Whither Securities Class Actions?

By Robert H. Klonoff and David L. Horan

Through the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 ("PSLRA"), and the Securities Litigation Uniform Standards Act of 1998, 15 U.S.C. §§ 77p and 78bb ("SLUSA"), Congress attempted to address abuses in securities-fraud class actions. The PSLRA was enacted to target what Congress perceived as "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and manipulation by class-action lawyers of the clients whom they purportedly represent [that] had become rampant" and had "resulted in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors."

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1510-11 (2006) (internal quotation marks omitted). To that end, the PSLRA reformed several rules governing securities class actions in federal court, including new restrictions on the selection and compensation of lead plaintiffs. 15 U.S.C. § 78u-4. SLUSA was enacted three years after the PSLRA to respond to plaintiffs' attorneys' efforts to avoid the PSLRA's reforms by bringing class actions under state law in state court. To curb this trend, SLUSA prohibits state-law class actions that properly belong in federal court as federal securities-fraud actions from going forward in state court. It also permits defendants to remove such cases to federal court. 15 U.S.C. §§ 77p, 78bb; *Dabit*, 126 S. Ct. at 1511-12.

In the years following the Acts' passage, their scope and operation have been hotly contested in the federal courts. In particular, courts have addressed several issues, including: (1) whether SLUSA prohibits a state-law securities-fraud class action from being litigated in state court even when the plaintiff would not have a claim in federal court under federal law; (2) whether a defendant sued for securities fraud in federal court should be allowed to opine on which plaintiff should be appointed lead plaintiff under the PSLRA; and (3) whether a court can properly group together multiple, unrelated plaintiffs as lead plaintiffs under the PSLRA.

THE SUPREME COURT RULES THAT CONGRESS DID NOT CARE WHETHER PLAINTIFFS COULD "MAKE A FEDERAL CASE OUT OF IT"

It is well established under federal securities laws that only investors who bought or sold stocks, and not mere "holders," can sue for securities fraud in federal court. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-36 (1975). In one of the most closely watched securities decisions in years, the Supreme Court recently resolved a disagreement among the federal courts as to whether SLUSA nonetheless precludes *state*-court securities-fraud class actions brought by mere "holders" of stocks. In a major victory for stock issuers, the Court held (8 to 0) in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503 (2006), that SLUSA prohibits such cases from going forward as class actions in state court.

SLUSA provides that no "covered class action"—which includes any case brought as a class action on behalf of 50 or more persons—can proceed in state court "based upon [state law] . . . by any private party alleging . . . an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. §§ 77p(b)(1), 77p(f)(2)(A), 78bb(f)(1), 78bb(f)(5)(B)(i)(I). The Supreme Court held that SLUSA prohibits any such class action from proceeding in state court regardless of whether the plaintiff has a private remedy under federal law. The Court noted that "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated." 126 S. Ct. at 1509. The Court observed that, under the language Congress enacted in SLUSA, the identity of the plaintiffs simply does not determine whether a complaint in state court alleges "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." *Id*. at 1511. Rather, the key determination is whether the alleged conduct can be said to have been "in connection with the purchase or sale of a covered security," *id*., and the Court concluded that, given its broad interpretation of this same language in related statutes and the policy behind SLUSA, "[t]he misconduct of which [the plaintiff] complains here—fraudulent manipulation of stock prices—unquestionably qualifies as fraud 'in connection with the purchase or sale' of securities," *id*. at 1515. The *Dabit* Court observed that a contrary ruling by the Court "would give rise to wasteful, duplicative litigation" because "[f]acts supporting an action by purchasers under Rule 10b-5 (which must proceed in federal court if at all) typically support an action by holders as well, at least in those States that recognize holder claims." *Id*. at 1514. The Court accordingly refused to interpret SLUSA to permit plaintiffs to bring "parallel class actions proceeding in state and federal court, with different standards governing claims asserted on identical facts." *Id*. The Court thus closed off a significant possible loophole in Congress's efforts to stem the tide of meritless class actions and thereby avoided a flood of state-court cases that was already rising in the wake of the PSLRA's enactment.

The importance of *Dabit* is clear. Indeed, the U.S. Chamber of Commerce filed an amicus brief urging the very outcome reached by the Court and predicted that, unless prohibited by SLUSA, state-law holder suits would "become the plaintiffs' vehicle of choice"—even though they "present the very dangers of abuse that led to enactment" of the PSLRA and SLUSA. Amicus Brief of the U.S. Chamber of Commerce in *Dabit*. Similarly, the Solicitor General urged the Court to rule that SLUSA prohibits these suits because a "contrary holding would open a gaping and illogical loophole by

permitting potentially the most abusive securities class actions to escape SLUSA and the PSLRA, contrary to Congress's expressed intent to require such class actions to proceed only under uniform federal standards." Amicus Brief of the United States in *Dabit*.

Neither was the impact of *Dabit* on securities class actions lost on the popular press after the Court's decision was issued. *The Washington Times* explained that "the court delivered a broad-reaching opinion sure to block future class-action claims based on state law from being brought against firms that deal in the national securities market regulated by federal law." *The Washington Times*, Mar. 22, 2006, at C9. *Newsday* observed that "[t]he decision effectively ends such 'holder' class-action suits, because federal courts only allow class actions claiming securities fraud to be brought by people who say they actually bought or sold stock because of bad information." *Newsday*, Mar. 22, 2006, at A42. *BusinessWeek* similarly commented: "Big losers in the case: savvy lawyers seeking to have claims heard by sympathetic state judges." *BusinessWeek*, Apr. 3, 2006, at 30.

In fact, the impact of *Dabit* has already been dramatic, as numerous courts post-*Dabit* have dismissed alleged state-law claims as preempted by SLUSA. *E.g., In re Edward Jones Holders Litig*., 453 F. Supp. 2d 1210, 1214-17 (C.D. Cal. 2006) (violation of unfair competition statute and breach of fiduciary duty); *Mehta v. AIG SunAmerica Life Assur. Co. (In re Mut. Funds Inv. Litig.)*, 437 F. Supp. 2d 439, 443-44 (D. Md. 2006) (negligence); *In re Salomon Smith Barney Mut. Fund Fees Litig*., 441 F. Supp. 2d 579, 603-04 (S.D.N.Y. 2006) (breach of fiduciary duty); *Felton v. Morgan Stanley Dean Witter & Co*., 429 F. Supp. 2d 684, 692-95 (S.D.N.Y. 2006) (breach of contract).

FEDERAL COURTS SHARPLY DISAGREE ON WHETHER DEFENDANTS CAN HAVE A SAY IN WHICH PLAINTIFF TAKES THE LEAD

Once securities-fraud class actions are in federal court, the PSLRA governs the case. Importantly, in an effort to eliminate "lawyer-driven" securities litigation, the PSLRA requires the district court to appoint the lead plaintiff or plaintiffs early in the case. Lead plaintiffs serve an important role, including choosing their attorneys who will, with the district court's approval, serve as lead counsel for the proposed plaintiff class and then monitoring class counsel throughout the case. 15 U.S.C. § 78u-4(a)(3)(B)(v). Companies and individuals defending such actions will thus often have a real interest in who will serve as lead plaintiffs.

The PSLRA mandates that, 20 days after a case is filed, the plaintiffs' attorneys must publish a notice telling potential class members about the case and advising that, within 60 days of the notice, any potential class member may request that the district court appoint him or her as lead counsel. 15 U.S.C. § 78u-4(a)(3)(B)(i). Within 90 days of this notice, the district court must, based on any such requests, "appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members"—that is, the "most adequate plaintiff." *Id*. The district court, however, must:

> presum[e] that the most adequate plaintiff . . . is the person or group of persons that—[1] has either filed the complaint or made a motion in response to a notice []; [2] in the determination of the court, has the largest financial interest in the relief sought by the class; and [3] otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure [for a federal-court class action].

Id. § 78u-4(a)(3)(B)(iii)(I). This presumption "may be rebutted only upon proof by a member of the purported plaintiff class that the presumptively most adequate plaintiff—[1] will not fairly and adequately protect the interests of the class; or [2] is subject to unique defenses that render such plaintiff incapable of adequately representing the class." *Id*. § 78u-4(a)(3)(B)(iii)(II).

Some courts hold that defendants may provide evidence to oppose a plaintiff's appointment as lead plaintiff. *E.g., In re Flight Safety Techs., Inc. Sec. Litig*., 231 F.R.D. 124, 129-31 (D. Conn. 2005); *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. LaBranche & Co*., 229 F.R.D. 395, 405-06 (S.D.N.Y. 2004); *In re Terayon Communication Sys., Inc*., No. C-00-01967 MHP, 2004 WL 413277, at *6-*7 (N.D. Cal. Feb. 23, 2004). These courts have emphasized that the PSLRA requires district courts to be active in the selection process; that the process functions better with more and not less information; and that defendants can provide useful information,

regardless of whether they have standing to formally oppose a plaintiff's motion for appointment. Indeed, the defendant in *Terayon* actually succeeded in defeating the lead-plaintiff bid of some short-selling plaintiffs. *Terayon*, 2004 WL 413277, at *8.

On the other hand, other courts have held that defendants cannot challenge a plaintiff's appointment as lead plaintiff. The Third Circuit has emphasized that "only class members may seek to rebut the presumption, and the court should not permit or consider any arguments by defendants or non-class members," *In re Cendant Corp. Litig*., 264 F.3d 201, 268 (3d Cir. 2001), "because defendants w[ould] rarely have the best interests of the class at heart," *In re Merck & Co. Sec. Litig*., 432 F.3d 261, 267 (3d Cir. 2005). At least one district court has likewise rejected defendants' attempts to challenge plaintiffs' suitability to serve as lead plaintiffs. *See In re Universal Access, Inc., Sec. Litig*., 209 F.R.D. 379, 383 (E.D. Tex. 2002).

Unless the remaining federal circuits join in the approach of the Third Circuit, this conflict will likely require resolution by the Supreme Court.

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FEDERAL COURTS ALSO DISAGREE ON HOW MANY UNRELATED "LEAD PLAINTIFFS" ARE TOO MANY

As a related matter, since the PSLRA allows a court to appoint a "group of persons" as lead plaintiff, 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I), can a court appoint a group of unrelated investors that a plaintiffs' lawyer or the court itself put together as lead plaintiffs? Courts disagree on whether they can do so and, if so, how many unrelated plaintiffs can be aggregated.

The vast majority of recent decisions have found that unrelated plaintiff class members can be grouped as lead plaintiffs, but the courts frequently adopt different approaches as to how many unrelated plaintiffs can be grouped together. In *In re Flight Safety Technologies, Inc. Securities Litigation*, 231 F.R.D. 124, 128-31 (D. Conn. 2005), the court decided that a proposed group of "eight unrelated and unfamiliar plaintiffs as co-lead plaintiffs" needed to be reduced in number to improve the overall efficiency of the litigation. Another court concluded that a group of three unrelated investors should be permitted to serve as lead plaintiffs where "it would be most beneficial to the class under the circumstances of [the] given case." *In re Star Gas Sec. Litig*., No. 3:04CV1766(JBA), 2005 WL 818617, at *4-*5 (D. Conn. April 8, 2005).

Other courts generally reach the same result but through different reasoning. In *In re eSpeed, Inc. Securities Litigation*, the court began by acknowledging two earlier New York courts' decisions that "forcefully assert[ed]" that "unrelated investors may not band together for the purpose of achieving lead plaintiff status." 232 F.R.D. 95, 99 (S.D.N.Y. 2005). The court disagreed with these courts' "minority" view and concluded that "[g]enerally, a lead plaintiff group should be held to a reasonable number [generally not more than five], so that the group does not become too unwieldy." *Id*. A later decision applied a three-factor test in deciding that a group of six unrelated plaintiffs was not too many: (1) the size of the proposed group, (2) the intentions behind the group's formation, and (3) the plaintiffs' relationship. *Barnet v. Elan Corp*., 236 F.R.D. 158, 161-63 (S.D.N.Y. 2005).

The Third Circuit has similarly concluded that no preexisting relationship is required for multiple lead plaintiffs. *In re Able Labs. Sec. Litig*., 425 F. Supp. 2d 562, 567-68 (D.N.J. 2006) (citing *In re Cendant Corp. Litig*., 264 F.3d 201, 266 (3d Cir. 2001)). Lawyers, however, may not create groups simply to meet the PSLRA's largest-financial-interest requirement, and any group

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generally should not exceed five members. *Cendant*, 264 F.3d at 266-67. Other courts have endorsed a similar analysis. *In re Cardinal Health, Inc. Sec. Litig*., 226 F.R.D. 298, 307-08 (S.D. Ohio 2005) (endorsing a "case-by-case evaluation"); *Meyer v. Paradigm Med. Indus*., 225 F.R.D. 678, 681 (D. Utah 2004) (generally no more than 10 members).

Other district courts, however, have refused to appoint groups of unrelated plaintiffs as lead plaintiffs. *E.g., Ruland v. InfoSonics Corp*., Nos. 06cv1231 BTM(WMc), 06cv1233 BTM(WMc), 06cv1309 BTM(WMc), 06cv1331 BTM(WMc), 06cv1378 BTM(WMc), & 06cv1435 BTM(WMc), 2006 U.S. Dist. LEXIS 79144, at *7-*11 (S.D. Cal. Oct. 23, 2006); *In re Cree, Inc. Sec. Litig*., 219 F.R.D. 369, 372 (M.D.N.C. 2003); *In re Critical Path, Inc. Sec. Litig*., 156 F. Supp. 2d 1102, 1112 (N.D. Cal. 2001); *Gluck v. CellStar Corp*., 976 F. Supp. 542, 549 (N.D. Tex. 1997). As one court explained, some courts have done so because "groups of unrelated class members are more likely to abdicate their responsibility to coordinate the litigation to their attorneys, in contravention of the PSLRA's goal to eliminate lawyer-driven litigation." *Rozenboom v. Van Der Moolen Holding, N.V*., No. 03 Civ. 8284(RWS), 2004 U.S. Dist. LEXIS 6382, at *11-*12 (S.D.N.Y. Apr. 14, 2004). Recently, a California district court held that "[m]any of the cases appointing co-lead plaintiffs . . . appear to be fundamentally at odds with [the Ninth Circuit]'s interpretation of the PSLRA." *Tanne v. Autobytel, Inc*., 226 F.R.D. 659, 673 (C.D. Cal. 2005). In particular, the court was concerned about *In re Cavanaugh*, 306 F.3d 726, 729-31 (9th Cir. 2002), in which the Ninth Circuit spoke in terms of a single lead plaintiff when explaining that "the district court must consider the losses allegedly suffered by the various plaintiffs" and select as the "presumptively most adequate plaintiff . . . the one who has the largest financial interest in the relief sought by the class and [who] otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure."

Companies facing securities actions should be vigilant in monitoring these two PSLRA lead-plaintiff issues and should consider appropriate challenges to would-be lead plaintiffs and groups of lead plaintiffs.

CONCLUSION

Congress' efforts to reform securities-fraud class-action litigation have given rise to several difficult issues that have divided the federal courts. The issues discussed in this article are only a few of the questions that the Acts' provisions raise but which federal courts have not conclusively answered. Companies facing such suits should be attentive to these issues and give careful consideration to how they can encourage courts to address them in a manner that befits the purpose of the Acts: reducing and eliminating problems with and abuses in securities-fraud class actions. ■

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