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Stemming the tide of meritless securities class actions

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With the number of securities class actions skyrocketing and the actual recoveries primarily lining the pockets of plaintiff lawyers, Congress should closely consider potential legislative action to protect companies from nuisance securities class actions.

RISE IN EVENT-DRIVEN SECURITIES CASES

There is a new normal in federal securities class-action cases. Between 1997 and 2017, plaintiffs filed an average of 203 new federal securities class actions per year.[1] In 2018 federal courts saw nearly double that number, at 403.

As high as that number is, it actually represents a modest decrease compared to 2017, in which securities plaintiffs filed a record 412 new class actions in federal courts. Before that, 2016 had established the high-water mark with 271 new filings.

This increase in the frequency of securities filings has occurred despite the fact that the number of public companies in the U.S. has significantly declined over the last several years. In 1996 there were 7,439 U.S. publicly traded companies. That number declined to 4,697 by 2006 and to 3,616 by 2017.

In addition, the number of reissuance restatements filed by public (those significant enough to require wholesale withdrawal of prior statements rather than mere correction) declined every year from 2006 through 2017, with only 10 percent of the number of reissuance restatements in 2017 that existed in 2006.[2]

With fewer public companies and fewer reissuance statements (a common harbinger of securities cases), what accounts for the increase in securities litigation?

One obvious explanation is the apparent shift of merger and acquisitions suits from Delaware state court to federal court.

In January 2016 the Delaware Chancery Court in *In re Trulia Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016), announced it would generally no longer approve "disclosure only" settlements in merger objection lawsuits.

In *Trulia* and similar cases, the Chancery Court expressed its disdain for such settlements, which often involve threats by plaintiffs to enjoin a merger followed by quick settlements that award fees to the plaintiffs' attorneys while precluding future litigation on the merger — and providing for only nominal benefits to stockholders through added disclosures.

Following the *Trulia* decision, many commentators expected to see an influx of M&A cases brought in federal court by plaintiffs who were wary of filing suit in Delaware. The data so far bears out this assumption.

From 2009 (when analysts started separately tracking M&A filings) through 2015, plaintiffs filed an average of 23 M&A securities actions each year in federal courts. In 2016 that number jumped to 85, nearly doubling the previous high of 43 in 2011. In 2017 and 2018 the number exploded to 198 and 182, respectively.[3]

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But increased M&A litigation tells only part of the story. Core filings (securities class actions excluding M&A litigation) have also steadily risen for the past several years, reaching a 10-year high of 221 in 2018.[4] The odds are now greater than ever that a U.S. exchange-listed company will face a core filing.

In 2018 a record-high 4.5 percent of all such companies were the subject of a core filing, eclipsing the previous record of 4.2 percent set in 2017 and well above the 2.9 percent average for the years 1997-2017.

Core filings can include a number of different types of cases, but one category — those relating to financial misstatements — has been stagnant at best over the last several years. Financial misstatement cases were once the bread and butter of plaintiffs' firms, but a steady decline in the yearly number of restatements issued by U.S. public companies has correlated with a decline in corresponding securities litigation.

The slack in decreased financial misstatement cases appears to have been picked up by a new class of securities cases: event-driven claims. These are claims filed in response to adverse company events such as a data security breach, sexual harassment allegations, a catastrophic explosion, allegations that a drug or product has side effects or caused injury, or a regulatory investigation or enforcement action.

While it has always been normal for such events to trigger personal injury or other tort litigation, plaintiffs' firms are increasingly bringing tag-along securities lawsuits alleging that the risks underlying the adverse events were not properly disclosed.

Although it is difficult to track the raw number of event-driven cases filed by year, commentators have identified a rise in such claims through a few different observations.

First, high-profile, event-driven securities cases are increasingly in the news. For example, a case triggered by the BP Deepwater Horizon explosion resulted in one of the largest class-action settlements of 2017.[5]

Second, there have been rapid increases in lawsuits against industries disproportionately affected by event-driven claims, such as regulatory actions targeting biotechnology and pharmaceutical companies.

Third, new securities cases increasingly feature lesser-established plaintiffs' firms that typically do not possess the connections or political capital to gain control as class counsel for more meritorious traditional securities cases.

Each of these metrics indicates that suspect event-driven securities cases are on the rise and accordingly warrant attention by companies, courts and potentially even Congress.

EXAMPLES OF EVENT-DRIVEN SECURITIES CLAIMS

Event-driven securities cases can take a number of different forms. Recent high-profile cases have included allegations based on cybersecurity issues (including breaches and vulnerabilities), sexual harassment, explosions or environmental disasters, bribery or corruption, and products causing health risks.

The U.S. Supreme Court's decision in *Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), provided a hook on which plaintiffs tie event-driven suits.

In *Omnicare,* the Supreme Court found that a statement of opinion that the company "believed" itself to be in compliance with the law could be materially misleading if investors assumed this statement implied that the company had made a procedurally adequate investigation to support its views.

When Omnicare's stock price fell after a federal raid on the company to seize evidence, the plaintiffs used the earlier statement of opinion as to compliance with the law to show a misleading statement or omission.

The Supreme Court found Omnicare's omissions actionable, stating, "to avoid exposure for omissions … an issuer need only divulge an opinion's basis, or else make clear the real tentativeness of its belief."

Many public companies state opinions on compliance, and these opinion statements end up becoming the alleged misstatement on which plaintiffs base their claims.

The common problem (from a company's perspective) with many of these event-driven securities class actions is that they are tied to an unforeseen event that plaintiff lawyers then re-tool to claim the event (or risk thereof) should have been disclosed earlier.

In the cybersecurity context, there have been at least nine federal securities class actions filed after data security incidents, with plaintiffs claiming inadequate pre-breach disclosure on cyber-risks, overstatement of cyberstrengths or delayed disclosure to the market following breach detection.

Meritless cases fill courts' dockets and cost shareholders money.

In the wake of the #MeToo movement, the boards of numerous public companies have found themselves the target of event-driven securities cases based on the alleged sexual misconduct of company representatives. Such cases have included claims against the boards of CBS, Papa John's and Wynn Resorts. Over the past year alone, investors have filed similar lawsuits involving Lululemon, Nike and Google.

The claims are predicated on the alleged failure of companies to address or disclose a systemic culture of sexual harassment or abuse by executives and others, thus artificially inflating their share price. Shareholders claim that, when the conduct was finally disclosed, they were damaged by the sudden drop in stock price and the avalanche of lawsuits that could have otherwise been avoided or minimized.

Similar event-driven class actions have been filed in the context of explosions or environmental disasters. These include BP's Deepwater Horizon explosion; Foreign Corrupt Practices Act of 1977 and corruption claims, including the $2.95 billion settlement in Petrobras' alleged Brazilian bribery case in June 2018[6]; and products such as pharmaceuticals or medical devices that have allegedly undisclosed health risks — such as Matrixx Initiatives' Zicam Cold Remedy, which was alleged to cause loss of sense of smell.[7]

PROBLEMS WITH EVENT-DRIVEN CASES

More securities litigation generally means more problems for companies, courts and shareholders. Meritless cases fill courts' dockets and cost shareholders money. In 2016 the average cost of M&A cases resulting in dismissal was $2.3 million, up 162 percent from the cost of such cases in 2012.[8] Even among cases that ostensibly have merit, shareholders are often not the primary beneficiaries. In 2016 the average cost of settled M&A claims was $4.5 million, with roughly 61 percent of that amount flowing to plaintiffs and defense attorneys for fees and expenses.[9]

Across all securities class actions from 2012-2016, the average cost per case was $11.9 million, with 43 percent of that going to attorneys.[10]

While these problems are shared among all securities cases, they are particularly relevant in the context of event-driven securities class actions. This is because such cases are easy for plaintiffs to bring even though they are less likely to have merit. Plaintiffs in event-driven securities cases can rely on the investigative work of plaintiffs already suing the company under personal injury or tort causes of action pertaining to the same event.

And while there is not a comprehensive data set focusing on event-driven securities cases, their rise appears to have corresponded with a rise in overall dismissal rates for securities class actions over the last few years.[11]

Higher dismissal rates have also tracked with cases brought by less established, emerging plaintiffs' firms that are more likely to bring event-driven cases.[12]

Higher dismissal rates indicate a properly functioning court system's response to increased meritless cases. But even vindication has a price. As discussed above, early dismissal of a securities class action still costs companies millions of dollars in many instances.

Moreover, closer cases (or those pleaded cleverly enough) may survive a motion to dismiss even if they lack any strong supporting evidence. If plaintiffs can survive dismissal, many securities class-action defendants will settle regardless of the perceived merits of the claims because they stand to lose more money defending against them.

For the years 2014-2017, well over half of all securities class-action settlements were for less than $10 million.[13] Although that number dipped 45 percent in 2018, on the whole it still indicates that the majority of settlements over the last few years have been for nuisance value given that attorney fees alone can easily exceed $10 million in many securities class actions..

Accordingly, plaintiffs still see value in pursuing suspect event-driven claims despite high dismissal rates because it is not cost-prohibitive to bring a high number of non-paying event-driven claims, and the claims that do survive the relatively low dismissal standard frequently pay out, making the overall suite of cases profitable.

POTENTIAL SOLUTIONS

While the Private Securities Litigation Reform Act of 1995 serves an important role in winnowing meritless class actions, further reforms are necessary. Such reforms need not be limited to curbing event-driven claims.

To the contrary, reform is needed across the board to lessen the burden imposed on companies, shareholders and courts by all types of meritless securities class actions. Of course, the extent to which any such measure is able to stem the tide of event-driven cases in particular may be a good benchmark for its efficacy across all securities class actions.

One way to curtail meritless securities class actions is to adopt a rule requiring a plaintiff who loses at the dismissal stage to pay the winning party's attorney fees. These fees can be substantial, and the threat of being on the hook for them would change the risk/benefit analysis for plaintiffs and their attorneys when it comes to bringing tenuous cases.

Loser-pays rules in the securities litigation context have been the subject of some scrutiny over the past few years.

While the Private Securities Litigation Reform Act serves an important role in winnowing meritless class actions, further reforms are necessary.

In 2014 there was a rush among Delaware corporations to adopt such loser-pays provisions in their bylaws after the Delaware Supreme Court tacitly approved them in *ATP Tour Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014). Part of the court's basis for its approval of the provisions was the fact no Delaware law prevented them. That changed just a year later when the state Legislature responded by amending the Delaware Corporations Code to expressly prohibit loser-pays bylaws.[14]

Many commentators continue to believe that loser-pays provisions (either incorporated into bylaws or imposed by statute) are the most effective way to curb meritless securities class actions. However, such provisions undoubtedly also carry some chilling effect for cases that do have merit.

Take the example of public pension funds, which are now among the most common lead plaintiffs in securities class actions. These funds owe a duty to their pensioners to maximize fund value. Given that charge, can a pension fund justify bringing suit for a potential 1-3 percent recovery of its market losses (in terms of the decline in the stock's market capitalization) when the litigation also carries even close to a 50 percent chance that the fund will have to pay hundreds of thousands if not millions of dollars in attorney fees?[15]

At the other end of the spectrum, take an individual plaintiff who is likely judgment proof. Would a loser-pays provision deter that individual from bringing a meritless case when there is even a modest chance for a significant recovery?

Another potential solution is for federal and state courts to expand the reasoning of the *Trulia* decision beyond the M&A context. In *Trulia*, the Delaware Chancery Court refused to approve a merger objection class-action settlement (including an award of attorney fees) that the court determined would provide no real value for shareholders. The calculation in *Trulia* was relatively straightforward: Shareholders received no tangible benefit from the company's issuance of marginally more detailed disclosures surrounding a proposed merger.

While the calculation becomes more complicated outside of the disclosure-only context, courts can still resolve to take into account factors such as recovery for shareholders relative to fees paid to counsel and the likelihood of success on the merits when determining whether to approve proposed class-action settlements.

While imposing a higher bar on settlement approvals can result in higher costs to both plaintiffs and defendants in some cases, it may also discourage the filing of frivolous cases altogether. There can be little doubt that *Trulia*, and cases consistent with its reasoning, were directly responsible for moving a significant number of M&A cases from Delaware.

However, whether federal courts can take a strong-enough stance to dissuade plaintiffs from filing meritless cases in the first place remains unclear. While some federal courts have already spoken approvingly of *Trulia*, we have yet to see a corresponding reduction in new federal M&A cases. To the contrary, plaintiffs continue to file a high number of federal M&A cases despite an average dismissal rate of 86 percent from 2009-2017, including a high of 94 percent in 2017.[16]

Still, judicial expansion of the principles in *Trulia* has at least the potential to discourage event-driven cases in particular. "Emerging" plaintiffs' firms, which are more likely to bring event-driven cases, tend to settle cases earlier and for less money than more established firms.

According to Stanford Securities Litigation Analytics, from 2006-2015, emerging firms settled an average of 34 percent of cases for an average of $3.82 million before the court even ruled on any motion to dismiss. That is in stark contrast to more established firms, which settled only 16 percent of such cases for an average of $46.7 million.[17]

CONCLUSION

The path to curbing meritless class actions could be judicial (with consistent *Trulia*-like dismissals) or legislative. The controversial loser-pays approach may have an overly deterrent effect for pension funds and little deterrent effect for individual single investors.

Imposing a *Trulia*-like bar on nuisance-value settlements could deter meritless claims, but it could also increase litigation costs for defendants by forcing plaintiffs to fight longer and harder to achieve a more substantial settlement.

NOTES

[1] Cornerstone Research, *Securities Class Action Filings: 2018 Year in Review at 41 (2019)*, https://bit.ly/2Tdlzkg.

[2] Audit Analytics, *2017 Financial Restatements Review* (2018), https://bit.ly/2xulVXP (citing Don Whalen, Olga Usvayatsky & Dennis Tanona, *2017 Financial Restatements: A Seventeen Year Comparison* (2018)); Audit Analytics, *2016 Financial Restatements Review* (2017), https://bit.ly/2TztwQV (citing Don Whalen, Olga Usvayatsky & Dennis Tanona, *2016 Financial Restatements: A Sixteen Year Comparison* (2017)).

[3] *See* Cornerstone, *supra* note 1 at 5.

[4] *Id.* at 11, 41.

[5] *See* Institutional Shareholder Services, *Two of 100 Largest U.S. Class Action Settlements Approved Last Year, New Report Finds: Top 100 List Includes Salix Pharmaceuticals and BP PLC 2017 Settlements* (Feb. 6, 2018), https://bit.ly/2GHdChi. The case was *In re BP PLC Securities Litigation*, No. 04-md-2185 (S.D. Tex.), Dkt. Nos. 1399, 1512 (settlement stipulation and order approving settlement).

[6] *In re Petrobras Sec. Litig.*, No. 14-cv-9662 (S.D.N.Y. 2018), Dkt. No. 834 (opinion and order approving settlement).

[7] *Matrixx Initiatives Inc. v. Siracusano*, 563 U.S. 27 (2011).

[8] Chubb, Rising Volume and Cost of Securities Class Action Lawsuits is a Growing Tax on U.S. Business, Chubb Data Reveals (July 10, 2018), https://bit.ly/2L1HTpI.

[9] *Id.*

[10] U.S. Chamber Institute for Legal Reform, *A Rising Threat: The New Class Action Racket that Harms Investors and the Economy*, at 18 (October 2018), https://bit.ly/2SPi4RK.

[11] *See* Cornerstone, *supra* note 1, at 16; NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review*, at 25 (Jan. 29, 2019), https://bit.ly/2VdrPWE.

[12] *See* John C. Coffee Jr., *What's Really Happening in Securities Litigation? A Tale of Two Bars*, N.Y.L.J., Mar. 14, 2018, https://bit.ly/2T6weNz.

[13] NERA, *supra* note 11, at 31.

[14] Del. Code Ann. tit. 8, § 102(f); Del. Code Ann. tit. 8, § 109(b).

[15] *See* John C. Coffee Jr., *"Loser Pays": The Latest Installment in the Battle-Scarred, Cliff-Hanging Survival of the Rule 10b-5 Class Action*, 68 S.M.U. L. Rev. 689, 698-99 (2015).

[16] Cornerstone, *supra* note 1, at 15, 43.

[17] Michael Klausner & Jason Hegland, *Recent Trends in Securities Class Actions, 2006-15*, Stanford Securities Litigation Analytics, at Figure 9b, June 24, 2016, https://stanford.io/2EuLCKz.

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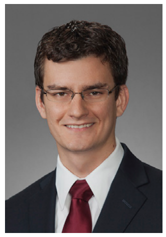

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