Securities Fraud Class Action Litigation in the United States: A Primer on Preliminary Procedure

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The Canadian Institute
April 2009

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<u>Introduction</u>

"10b-5 class action" is a phrase that one hears often in the United States: it is the short-hand for the most common class actions alleging securities fraud under U.S. law. Specifically, the federal courts, beginning with <u>Kardon</u> v. <u>National Gypsum Co</u>., 69 F. Supp. 512 (E.D. Pa. 1946), have implied a private right of action, on behalf of purchasers and sellers of securities (in the public markets, as well as private transactions), for violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5, promulgated thereunder.

In response to what were perceived as serious abuses in the 10b-5 class action - - including (i) the filing of vaguely-pled complaints with little or no factual underpinning and only boiler-plate assertions of wrongdoing, (ii) followed by massive, expensive pre-trial discovery by which plaintiffs sought to discover whether they indeed actually had any basis to assert fraud claims, (iii) imposing enormous pressure on defendants to settle even claims with little likelihood of success, because of the potential for ruinous money judgments - - Congress enacted the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). <u>See</u> generally <u>Brigham</u> v. <u>Royal Bank of Canada</u>, No. 08-4431 at 4 (S.D.N.Y. April 7, 2009)(WPP) (copy annexed). The PSLRA imposed a structure designed to better assure that a 10b-5 plaintiff have a good faith, fact-based predicate for

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its claims before filing a complaint; and that the potential merit of such allegations would have to survive judicial scrutiny before the burdens of discovery and pressure to settle could be imposed on defendants.

The following is a primer regarding some of the basic principles governing 10b-5 actions and, in particular, the process that one should assume will ordinarily be involved -- all of which differ in significant respects from Canadian law and practice..

Pleading Requirements for Section 10(b) Claims

"To state a claim for a violation of section 10(b), a plaintiff must plead the following elements: '(1) a material misrepresentation (or omission); (2) *scienter, i.e.,* a wrongful state of mind; (3) in connection with the purchase or sale of a security; (4) reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as 'transaction causation;' (5) economic loss; and (6) 'loss causation,' i.e., a causal connection between the material misrepresentation and the loss.'" Key Equity Investors, Inc. v. Sel-Leb Mktg. Inc., 2007 WL 2510385, at *2 (3d Cir. Sept. 6, 2007) (citations omitted). The essence of a 10b-5 claim is that it is based on fraud or other deceptive or manipulative conduct. Honest mistakes, differing judgments and even negligence do not suffice. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976)). [2]

Because Section 10(b) claims sound in fraud, "plaintiff must satisfy the heightened pleading requirements" of Rule 9(b) of the Federal Rules of Civil Procedure.

[2] For example, it is well settled that even where an action alleging materially false and misleading financial statements is based on a restatement, the GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim. "[O]nly where such allegations are coupled with evidence of corresponding fraudulent intent, might they suffice." Nappier v. PricewaterhouseCoopers, LLP, 227 F. Supp. 2d 263, 276 (D.N.J. 2002).

In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1417-18 (3d Cir. 1997). Under Rule 9(b): "In all averments of fraud . . . the circumstances constituting fraud . . . shall be stated with particularity." The PSLRA further requires a plaintiff to "specify each allegedly misleading statement, why the statement was misleading, and, if an allegation is made on information and belief, all facts supporting that belief with particularity." Winer Family Trust v. Queen, 503 F.3d 319, 326 (3d Cir. 2007) (citing 15 U.S.C. § 78u-4(b)(1)(B)). And the PSLRA requires that as to each defendant, plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," i.e., scienter. 15 U.S.C. § 78u-4(b)(2); Winer, 503 F.3d at 337.

Significantly, scienter may be satisfied by pleading conduct rising to the level of recklessness. But sufficiently culpable reckless conduct entails "highly unreasonable conduct, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977). "[T]he culpability attaching to such reckless conduct [must] closely approach[] that which attaches to conscious deception." In re Digital Island Sec. Litig., 357 F.3d 322, 332 (3d Cir. 2004) (quoting McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979)). See also Dolphin and Bradbury, Inc. v. SEC, 512 F.3d 634 (D.C. Cir. 2008) ("Extreme recklessness is not merely a heightened form of ordinary negligence, and does not involve a should have known standard. It is, in fact, a lesser form of intent, implying the danger was so obvious that the actor was aware of it and consciously disregarded it.")

On a motion to dismiss a Section 10(b) complaint, courts should: (1) accept factual allegations in the complaint as true; (2) consider the complaint in its entirety, including documents incorporated by reference and matters subject to judicial notice; and (3) "consider plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2509-10 (2007). Any "omissions and ambiguities count against inferring scienter." Id. at 2511. "To qualify as 'strong' . . . an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." Id. at 2505-06 (emphasis added). Indeed, a complaint can survive "only if a reasonable person would" – and not merely "could" – "deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." Id. at 2510 (emphasis added); see also Mizzaro v Home Depot, Inc., 2008 WL 5498940 (11th Cir. Oct. 8, 2008)[3].

[3] Scienter is not required under the Ontario Securities Act ("OSA"). The OSA is more plaintiff-friendly in that it suggests a strict liability approach and includes two liability standards, absence of due diligence and gross misconduct, based on a matrix of factors, including the importance and nature of the document ("core documents" – i.e. required disclosure documents) and the person responsible for it. The legislation puts the onus on the defendant to establish due diligence unless knowledge or gross misconduct is required to establish liability (i.e. a "non-core document" or a "public oral statement"). In those cases, the plaintiff will have to prove that the defendant was aware of the misrepresentation or the failure to make timely disclosure (or deliberately avoided acquiring knowledge) or was otherwise guilty of gross misconduct. In many ways, the OSA is more akin - - though far from identical to - - an action under Section 11 of the Securities Act of 1933 (the "Securities Act"). That statute provides a cause of action for rescission (or rescissory damages) for those alleging a materially false or misleading statement in a registration statement. Unlike a claim under Section 10(b) of the Exchange Act, the Securities Act claim -- which may be asserted only by those who purchased in or can trace their securities to, the initial public offering -- does not ordinarily require a showing of scienter. There is strict liability for the issuer; and

Thus, even where a complaint quotes liberally from defendants' disclosures and invokes the boiler-plate language of a 10b-5 violation, it may be readily susceptible to a motion to dismiss, for failure to state a claim (pursuant to Rule 12(b)(6), F.R.C.P.) or for failure to plead fraud adequately under Rule 9(b) and the PSLRA. Among other things, the complaint may have failed to plead facts showing: [i] that any representation actually was false (much less materially so) when made, or that any material facts were omitted; [ii] scienter (i.e., either knowing fraud or "severe recklessness" tantamount to conscious disregard of the truth), or [iii] that alleged losses were caused by a correction of a prior false statement – generally, that the price of the stock dropped on disclosure of the corrective facts, see Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 344 (2005). "Allegations of artificial price inflation alone do not satisfy the loss causation requirements." Venezia Amos, LLC v. Favret, 2008 WL 410153, at *9 (N.D. Fla. Feb. 12, 2008).

What Usually Happens in a 10b-5 Case

The typical fashion for a 10b-5 case to proceed under the PSLRA is as follows:

[i] The initial complaint or complaints (for it is common for numerous "copy-cat" 10b-5 class action complaints to be filed following an announcement by an issuer and a price-drop) are simply "place-holders," which plaintiffs do not seriously expect to prosecute and on which defendants therefore do not waste time or financial resources.[4]

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directors who sign a registration statement may be liable unless they can establish an affirmative defense of due diligence.

[4] Unlike the U.S. litigation regime, under s. 138.8 of the Ontario Securities Act ("OSA"), leave of the court is required before a securities fraud action may be brought and before a complaint becomes operative. The court shall only grant leave if it is satisfied that: (a)

Counsel for the plaintiffs who filed the complaints - - and even other class action lawyers who do not have clients (yet) - - publish notice of the filing of the complaint and of the right of other purchasers of shares to seek to be appointed "lead plaintiff" and to gain approval of their attorneys as "lead counsel." Shareholders have 60 days from the initial notice to seek such appointment, and they need not even file a complaint to be approved.[5]

If actions are filed in multiple courts (often around the country), they are likely to be consolidated and transferred to a single court by the Judicial Panel on Multi-District Litigation, for the convenience of parties and witnesses, to avoid duplicative burdens and inconsistent rulings and to otherwise "promote the just and efficient conduct of the litigation." In re Satyam Computer Services, Ltd. Securities Litigation, Transfer Order, MDL No. 2027 (JPMDL April 9, 2009) (transferring a 10b-5 action from federal court in San Jose, California, to New York City, where other actions are pending),

[ii] Presumptively, the shareholder with the largest losses should be selected by the court as the lead plaintiff (per the PSLRA's goal of encouraging large institutional

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the action is being brought in good faith and (b) there is a reasonable possibility that the action will be resolved at trial in favor of the plaintiff.

[5] Apart from the aforementioned leave test and the requirement to be appointed representative plaintiff under class action legislation, there is no analogous lead plaintiff or lead counsel requirement in Canada. Rather, unlike the U.S. in the post-PSLRA era, it is somewhat of the race to the courthouse in Canada. As for notice under the OSA:

138.9 A person or company that has been granted leave to commence an action under section 138.3 shall,

(a) promptly issue a news release disclosing that leave has been granted to commence an action under section 138.3;
(b) send a written notice to the Commission within seven days, together with a copy of the news release; and
(c) send a copy of the statement of claim or other originating document to the Commission when filed.

holders, who are expected to be more independent of the plaintiffs' class action bar, to be plaintiffs). Frequently, multiple individuals or groups of plaintiffs will compete for the appointment as lead plaintiff, with issues commonly arising as to who in fact suffered the greatest losses. Defendants generally have no involvement in this contest.

[iii] Eventually, lead plaintiff(s) will be appointed, but this may take months, especially if the matter is contested by the various plaintiffs' counsel. And the court may later revisit the lead plaintiff designation. See In re NYSE Specialists Sec. Litig., 240 F.R.D. 128 (S.D.N.Y. 2007).

[iv] Typically, the lead plaintiff will file an amended consolidated class action complaint within 30 to 60 days after being appointed. This is the "real complaint" to which a motion to dismiss ordinarily will be addressed. The amended complaint often will contain far more facts than the original pleading. Indeed, the lead plaintiff's counsel (and its private investigators) usually can be expected to use the period prior to filing the amended complaint to try to find disgruntled current and former employees who may be willing and able to provide information (or often, speculation) about meetings, internal reports, etc., that plaintiff hopes will provide the factual particularity needed to survive a motion to dismiss. These facts are then presented in the form of "Confidential Witness" pleadings which cite or even quote - - but do not name - - their sources. (Such process is less important where the issuer has already admitted material errors, as when announcing a restatement, or even fraud by senior executives.)

For an interesting view of how two panels of the same Court of Appeals, within a matter of months, addressed "confidential witness" pleadings, compare Higginbotham v. Baxter Int'l, Inc., 495 F.3d 753, 758 (7th Cir. 2007) ("It is hard to see how information

from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences. Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist."), with the subsequent decision in Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 711-12 (7th Cir. 2008) ("[A]llegations based on anonymous informants are very difficult to assess. This concern led us to suggest in Higginbotham that such allegations must be steeply discounted. But that was a very different case from this one. . . . The information that the confidential informants are reported to have obtained [here] is set forth in convincing detail, with some of the information, moreover, corroborated by multiple sources.")

[v] The parties typically enter into a stipulation (often before lead plaintiff even has been named) providing that defendants will move to dismiss the amended complaint within 45-60 days after its filing. Plaintiffs will oppose the motion within a like time period (unless they seek to amend their complaint yet again, in response to the motion to dismiss); and defendants will reply 30 days after that. The parties then will await oral argument and decision by the court. If the court grants the motion to dismiss, it usually will grant plaintiffs leave to replead. If this motion is so granted, plaintiffs may decide to file an amended complaint - - or they may choose to take an immediate appeal from the dismissal. (Absent unusual circumstances and leave of court, defendants cannot appeal from the denial of a motion to dismiss because such order is deemed interlocutory.)

[vi] If, and only if, the amended complaint survives a motion to dismiss will the case proceed to a motion by plaintiff for class certification (which will be the subject of discovery and a ruling on the motion) and merits discovery. But significantly, under the PSLRA, absent unusual circumstances, all discovery is automatically stayed unless and

until plaintiffs' pleadings survive a motion to dismiss. Accordingly, the stay of discovery can last for one or more years. [6]

PSLRA Automatic Discovery Stay

Ordinarily, discovery in civil actions in the United States begins almost immediately. Indeed, Federal Rule of Civil Procedure 26(a) requires that parties to any civil action must, without waiting for discovery requests, provide to the other parties certain "initial disclosures." In an action not subject to the PSLRA, a defendant seeking relief from discovery (as during the pendency of a motion to dismiss the complaint) would have to move for a protective order. The discovery process, including initial disclosures, however, is markedly different in private actions arising under the PSLRA. See Medhekar v. U.S. Dist. Court, 99 F.3d 325, 328-29 (9th Cir. 1996). Under the PSLRA, "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss." 15 U.S.C. § 78u-4(b)(3)(B). The PSLRA instituted the "mandatory stay of discovery so that district courts could first determine the legal sufficiency of the

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[6] In contrast to the PSLRA's automatic stay, as part of the leave requirement, s. 138.8(2) of the OSA requires that "the plaintiff and each defendant shall serve and file one or more affidavits setting forth the material facts upon which each intends to rely." The affiants may also be deposed ("examination for discovery") in Canada. However, Madame Justice Lax's decision of December 3, 2008 in Ainslie v. CV Technologies confirms that a defendant may elect not to file an affidavit on the leave application and may simply take the position that the plaintiff has not met its burden. She also concluded that the plaintiffs are not entitled to subpoena a defendant who does not file an affidavit to give evidence on the pending application. Justice Lax expressed concern that the leave application was meant to be a bar or deter non-meritorious suits and, contrary to its purpose, could become an instrument of abuse if courts do not restrictively construe a defendant's obligations to file evidence on the application. In that sense, Justice Lax's decision is quite consistent with the PSLRA.

claims in all securities class actions." Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 107 (2d Cir. 2001) (emphasis added).

The Congressional rationale was two-fold. First, the PSLRA was enacted in significant part to avoid the enormous but potentially unnecessary cost and other expenses of U.S. pre-trial discovery. But Congress also enacted this mandatory stay of discovery to prevent plaintiffs from filing securities fraud lawsuits as a vehicle to conduct discovery in the hopes of finding facts to support a sustainable claim that had not been alleged in the complaint. See In re Vivendi Universal, S.A. Securities Litigation, 2003 WL 2035383 at *1 (S.D.N.Y. May 6, 2003) (quoting S. Rep. No. 104-98, at 14 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 693). "Manifest in the 1995 Reform Act is the mandate that courts assess the legal sufficiency of plaintiffs' securities fraud allegations according to what plaintiffs know at the time the complaint is filed, rather than what they wish to learn through discovery and recover from defendants merely by reason of commencing an action charging fraud." In re Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 423 (S.D.N.Y. 2001). Indeed, Court decisions, such as Tellabs, imposing stricter pleading requirements themselves have been prompted by such concerns.

The PSLRA permits a lifting of the automatic discovery stay only in two exceptional circumstances – when "particularized discovery is necessary to preserve evidence or to prevent undue prejudice to [a] party." 15 U.S.C. § 78u-4(b)(b)(B). These exceptions are narrowly construed. For example, the sole illustration proffered by Congress as to what justifies lifting the stay is the terminal illness of an important witness which might necessitate a deposition of the witness prior to ruling on the motion to dismiss. H.R. Conf. Rep. No. 104-369, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N.

730, 736. Accordingly, "'[u]nless exceptional circumstances are present, discovery in securities actions is permitted only after the court has sustained the legal sufficiency of the complaint.'" In re Vivendi Universal, S.A., Sec. Litig., 381 F. Supp. 2d 129, 130 (S.D.N.Y. 2003) (citation omitted).

A party alleging that discovery is necessary to preserve evidence must make a specific showing that the loss of evidence is imminent, as opposed to merely speculative. In re Tyco Int'l, Ltd. Sec. Litig., No. 00MD1335, 2000 WL 33654141, at *3 (D.N.H. July 27, 2000) (lifting the automatic discovery stay for an "appropriately tailored preservation subpoena on specified third parties" to preserve relevant evidence – electronic data subject to possible destruction during routine backup procedures); In re Rambus, Inc. Sec. Litig., No. 06-4346 JF (HRL), 2007 WL 1430047, at *2 (N.D. Cal. May 14, 2007) (refusing to lift the stay because defendant's "history of destroying documents many years ago in [unrelated] patent infringement cases is insufficient to satisfy the 'preserve evidence' prong . . . in this securities fraud case").

A party alleging that discovery is necessary to prevent undue prejudice must show that it faces a degree of prejudice distinct from that inherent in all stays of discovery. SG Cowen Sec. Corp. v. U.S. Dist. Court, 189 F.3d 909, 913 (9th Cir. 1999) ("failure to muster facts sufficient to meet the Act's pleading requirements cannot constitute the requisite 'undue prejudice' to the plaintiff justifying a lift of the discovery stay under [the PSLRA]"). Plaintiff must show "improper or unfair detriment," but it may be something less than "irreparable harm." Med. Imaging Ctrs. of Am., Inc. v. Lichtenstein, 917 F. Supp. 717, 720 (S.D. Cal. 1996) (declining to find "undue prejudice" based upon a corporation's need to have discovery before an election of directors). Compare, e.g., In

re WorldCom, Inc. Sec. Litig., 234 F. Supp. 2d 301, 306 (S.D.N.Y. 2002) (finding undue prejudice and lifting the stay where global settlement negotiations involving a bankrupt issuer, the U.S. government and ERISA plaintiffs were about to begin - - and the securities class action plaintiff, if forced to "wait until the resolution of a motion to dismiss," "face[d] the very real risk that it [would] be left to pursue its action against [insolvent] defendants who no longer have anything or at least as much to offer").

A wrinkle - - and significant inconsistency - - in the case law concerns a request to partially lift the stay to require defendant to produce, to a private plaintiff, documents previously produced by that defendant to a governmental agency (e.g., the SEC, in the course of a regulatory investigation). The PSLRA contains no exception for discovery of such documents. And where documents have been produced to a regulatory or law enforcement agency, some courts consider the documents preserved and are even less likely to lift the stay. In re Am. Funds Sec. Litig., 493 F. Supp. 2d 1103, 1106 (C.D. Cal. 2007) (denying a motion to partially lift the stay when plaintiffs sought documents already produced to the California Attorney General's Office). However, other courts have lifted the stay, when plaintiffs limit their particularized request to those documents already produced to the government, to prevent undue prejudice and because complying with the request will place little additional burden upon defendants. See WorldCom, supra; In re FirstEnergy Corp. Sec. Litig., 229 F.R.D. 541, 545 (N.D. Ohio 2004) (partially lifting the stay where defendant already reviewed, compiled, and produced the requested information to government entities). For the most recent decision surveying the inconsistent case law - - and denying discovery of documents that had been provided

to regulators, prior to a ruling on a motion to dismiss - - see Brigham v. Royal Bank of Canada, No. 08-4431 (S.D.N.Y. April 7, 2009).

Class Certification

Assuming a complaint survives a motion to dismiss, the next order of business is ordinarily the determination of whether a class should be certified – a process that itself often entails considerable document, deposition (and at times, expert) discovery. With respect to class certification, notwithstanding that courts tend to be reluctant to deny certification in a traditional public company "stock drop" case, it is essential for defendants not to simply assume certification will be granted. Instead, the strategy would be to take document and deposition discovery concerning the ultimate lead plaintiff and its counsel in order to test such issues as adequacy of representation, typicality, standing to assert certain claims, intra-class conflicts, the relevant class period and loss causation, and the possibility of defeating the presumption of reliance that generally attaches to class actions on behalf of open market purchasers of securities. See Basic, Inc. v. Levinson, 485 U.S. 224 (1988). The burden is on plaintiff to establish all elements of Rule 23, F.R.C.P., before a class can be certified, and the courts recently have begun to more strictly scrutinize such applications. See, e.g., Oscar Private Equity Inc. v. Allegiance Telecom, Inc., 487 F.3d 261 (5th Cir. 2007); In re Initial Public Sec. Litig., 471 F.3d 24 (2d Cir. 2006); Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc., 546 F.3d 196, 202 (2d Cir. 2008).

Some Additional Thoughts for 10b-5 Action Defendants

Given the foregoing, 10b-5 defendants (as a legal and practical matter) generally need not do very much for quite some time after a complaint is filed. However, some steps (in addition to giving notice to the D&O carrier), would be prudent. First, be sure to formulate and promptly circulate a comprehensive document retention program/notice appropriate for the organization. This includes suspending automatic or routine disposal of documents or deletion of emails and other electronically-stored information by notice to IT, records department and other relevant personnel. Second, it may well be prudent to notify a wide range of employees that there is now a litigation against the company; that representatives of the plaintiffs (who may or may not identify themselves as such) may contact them to try to get information or documents that plaintiffs can try to use against the company; that employees should remember their duties of confidentiality as to company information and documents; and perhaps requesting that if anyone is contacted, they promptly notify the company's general counsel. Third, because litigation under the PSLRA is quite different than most federal court litigation, an introductory presentation by outside counsel to the company's executives and Board of Directors (either in person or telephonically) is often useful – but in general, PSLRA litigation should not in any way interfere with ordinary operations of the company, its board, its management or its employees.