, 109 Stat. 737 [hereinafter Reform Act].

2. Dean Starkman, *Securities Class Action Suits Seem Immune to Effects of a New Law*, WALL ST. J., Nov. 12, 1996, at B7.

3. *See* Reform Act § 101(a) (codified at 15 U.S.C. § 77z–1(a)(3)(A) (1994 & Supp.

persons with the "largest financial interest in the relief sought by the class" are the "most adequate plaintiffs,"[4] the plaintiff's counsel publishing the notice may attract other shareholders who consult with and retain him, thus enhancing his position and enabling that law firm to become lead counsel.

2. **Slightly fewer suits are being filed in federal court, but more are being filed in state court, particularly in California.** The NERA study mentioned above reported that between April 1, 1996 and October 31, 1996, eighty-one securities class action suits were filed in federal court, which was about the same as in the comparable period in 1995.[5] Going back to the first ten months of 1996 compared to 1995, fewer suits were filed since the passage of the Reform Act—104 in 1996 versus 127 in 1995.[6] In state court, however, the trend is the opposite, with seventy-nine cases filed during the first 10 months of 1996 versus forty-eight during the same period in 1995.[7]

It is too early to evaluate how these suits will fare since the substantive issues are hardly developed yet. In the state courts, one key issue is whether national classes will be certified or will instead be limited to purchasers of the stock in question for that state alone. Whether classes will be certified at all in state court sometimes depends on whether a state's law allows that reliance need not be proven, but rather that a presumption of reliance can be applied as it is in the federal courts, or whether the relevant state statute eliminates the reliance requirement.

In the federal courts, there are only six decisions as yet on motions to dismiss.[8] Of the six decided, regardless of outcome, five out of six applied a legal analysis similar to that used by the Second Circuit or other circuits pre-Reform Act. With respect to Section 10(b)'s scienter requirement, all but one decision holds that the Second Circuit's "strong inference of fraud" standard is still in effect.

In *Marksman Partners, L.P. v. Chantal Pharmaceuticals*,[9] decided in the Central District of California, the complaint was upheld applying the pre-Reform Act "motive and opportunity" test employed in the Second Circuit. In *Chantal*, significant insider selling, which had occurred in the period in question, but not during the three prior years, was considered important to pleading scienter.[10] The court rejected arguments that the Reform Act's pleading standards—set forth in the new Section 21D(6)(2) of the Securities and Exchange Act of 1934—had abolished liability for reckless

I. 1995)); *id.* § 101(b) (codified at 15 U.S.C. § 78u-4(a)(3)(A) (1994 & Supp. I. 1995)).

4. *See id.* § 101(a)(3) (codified at 15 U.S.C. § 77z-1(a)(3)(B)(iii) (1994 & Supp. I. 1995)); *id.* § 101(b) (codified at 15 U.S.C. § 78(a)(3)(B)(iii) (1994 & Supp. I. 1995)).

5. Starkman, *supra* note 2, at B7.

6. *Id.*

7. *Id.*

8. *See* Rehm v. Eagle Finance Corp., No. Civ.A 96-C-2455, 1997 U.S. Dist. LEXIS 767 (N.D. Ill. Jan. 28, 1997); Marksman Partners, L.P. v. Chantal Pharm. Corp., 927 F. Supp. 1297 (C.D. Cal. 1996); Zeid v. Kimberly, 930 F. Supp. 431 (N.D. Cal. 1996); *In re* Silicon Graphics Inc., Sec. Litig., No. Civ.A C-96-0393, 1996 WL 664639 (N.D. Cal. Sept. 25, 1996); Fischler v. AmSouth Bancorporation, 1996 WL 686565 (M.D. Fla. Nov. 14, 1996); STI Classic Fund v. Bollinger Indus. Inc., No. CA 3: CV-0823-R, (N.D. Tex. Nov. 12, 1996).

9. 927 F. Supp. at 1297.

10. *Id.* at 1312-13 n.9.

misconduct. The *Chantal* court held that "there is no basis to conclude that Congress eradicated...the well-established motive and opportunity test for examining scienter pleadings in Section 10(b) and Rule 10b–5 cases," with enactment of Section 21D(b),[11] and that "[t]he legislative history of the [Reform Act] does not indicate that Congress acted to eliminate recklessness as a basis for scienter in actions like the instant one," which was based on accounting violations.[12]

By contrast, in *In re Silicon Graphics Inc., Securities Litigation*,[13] decided in the Northern District of California, the case was dismissed despite massive insider selling. The court applied a stricter standard of scienter than ever before applied, requiring actual facts to be pled which set forth a conscious intention to defraud.[14] The court expressly held that the Reform Act intended a stricter standard of scienter than the Second Circuit's previously required "strong inference of fraud."[15]

Four other cases decided, *Zeid v. Kimberly*,[16] in the Northern District of California, *STI Classic v. Bollinger Industries, Inc.*,[17] in the Northern District of Texas, *Fischler v. AmSouth Bancorporation*,[18] in the Middle District of Florida, and *Rehm v. Eagle Finance Corp.*,[19] in the Northern District of Illinois, applied the law regarding scienter as it would have been applied pre-Reform Act. In *Zeid*,[20] the court held that under the Reform Act, consistent with Second Circuit law, "[a] plaintiff can allege 'facts' constituting circumstantial evidence of either reckless or conscious behavior, or facts establishing a motive to commit fraud and an opportunity to do so," in order to raise a strong inference of scienter.[21] In *Bollinger*,[22] the court endorsed the *Chantal* court's interpretation of the provisions of the Reform Act as "persuasive."[23] In *Fischler v. AmSouth Bancorporation*,[24] the court held that the complaint met the requirements of Section 21D(b)(3)(A) of the Reform Act based on allegations showing motive and opportunity.[25] And most recently, in a comprehensive discussion of the legislative history and purpose of the Reform Act, the court in *Rehm v. Eagle Finance Corp.*[26] concluded that Congress did not adopt a scienter pleading requirement more rigorous than the Second Circuit's strong inference of fraud standard.[27]

11. *Id.*
12. *Id.* at 1309.
13. 1996 WL 664639 at *1.
14. *Id.* at *6.
15. *Id.* In reaching this conclusion, the court in *Silicon Graphics* relied on President Clinton's comments regarding the Statement of the Managers accompanying the Conference Committee Report on the Reform Act, which the President relied on to veto the bill.
16. 930 F. Supp. 431 (N.D. Cal. 1996).
17. No. CA 3:96–CV–0823–R, slip op. (N.D. Tex. Nov. 12, 1996).
18. 1996 WL 686565 (M.D. Fla. Nov. 14, 1996).
19. 1997 U.S. Dist. LEXIS 767.
20. 930 F. Supp. at 431.
21. *Id.* at 438.
22. No. CA 3:96–CV–0823–R, slip op. (N.D. Tex. Nov. 12, 1996).
23. *Id.* at 2.
24. 1996 WL 686565 at *1.
25. *Id.* at *3.
26. 1997 U.S. Dist. LEXIS 767 at *1.
27. *Id.* at *18.

3. **The Reform Act produces great delay in getting the case moving to the merits.** Under the Reform Act, the early notice to potential class members must be filed twenty days after the first complaint is filed.[28] The notice allows sixty days for applications to be made for lead plaintiff,[29] and the lead plaintiff, once selected, hires lead counsel subject to court approval.[30] The Reform Act provides that the court should select lead plaintiff and lead counsel by ninety days, provided consolidation has occurred.[31]

It often takes even longer than ninety days for the court to select lead plaintiffs and lead counsel, especially if there are competing applications.

Moreover, discovery is automatically stayed under the Reform Act pending resolution of a motion to dismiss,[32] which is almost invariably filed. The Ninth Circuit, in *Medhekar v. United States District Court*,[33] recently decided that the Reform Act's automatic stay provisions even supersede the mandatory disclosure requirements of Federal Rule of Procedure 26.[34] Practically speaking, this means a total of 90–120 days to choose lead plaintiffs and lead counsel, 30–45 days thereafter to file a consolidated amended complaint, and at least ninety days to complete motion to dismiss briefing. Thus, the motion to dismiss is not ripe for decision, optimistically, until eight months after the case begins. The court's decision time on a motion to dismiss is uncertain, but even if a judge decides in one month, it will be a minimum of nine months from the filing of the complaint before discovery can even start. This represents a much greater delay than existed before.

4. **Institutional investors and large individual investors are coming forward and bringing class actions, which they rarely ever did before.** These institutions sometimes do emerge from the notices to shareholders disseminated pursuant to the "lead plaintiff" provisions of the Reform Act. In several instances the institutions are hiring traditional plaintiffs' class action lawyers, but in at least one known case, *Gluck v. CellStar*,[35] such clients hired a traditional defense firm to represent them and the court knocked out the traditional plaintiffs' firm as co-lead counsel, rejecting the plaintiffs' firm's argument that large as well as small investors should be represented on the leadership team.[36]

It remains to be seen whether the presence of institutional investors as securities class action plaintiffs will make a difference to the results obtained. However, based

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28. Reform Act § 101(a) (codified at 15 U.S.C. § 77z–1(a)(3)(A) (1994 & Supp. I. 1995)); *id.* § 101(b) (codified at 15 U.S.C. § 78u–4(a)(3)(A) (1994 & Supp. I. 1995)).

29. *See id.*

30. *See* Reform Act § 101(a) (codified at 15 U.S.C. § 77z–1(a)(3)(B)(v) (1994 & Supp. I. 1995)); *id.* § 101(b) (codified at 15 U.S.C. § 78u–4(a)(3)(B)(v) (1994 & Supp. I. 1995)).

31. *See id.* § 101(a) (codified at 15 U.S.C. § 77z–1(a)(3)(A), (B)(i),(B)(iii) (1994 & Supp. I. 1995)); *id.* § 101(b) (codified at 15 U.S.C. § 78u–4(a) (3)(A),(B)(i),(B)(iii) (1994 & Supp. I. 1995)).

32. *See id.* § 101(a) (codified at 15 U.S.C. § 77z–1(b)(2) (1994 & Supp. I. 1995)); *id.* § 101(b) (codified at 15 U.S.C. § 78u–4(b)(3)(c)(i) (1994 & Supp. I. 1995)).

33. 909 F.3d 325 (9th Cir. 1996).

34. *Id.*

35. C.A. No. 3:96 Civ. 1353–R (N.D. Tex. May 14, 1996).

36. *See id.* The *CellStar* court did not issue a written opinion.

on the thesis that the key factors determining settlement size are the strength of the merits and the defendant's ability to pay, it is unlikely that the presence of large institutional or individual investors with sizeable financial stakes in the outcome will increase the size of the recoveries relative to claimed damages. Plaintiffs' counsel have always had, and still have a huge incentive to generate the largest settlement possible, so it is not clear that the presence of financially sophisticated, larger plaintiffs will change the dynamics materially. On the other hand, large sophisticated plaintiffs may force class counsel to demand higher percentage recoveries than previously experienced or force plaintiffs' counsel to takek more cases to trial or near trial.

Finally, these issues will have to be revisited in a year or two when the Reform Act has had a chance to play out on the federal court litigation screen. It is clear that that screen has some new technology and twists never seen before, while many of the of the old dramas continue to blaze.