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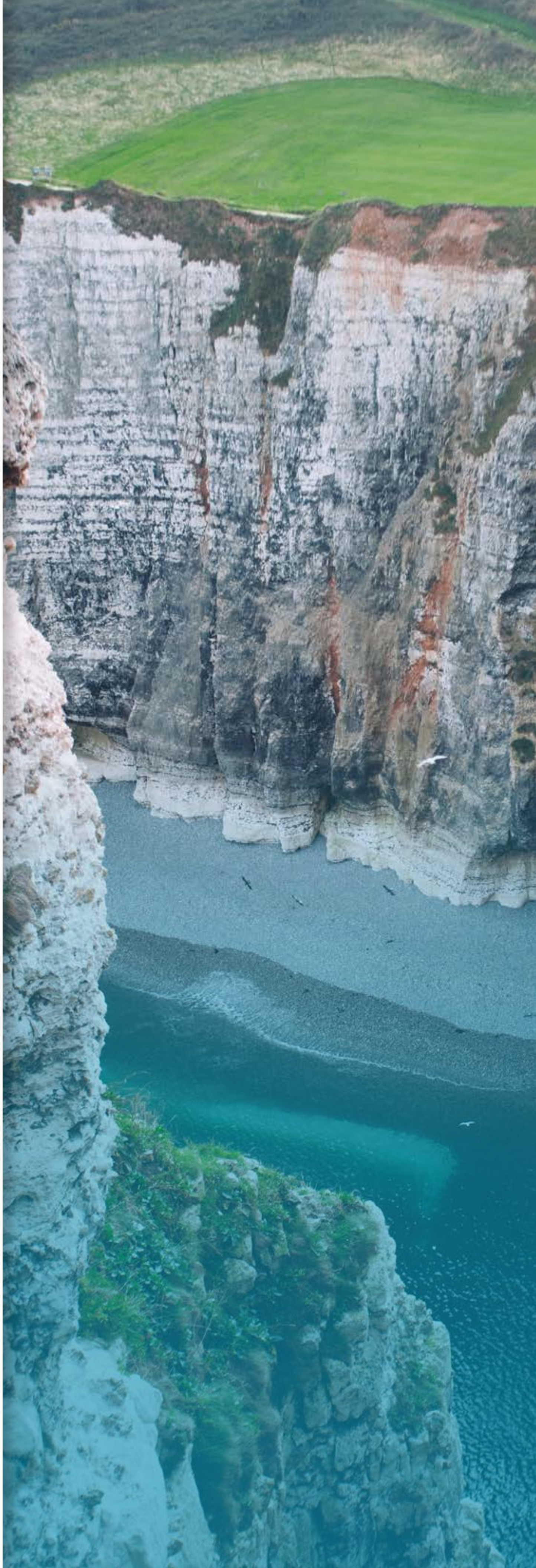
A FREE-MARKET SOLUTION TO MERITLESS SECURITIES LITIGATION

BY: DOUG GREENE AND RANDY HEIN

Meritless securities litigation is an economic externality that should be eliminated.

The federal securities laws should protect shareholders from losses caused by their company's directors' and officers' violation of securities laws. However, fueled by contingency fee arrangements, litigation funders, fear of a possible run-away-jury verdict and availability of D&O insurance, our system for enforcing securities laws today often allows shareholders' *counsel* to be compensated by *D&O carriers* in situations where directors and officers did not violate securities laws. The real beneficiaries of such litigation are the plaintiffs' lawyers. Ironically, the cost of this unnecessary litigation is borne by shareholders in the



form of elevated D&O insurance premiums. Meritless securities litigation is an economic externality that should be eliminated.

Congress attempted to curb frivolous securities class actions through legislation, most notably through the Private Securities Litigation Reform Act of 1995 ("Reform Act") and the Securities Litigation Uniform Standards Act of 1998. The judiciary, for its part, dismisses about half of securities suits, according to Cornerstone Research's Securities Class Action Filings, 2020 Midyear Assessment, at p. 13.

The allure of contingency fees, however, motivates the plaintiffs' bar to remain undaunted because the cost of filing a frivolous suit is low. The strategy of filing many suits to see if a few survive a motion to dismiss is in fact rational in our current system. Surviving a motion to dismiss will often assure plaintiffs' lawyers of winning contingency fees.

Plaintiffs sometimes obtain outsized settlements even when the merits heavily favor the defendants. Plaintiffs may make outrageous monetary demands and threaten protracted and expensive litigation that could result in defense costs and/or a settlement or judgment exceeding the defendants' D&O insurance limits. In these scenarios, plaintiffs don't have much to lose, while the defendants are faced with distressing risks and uncertainties.

The presence of D&O insurance provides defendants a potentially expedient solution to settling securities litigation, even if the litigation is without merit. While "plaintiff-style" damages (discussed below in greater detail) often exceed D&O policy limits, it is not coincident that many securities class actions settle just within the D&O policy limits. However, using D&O insurance to fund meritless litigation further emboldens plaintiff lawyers and ensures the continuance of these market inefficiencies in the form of elevated D&O insurance premiums.

We believe there is a free-market solution to address meritless securities litigation.

Defendants rarely seize the opportunity to litigate their defenses.

Defendants could potentially prevail in many securities class actions if the cases were litigated to completion. However, defendants typically choose to settle before testing the merits. While defendants understandably focus on the outcome of the motion to dismiss, given the Reform Act's high hurdles and sufficiency of D&O insurance to cover even outrageously high defense costs through that stage, defendants also have effective post-motion to dismiss tools at their disposal. Unfortunately, defendants rarely take them out of the toolbox. Instead, defendants often times head to an early mediation and settlement at which the merits rarely are reached. For more on premature settlement and the reasons for it, please see Doug's D&O Discourse blog post" Putting 'Litigation' Back in 'Securities Litigation'".

This culture of premature settlement means that defendants use only one of their four litigation escape hatches – the motion to dismiss – and forego the other three – class certification, summary judgment, and trial. In our opinion this results in resolution of cases for amounts vastly above their actual value.

At class certification, defendants have a set of important defenses to defeat or limit the litigation proceeding as a class action.[1]

- Defendants can show that the market for trading in the company's securities was inefficient. Increasingly, plaintiffs base securities class actions on articles by short sellers or their accomplices, designed to drive down the stock price to make their short positions more valuable. Arguably, any stock that can be significantly driven down by a sinister spin on public information is not efficiently traded. Other fact patterns raise an efficiency issue too. Yet rarely is this issue tested. Indeed, the leading court decision on market efficiency is *Cammer v. Bloom*, a 31-year-old district court decision.[2] If more cases were litigated to point of class certification, the defense bar could potentially establish law that wipes out the unseemly strain of short-seller cases, and many other cases against companies with unstable stock prices.

- Defendants can show that the challenged public statements did not significantly impact the price of the company's stock price, under the U.S. Supreme Court's 2014 decision in *Halliburton Co. v. Erica P. John Fund (Halliburton II).* [3] *Halliburton II* can narrow the set of public statements that are truly at issue in the litigation, thus limiting the cost of further litigation defense and, of course, damages and settlement value. Yet defendants have only used *Halliburton II* in just a handful of securities class actions in the six years since this arguably defendant-friendly decision.
- Defendants can argue that class-wide damages do not meet FRCP Rule 23's predominance requirement under the Supreme Court's 2013 decision in *Comcast v. Behrend*.[4]

At summary judgment and at trial, defendants can put plaintiffs to the test, requiring them to meet their heavy burden of proving the essential elements of their claim: falsity, scienter, or loss causation. Defendants also can use their class certification opposition arguments in this procedural setting as well. At summary judgment and trial, defendants can brandish other defendant-friendly holdings from Supreme Court decisions:

- *No false or misleading statement.* Statements of opinion are ubiquitous in corporate communications and are the most frequent type of challenged statements. From earnings guidance, to accounting estimates, to Sarbanes-Oxley certifications, to statements about a company's performance and outlook, companies and their directors and officers speak in opinions. *In Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund,*[5] the Supreme Court provided significant protection for statements of opinion. *Omnicare* also better protects statements of fact through its requirement that courts examine the truth of a statement in their full context.
- *Safe harbor protection*. Even if a forward-looking opinion is found false, the Reform Act's safe harbor nevertheless can protect it if it was accompanied by meaningful cautionary language or the plaintiff fails to prove it was made with actual knowledge. The safe harbor usually is invoked on motions to dismiss, but it can apply at summary judgment or trial, too.
- *No scienter*. Proving scienter is no easy task for plaintiffs. Although the standard is some form of recklessness, proving that a defendant intended to mislead investors is no easy task. Although the Supreme Court's 2011 decision in *Tellabs v. Makor Rights Ltd.*[6] provides a strong basis for dismissal before discovery, it does not allow defendants to introduce probative nonpublic evidence, including the defendants' testimony about their disclosures and stock sales and corporate transactions that may suggest a motive for fraud. With actual evidence, corporate insiders can be transformed from the cartoonish villains portrayed in pleadings by plaintiffs to likeable people who have good-faith reasons for what they said and did.
- *No loss causation*. The Supreme Court's 2005 decision in *Dura Pharmaceuticals v. Broudo*[7] created high hurdles for plaintiffs on the essential element of loss causation. Over the years, courts have relaxed *Dura's* requirements on motions to dismiss, since it often presents difficult questions that are, or at least seem, difficult to sort out on such motions. But *Dura's* standard remains high, and plaintiffs' failure to meet it remains an important merits issue.
- *No transaction causation (i.e. reliance)*. Defendants can again invoke the lack of market efficiency and/or price impact, should they fail on class certification in that procedural context.

Thus, defendants have multiple chances to win on the merits. And, unlike denials of motions to dismiss, defendants have the ability to appeal the court's grant of class certification and denial of summary judgment.

Less than 1 percent of core federal filings have reached a trial verdict.[8] That's a shame. Not all cases should be litigated past the motion to dismiss stage. Not all cases that are litigated should proceed through the full litigation process. And, to be sure, only a small subset of those that are litigated through discovery should go to trial. But, in each and every case, we need to evaluate the merits and consider whether a case could and should be effectively litigated.

What is contingent liability insurance?

Insurance has a long history of providing a mechanism to address situations in which an insured faces a very low probability of a very large loss. Contingent liability insurance can address situations in which litigation is ongoing. Defendants may be able to buy a contingent liability insurance policy from a Transactional Risk carrier as a foil against unreasonable plaintiffs.

Unlike plaintiffs and defendants, Transactional Risk carriers are motivated to take a purely objective view of the facts and the law. If the facts and law heavily favor the defendant, Transactional Risk carriers may offer to insure the defendants against losses arising from a non-appealable adverse judgment. With respect to existing litigation, defense costs and settlements would not be considered fortuitous and therefore would not be covered by most contingent liability policies.

In a very recent market development, contingent liability insurance is now available for defendants in frivolous securities litigation. The contingent liability insurance would attach above the defendant's D&O policies. In most cases, the D&O policies would be available for defense costs, settlements and judgments (where all D&O insurers believe that actual fraud does not exist and, in an effort to encourage litigation, have waived the fraud exclusion).

When can contingent liability insurance be used to address securities litigation?

Contingent liability insurance can be used for securities litigation with the alignment of only a few factors. First, plaintiffs would have to be demanding an oversized settlement unsupported by the facts and the law. Second, the defendants and transactional risk carriers (and their experts) would have to agree that there is a significant likelihood of prevailing on class certification, summary judgment, and/or trial. Third, the D&O carriers would need to agree to fund the defendants' defense, despite any reservation of rights. Fourth, the defendants must agree to assist and cooperate in the defense of their litigation—to make employees available and the like. Finally, all parties must agree on premium, limits and other terms and conditions of the coverage. If a securities class action is highly defensible but is not dismissed on defendants' motion to dismiss, we anticipate the defendants and D&O and transactional risk carriers will be able to align on these issues in many cases.

For a contingent liability policy to be effective, it must remove enough uncertainty to encourage defendants to purchase the policy. This means sufficiently filling in the gap between the limit of the D&O tower and plaintiff-style damages.

Economic analysis can help quantify risk

"Plaintiff-style" damages in securities cases are often calculated as a rough measure of the maximum possible losses associated with the alleged corrective disclosure. One of the simplest proxies for potential damages is the observed decline in market capitalization of the defendant firm the day of the alleged corrective disclosure. Other "plaintiff-style" methods may be somewhat more rigorous, but give only a very rough approximation of potential damages in the case and fail to reflect a realistic view of potential damages in any specific case. Even under the assumption that the case-specific facts and the law favor the plaintiffs, in some cases, a "plaintiff-style" number could be several times the magnitude of a more reliable damages estimate.

There are a number of economic analyses that can be used to generate more reasonable damages estimates. Instead of looking at raw changes in stock price or market capitalization, experts can use tailored event studies to control for the impact of market and industry factors on stock returns. Experts may identify key events that are unrelated to any alleged fraud but that have an impact on stock price, and statistical techniques can be applied to quantify the impact of these factors on potential damages. These techniques can be combined with models of trading volume to estimate aggregate damages.

Other tools of financial economics can be used to further refine estimates of damages and liability. For example, statistical models can be applied to analyze the efficiency of the market. Careful review of public information and stock prices can allow experts to test the price impact of specific alleged disclosures, which may limit estimated potential exposure, or provide support for alternative class periods. Early on in a case, economists can review the allegations and basic fact pattern to identify which types of quantitative analyses are most likely to have an impact on any damages estimate.

Litigation of more securities class actions through trial would likely reduce damages in both individual cases and overall. In cases that go to trial, arguably defendants are liable only for the claims made based on the finding of damages per share. After more securities class actions are taken to trial and data on the claiming rates is collected, defendants can assert that the percentage to which estimated aggregate damages for the class exceeded the court-approved claims made in securities class action trials should reduce damages estimates. For example, if 10 cases go to trial over the next two years and the aggregate damages in those cases end up exceeding claims made by 35%, it can be argued that aggregate damages estimates in other cases should be reduced by 35%.

Alignment and cooperation

The successful implementation of a contingent liability policy on behalf of a securities litigation defendant requires the alignment and cooperation of many parties.

The concept might first be considered by the trio of the defendants, defense counsel and D&O tower participants who are all facing a plaintiff settlement demand that they collectively and genuinely feel is not supported on the merits.

Disagreement between these three parties on the utilization of contingent liability insurance may scuttle the opportunity avoid an inflated settlement. So the earliest possible alignment of these three parties likely would be necessary.

The winners of a successful trial would include the D&O carriers. Indeed, already faced with a settlement demand that would result in a limits loss, the prospect of a trial presents only upside to the D&O carriers. However, D&O carriers would need to overcome the incentive for defendants to use the D&O policy as a checkbook to fund an inflated settlement. After all, an adverse judgment in excess of the settlement demand or D&O limit could result in a serious financial loss for the defendant.

Would the D&O carriers perhaps be willing to take actions to encourage a trial? Would D&O carriers waive their fraud exclusion (after concluding, post-discovery, there is no actual fraud)? Would D&O carriers fund part of the contingent liability premium? Would the defendant agree to erode D&O limits with respect to such contributions? The answers to these questions may govern whether a contingent liability policy would provide a good alternative to succumbing to an inflated settlement demand.

While alignment may not be possible in certain situations, the early engagement of a Transactional Risk underwriter may help address the alignment issue. The underwriter will engage his own experts, including counsel and quantitative experts, and may be able to offer a limit that sufficiently addresses the defendant's financial risk at a premium that is far more attractive than the alternative payment of an inflated settlement.

The contingent liability underwriters, as well as the D&O underwriters, will have no interest in insuring "actual fraud". Note that recklessness satisfies the scienter prong of a 10b-5 claim in all jurisdictions. So if there are facts probative of "actual fraud" it is unlikely the underwriters will consider the coverage absent a warranty letter from the defendant disclaiming such alleged facts.

The effective utilization of contingent liability insurance could provide an effective free-market solution to meritless securities litigation.

End Notes

1. Arguably, fact discovery should be stayed during class certification, since class discovery addresses market issues that are based on public information - the market can't react to information it does not know. Not all courts will agree, but overall, taking this additional litigation step often should not open the door to fact discovery at all, or at most, just the first portion of it if defendants insist on defending class certification right away.Ibid.
2. 711 F. Supp. 1264 (D.N.J. 1989).
3. 573 U.S. 258 (2014).
4. 569 U.S. 27 (2013).
5. 135 S.Ct. 1318 (2015).
6. 551 U.S. 308 (2007).
7. 544 U.S. 336 (2005).
8. Cornerstone Research's Securities Class Action Filings, 2020 Midyear Assessment, at p. 13

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