

Overview of Securities Class Actions

By Doug Greene



Just the idea of securities class actions makes businesspeople uncomfortable. These cases accuse good people of defrauding investors in their company's stock, and they seek large theoretical damages. But virtually every case follows a predictable course and is manageable with the right approach.

This short guide provides tips on initial steps a company should take when it is sued, an overview of the law, and the procedural course and timeline of a typical securities class action.

What Should a Company's First Steps Be After Being Named as a Defendant in a Securities Class Action?

There are a number of practical steps a company should take as soon as it is named as a defendant in a securities class action complaint. With guidance from securities litigators, the company should consider taking some of these steps even before a lawsuit is filed.

1. Notify the D&O Insurance Carriers

As soon as a securities class action is filed, a company should notify its insurance broker, which will then provide notice to the company's D&O insurance carriers. This is important not only to secure coverage but also to allow companies to take advantage of the guidance D&O insurers and brokers can provide in helping to defend claims. D&O insurers and brokers are repeat players in

securities litigation, and they have the greatest economic interest in the outcome – both overall and in individual cases. A victory for the defendants is a victory for them. They employ highly experienced claims professionals, many of whom have been involved in exponentially more securities class actions than even the most experienced defense lawyers. And if they are involved throughout the litigation, starting with defense counsel selection, it will be easier to get them on board when important strategic decisions need to be made, such as whether to settle a claim and for how much.

Companies should commence this collaboration as the very first step in defending a claim – *even before engaging defense counsel*. Not all securities class actions are alike, and a company should

carefully evaluate and interview a number of lawyers to find the right one for their case. Experienced insurance professionals are an excellent source of information in this process.

2. Notify the Board and Auditors

A securities class action is an important event with potentially serious consequences, and it is crucial to get the board involved in the process from the beginning. Often the board will conduct or oversee defense counsel interviews and ultimately make the hiring decision. The board always should be given the opportunity to be involved in selecting defense counsel after a full briefing about the litigation and the selection process that management, the D&O insurers, and the insurance broker recommend.

3. Select the Right Defense Counsel

Selecting the right defense counsel is the most important strategic step in the successful defense of a securities class action. When sued, companies are inundated with solicitations from defense lawyers – including their regular outside counsel – all claiming to be the best choice, and it can be difficult for companies to evaluate lawyers.

We recommend to all companies that they select three to five lawyers to interview and, as noted above, ask their D&O insurers and broker to help them identify the right lawyers. It can be a significant strategic mistake to hire the company's regular outside counsel or another firm the company knows well without comparison shopping.

4. Initiate a Document Hold

Another important early step for the company (whether it's being sued or becoming aware that litigation may be commenced) is to issue a document preservation notice to the relevant people on its staff, directing them to immediately prevent potentially relevant documents from being destroyed. This notice should go not only to key directors, officers and employees involved in the issues that are implicated by the litigation but also to any departments (e.g., information technology and human resources) that may routinely manage documents and data.

Even though discovery may be a long way off – and hopefully will never occur – a company and its officers can be subject to serious sanctions if they fail to take steps to preserve documents.

5. Potentially Issue Public Communications

The company should consult an attorney to consider whether communications about the case, such as a press release or an attempt to reach out to current and former employees, would be appropriate. These actions may be advisable, but they should also be undertaken with care, as they may have important consequences for the looming litigation.

What Is a Securities Class Action?

Most companies and their directors and officers have never faced a securities class action and thus never had to learn firsthand about

securities litigation. It is important for companies that have been sued to understand the basics so they can make the decisions discussed in the previous section and work through the litigation with their defense counsel and D&O insurers and broker.

1. Overview

A securities class action asserts that the defendants made false or misleading public statements. The theory of the lawsuit is that the allegedly false statements made the stock price higher than it should have been and that when the alleged “truth” came out about those statements, the stock price dropped to its “true” value. The proposed class period usually begins at the time of the first alleged false or misleading statement and ends when plaintiffs allege the “truth” was revealed.

A securities class action can be based on allegedly false statements made in documents released pursuant to a public stock offering or during the course of other required or customary statements to the market. These include press releases, earnings releases, conference calls, and all filings made with the Securities and Exchange Commission (SEC).

Claims based on required or customary reports to the market are typically asserted under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder. These claims require proof of the defendants' intent to defraud, known as “scienter.”

Claims based on offering documents are typically asserted under Section 11 and Section 12 of the Securities Act of 1933. These claims impose lower standards for liability – most notably the lack of a requirement that the plaintiffs show scienter.

a. 10(b) Claims

For claims under Section 10(b) – the most common claim in a securities class action – plaintiffs are required to prove the following key elements:

1. That a defendant made a materially false statement or a statement that was rendered materially misleading because of an omission.
2. That the statement was made with scienter.
3. That the statement caused plaintiffs to suffer a loss through a drop in the value of their company stock after the market discovered the “truth.”

To show scienter, plaintiffs do not need to show that defendants had actual knowledge of the falsity of a statement but rather only that the defendants were “reckless” as to the falsity. The degree of recklessness that plaintiffs must show varies among the courts.

Plaintiffs also are not required to show that they specifically relied on a particular statement in purchasing stock. Instead, they may invoke the “fraud on the market” doctrine, which presumes that in an efficient market, the market price reflects (and thus “relies” on) all publicly available information about a company, including any allegedly fraudulent statements.

b. Section 11 Claims

For claims under Section 11 of the Securities Act of 1933 – the most common claim in the context of an initial public offering or secondary offering – plaintiffs must establish that:

1. They bought securities that are traceable to the offering.
2. The registration statement at issue contained a material misrepresentation or omitted a fact that rendered the statement materially misleading or that was otherwise required to be disclosed.
3. Plaintiffs suffered damages as a result.

A Section 11 claim is distinct from a Section 10(b) claim because Section 11 plaintiffs do not need to demonstrate that the defendants acted with scienter. However, directors and officers (but not the company) can assert the defense that they took reasonable care with respect to the challenged disclosure.

In addition, instead of plaintiffs carrying the burden of proving loss causation – as is the case under Section 10(b) – defendants in a Section 11 claim have the burden of proving that the misrepresentation or omission did not cause plaintiffs any damages. This is called “negative causation.”

Finally, plaintiffs in a Section 11 claim generally are not required to prove actual reliance on the statement, but defendants may be able to defeat a claim if they can show that the plaintiffs were aware of the “truth” behind the allegedly misleading statement when they purchased stock.

c. Private Securities Litigation Reform Act

In 1995, Congress enacted the Private Securities Litigation Reform Act (the Reform Act), designed to protect companies from the high costs stemming from frivolous securities class actions. Among other things, the Reform Act:

- Imposed strict pleading standards for showing falsity and scienter.
- Created a safe harbor for forward-looking statements.
- Created procedures for selecting a lead plaintiff with a substantial financial stake in the litigation.
- Imposed an automatic stay of discovery until the motion-to-dismiss process is resolved.

The Reform Act has had a significant effect on the way securities class actions are litigated and has provided defendants with meaningful protections. Because of the strict pleading standards, the safe harbor and the discovery stay, there is a substantial opportunity to gain early dismissal of many securities actions, allowing companies to dispose of a case before they incur the significant costs and other burdens of discovery. (Consistent with law governing spoliation of evidence, the company still must preserve relevant documents during the discovery stay.)

2. Related Issues That May Arise with a Securities Class Action

a. Related Derivative Lawsuits

Companion, or “tag-along,” derivative lawsuits arising out of the same events as a securities class action have become routine. In such an action, a current shareholder of the company files a suit ostensibly on behalf of the company, seeking damages against the company’s officers and directors for the harm allegedly suffered by the company as a result of their failure to prevent the underlying conduct alleged in the securities class action.

Typically, the main damages a derivative plaintiff seeks to recover on behalf of the company are the defense costs that the company incurs as a result of the securities class action, as well as any settlement or judgment amount.

The derivative plaintiff also will seek to recover the proceeds from any improper insider stock sales by directors or officers, and may seek payment for alleged harm to the company’s reputation and goodwill (pejoratively called a “liar’s discount”) resulting from the filing of the securities class action.

The law of the company’s state of incorporation governs the legal issues in a derivative case. That law typically requires that shareholders either make a “demand” on the board to commence litigation before they may do so themselves or demonstrate that such a demand would be futile (e.g., because there were not enough disinterested board members to fairly evaluate the demand). Many companion derivative cases are subject to a motion to dismiss on the grounds that these demand requirements have not been met. Such motions often are successful and dispositive. Derivative actions also are often subject to a stay pending developments in the securities class action, either by agreement or by motion.

In advance of filing a derivative action, a stockholder may seek books and records under corporate law. In Delaware, the basis for this request is Delaware General Corporation Law Section 220. Corporate law encourages books-and-records demands, but they involve expense and can undermine the Reform Act’s discovery stay.

Absent dismissal, derivative litigation can often be settled alongside the related class action. However, these actions can sometimes present complicated and expensive substantive and procedural issues. Derivative actions may also present unique issues with respect to legal representation and insurance coverage, both of which we address below. Thoughtful coordination of class actions and related derivative matters is among the most important and strategically complex work we do as securities defense counsel.

b. SEC Investigations or Actions

The same types of alleged false or misleading statements that can result in securities class action litigation may also prompt an investigation by the SEC, which can bring civil actions in federal court or before an administrative law judge or may result in a recommendation for criminal enforcement by the U.S. attorney’s office.

When the SEC commences an investigation, it typically begins with an informal investigation in which it has no formal subpoena power but instead relies on the cooperation of the relevant parties to provide information. The SEC staff may choose to close the matter following the informal investigation or proceed with a formal investigation, which empowers the SEC to issue subpoenas for documents and testimony. While circumstances vary, we often recommend cooperation with the SEC during the informal stage of the investigation, which may help convince its staff that there is no need to proceed with a formal investigation because they have been able to obtain the necessary information informally.

When the SEC staff concludes its informal or formal investigation, it may decide to take no further action, or it may recommend that the SEC commence enforcement proceedings. If the latter, the SEC provides prospective defendants with a “Wells notice” informing them of its intention to bring an enforcement action. The company then has the opportunity to respond to the Wells notice, explaining to the commission why no enforcement proceeding is justified. If the SEC chooses to proceed, it may do so either in federal court or through administrative proceedings.

What Are the Procedural Steps in a Securities Class Action?

Securities class actions proceed along the following path.

1. The Court Selects a Lead Plaintiff

A securities class action starts like any other action, with the filing of a complaint by a plaintiff. But the procedure is unique after that. The Reform Act mandates that the first plaintiff to file a securities class action must publish a press release giving notice of the lawsuit and advising absent class members that they can seek to be selected as the “lead plaintiff” by filing a motion with the court within 60 days of the press release.

The Reform Act provides that the “presumptively most adequate lead plaintiff” is the one who “has the largest financial interest in the relief sought by the class” and otherwise meets the requirements of Rule 23 of the Federal Rules of Civil Procedure, which governs class actions. That plaintiff will become the lead plaintiff unless a competing plaintiff rebuts the presumption. The court then approves the lead plaintiff’s choice of counsel.

This procedure has resulted in a regular flurry of additional press releases by plaintiffs’ law firms trying to recruit the “best” prospective lead plaintiff so that they can then be the lead plaintiff’s counsel. Additional plaintiffs will often file their own complaints in advance of the 60-day deadline, or they may simply file a motion to become lead plaintiff at the deadline.

Although Congress designed this procedure to stop the “race to the courthouse” and create greater coordination among

competing plaintiffs’ firms, the many press releases plaintiffs’ firms publish can create harmful confusion among employees, customers, and investors who aren’t familiar with the process.

Defendants do not generally have standing to participate in the lead plaintiff process, which means that they sit largely on the sidelines of the dispute for the first three months after a complaint is filed. This has the side benefits of giving defendants time to select defense counsel and of allowing counsel to get up to speed on the case before active litigation begins.

2. The Lead Plaintiff Files a Consolidated Complaint

The initial complaints filed before the lead plaintiff is selected are usually placeholders, and they are almost always too vague and conclusory to satisfy the Reform Act’s pleading requirements. Plaintiffs’ attorneys have little incentive to go through the time and expense of drafting a comprehensive and detailed complaint until they know whether they will be selected to be the lead plaintiff’s counsel.

The Reform Act provides that the various initial actions will be consolidated and, following appointment of the lead plaintiff and the lead plaintiff’s counsel, plaintiffs’ counsel will prepare a consolidated complaint, which is almost always longer and more detailed than the initial complaints.

To attempt to plead the degree of factual detail that the Reform Act requires, plaintiffs’ counsel routinely searches for – and often finds – disgruntled former employees to provide plaintiffs with internal information about the company. This internal information usually consists of internal documents and oral accounts from so-called confidential witnesses or confidential informants.

Although it can be uncomfortable for a company to read unfair allegations based on alleged interviews of its former employees, the law gives defendants tools to attack the allegations, even on a motion to dismiss.

3. The Defendants File a Motion to Dismiss

After plaintiffs file their consolidated complaint, the defendants have an opportunity to file a motion to dismiss the claim for failure to meet the Reform Act’s stringent pleading standards. To survive a motion to dismiss, a claim brought under Section 10(b) must specify each statement alleged to have been misleading and cite detailed facts indicating why the statement was allegedly misleading.

Similar pleading standards apply to allegations of false statements brought under Section 11, if those allegations “sound in fraud.” In addition, the specific facts pleaded in a Section 10(b) case must give rise to a strong inference that one or more defendants acted with scienter. The Supreme Court, in *Tellabs*¹, held that the court must evaluate allegations of fraud against exculpatory facts and inferences.

¹-*Tellabs, Inc. v. Makor Issues & Rts., Ltd.*, 551 U.S. 308, 309 (2007).

Claims brought under both Section 10(b) and Section 11 may also be dismissed under the Supreme Court's *Omnicare* decision² and the Reform Act's safe harbor for forward-looking statements. Under *Omnicare*, a statement of opinion is not false if the speaker genuinely believed it, and it is not misleading unless omission of particular facts would make it misleading to a reasonable investor reading it fairly and in its full context. Under the safe harbor, a forward-looking statement, such as a prediction or forecast, cannot be the basis for liability if it is (1) properly identified as a forward-looking statement and accompanied by meaningful cautionary statements that identify important facts that could cause actual results to differ materially from the prediction, (2) immaterial, or (3) made without actual knowledge of its falsity.

Omnicare and the Reform Act's heightened pleading standards, including *Tellabs* balancing requirement, and the safe harbor have made the motion-to-dismiss process a significant event in a securities class action such that many actions, if handled properly, can be dismissed before any discovery is taken.

It is common, however, for a judge to grant leave for the plaintiffs to amend their complaint following a dismissal, giving plaintiffs at least two chances to meet the Reform Act's stringent standards. As a result, defendants may need to go through multiple rounds of briefing before getting an action finally dismissed or, if the effort is unsuccessful, moving to the next phase of the litigation.

4. The Plaintiffs Seek Class Certification

Plaintiffs in securities class actions purport to bring claims on behalf of all persons who purchased securities of the company during the proposed class period. But the filing of a class action complaint does not suffice to make a lawsuit a class action. Before a case can proceed as a class action and before the plaintiffs can represent a proposed class, the court must certify that proposed class. The motion for class certification is usually filed fairly soon after a complaint survives a motion to dismiss.

Class certification is the first opportunity for defendants to attempt to rebut the "fraud on the market" presumption of reliance, which holds that in an efficient market, purchasers (or sellers) rely on the price of the stock. Defendants may attempt to show that the market for the security was inefficient and/or that one or more of the challenged statements did not impact the stock price. Defendants may also attempt to show that plaintiffs cannot prove a classwide theory of damages, such as when there are multiple alleged disclosures revealing the "truth." These and other defense arguments can prevent certification entirely or, more often, significantly narrow the case moving forward by limiting the class period and/or claims.

5. The Parties Proceed to Discovery

Discovery is a significant burden on the company defendant. In securities class actions, the discovery burden only runs in one direction, as there is usually little or no discovery for defendants to take from the representative plaintiffs that could affect the outcome of the case. Plaintiffs often use these burdens to prompt settlement and take advantage of defendants' document-preservation mistakes.

Plaintiffs begin discovery by serving a broad and burdensome set of document requests. Experienced defense counsel typically are able to work with plaintiffs' counsel to narrow the scope of these requests. Defense counsel then work closely with the company and relevant employees, including the IT group, to gather the requested documents.

After their document requests, plaintiffs' counsel frequently issue one or more sets of interrogatories, which often seek extensive, detailed information from the company and require the company's employees to work closely with defense counsel in order to formulate answers.

Depositions then follow. While this process is time-consuming, experienced defense counsel can usually strike the right balance of defending the case zealously and thoroughly and allowing senior management to maintain their focus on running the business.

6. Experts Are Engaged to Testify on Damages and Other Issues

Most securities class actions involve the reports and testimony of experts on issues specific to the subject matter of the challenged statements. In all cases, defendants engage economists to assist with class certification and damages analysis.

In simplistic form, the damages for a securities class action are estimated by looking at the difference between the price of the company stock at the time it was allegedly inflated by the allegedly false statement(s) and the value of the stock after it fell when the market supposedly learned the "truth." In practice, this estimation is complicated by a number of variable and complex factors, and the subject of damages is the focus of intensive expert analysis and testimony on subjects such as the amount of artificial inflation in the stock price and the number of shares that should be subject to the damages calculation.

7. Defendants May File Motions for Summary Judgment

After the close of fact and expert discovery, defendants usually file a summary judgment motion arguing that plaintiffs have failed to find through discovery the facts that are necessary to support the elements of their claims. Plaintiffs sometimes file cross-motions for summary judgment to attempt to establish elements of their claims. It can be difficult to obtain complete dismissal of a securities class action on summary judgment; many of the issues are fact-intensive and contextual, and when an important factual question is genuinely in dispute, a judge will rule that it must be resolved at trial.

But a summary judgment motion can play an important strategic role in an action even if it does not seek complete dismissal of the case. For example, defense counsel can seek dismissal of particular claims or of certain defendants, or they can argue that the class period should be shortened, thus simplifying the action for trial and reducing potential damages.

8. The Case Proceeds to Trial

For a variety of reasons, securities class actions have historically gone to trial only rarely. It is nonetheless important to staff and

²-*Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 575 U.S. 175 (2015).

defend the case from the beginning under the assumption that a trial will be necessary for resolution. Good trial preparation focuses defense work on the most important strategic components, increases the chances of success on a summary judgment motion, and puts the defense in a superior position for settlement discussions.

How Does the Settlement Process Work?

The vast majority of cases that survive a motion to dismiss are settled at some point in the process.

Nearly all securities class action settlements occur in connection with a mediation session conducted by a neutral mediator. Today there is a small group of highly experienced mediators who regularly conduct securities class action mediations.

The best time to mediate varies by case. Historically, mediation occurred after discovery and either shortly before or during the summary judgment motion process. In recent years, however, mediation increasingly occurs after the motion to dismiss and before discovery. This means that the vast majority of cases that survive a motion to dismiss now settle before the defendants and their insurers understand the real settlement value of the claims. It also means that the defendants leave two more grounds for dismissal – class certification and summary judgment – on the table.

It occasionally makes strategic sense to mediate a case even while the motion to dismiss is pending. But given the Reform Act's high pleading standards, it nearly always makes sense to defend the litigation through the motion to dismiss process.

Managing the complex dynamics among the plaintiffs, defendants, and insurers at mediation is one of a securities defense lawyer's most important jobs. The various interests of all three parties are often in tension, and identifying these interests and working with all parties in a particular case requires great judgment and skill.

But a defense attorney's most important work toward achieving a satisfactory settlement begins long before the mediation, with the following:

- Creating good working relationships with the company's insurers from the very beginning.
- Providing the defendants and the insurers with a realistic assessment of the strengths and weaknesses of the case.
- Conducting the defense in such a way that plaintiffs' lawyers know that defendants are ready and willing to go to trial if an acceptable settlement cannot be reached.

Conclusion

Securities class actions are indeed daunting. But they follow a predictable course and typically can be dismissed or resolved without much real risk to the company or its directors and officers if the company, with its board's involvement, selects the right defense counsel for the case and works in a coordinated way with its D&O insurers and broker.

Securities and Governance Litigation Team

Our nationwide team of more than 50 attorneys comprises full-time securities litigators, former SEC and Department of Justice enforcement trial lawyers, and prominent commercial litigators. Our turnkey team features the full skill set our clients need to win at each stage of the litigation.

We are devoted to winning every case at the earliest possible time. We have an excellent track record of obtaining dismissals prior to any discovery. But if the case survives a motion to dismiss, we don't just throw in the towel; we stand ready to defeat or limit class certification, prevail on summary judgment, and take the case to trial. We are committed to putting "litigation" back in securities and governance litigation.

Of course, we are always attuned to the right time to engage in mediation. Litigating to win – up to and including trial, if necessary – best positions our clients to achieve settlements that protect their reputations and resources. Through decades of experience, we have gained the respect of key mediators, plaintiffs' counsel, and D&O insurers and brokers. These relationships are critical to effective mediation of securities and governance cases.

We also are sensitive to the economics of each case. We have the ability to scale our team and approach to defend every case both efficiently and effectively. We also are highly experienced in the use of document-processing technology to handle discovery documents and help marshal key facts, which leads to significant efficiencies.

All of this is about protecting people. At the core of every securities or governance case are people accused of doing something wrong – not just directors and officers but also hardworking company employees who find themselves at the center of a securities suit. We focus our defense of each case on these people. From designing legal arguments that defend their honesty to client-focused economics that maximize their insurance protection to sensitivity to the stress the litigation may cause them, we work hard to protect people and keep them as comfortable as possible. This is our top priority in every case and at the heart of everything we do.

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