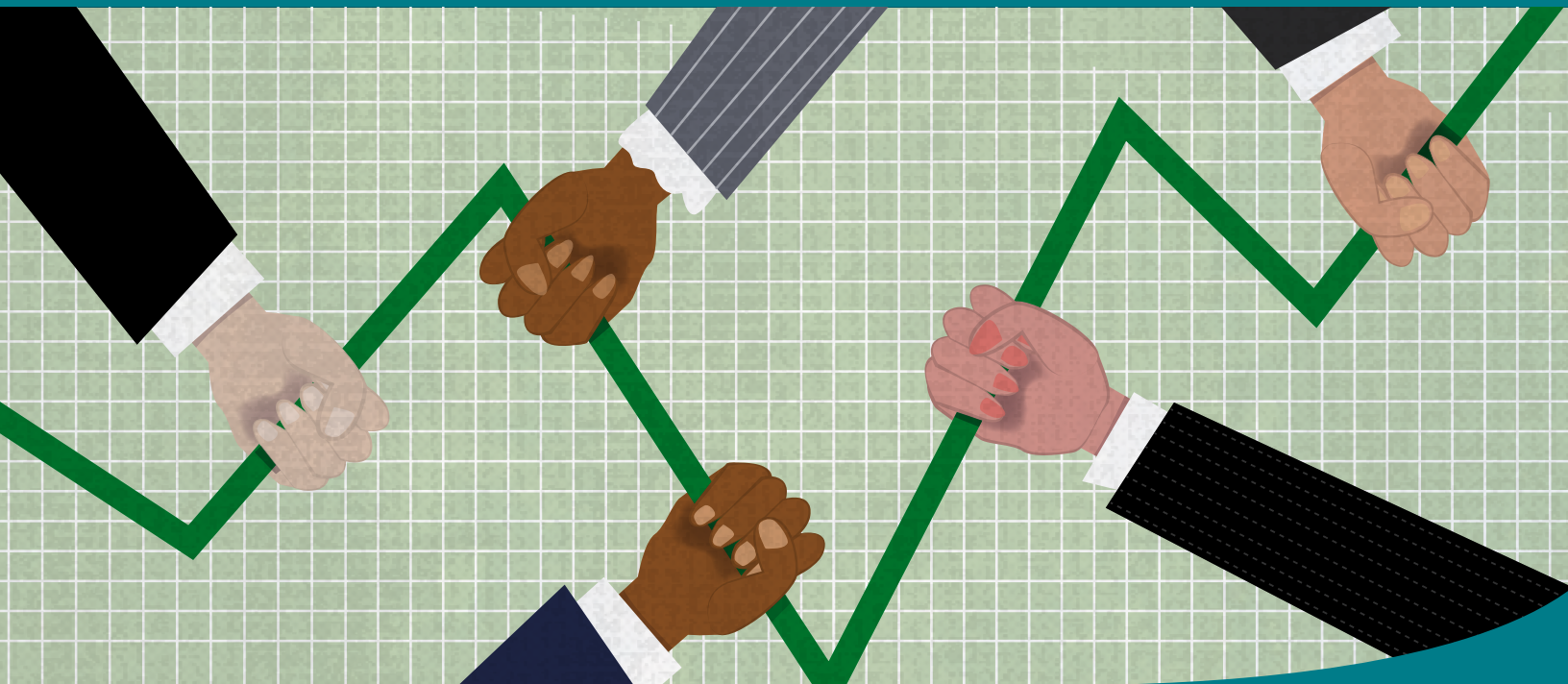


ILR BRIEFLY



An Update on Securities Litigation

“ New data confirms that the securities litigation crisis is continuing. Case filings remain at record highs for the third consecutive year. And we are seeing new evidence of the real-world adverse consequences for investors ... ”



U.S. CHAMBER
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Broken Securities Class Action System Continues Out of Control[†]

The securities litigation system is in crisis. Two previous ILR reports¹ explain in detail the serious problems and how they can be addressed—in particular:

M&A Litigation

There is an increasing onslaught of cases challenging virtually every merger and acquisition deal valued at more than \$100 million involving a public company. After a crackdown on abusive claims by the Delaware Court of Chancery, these cases migrated to federal court, where they are routinely settled with no benefits to investors and substantial payments to plaintiffs' lawyers, without any judicial oversight.

Event-Driven Claims

A new wave of "event-driven claims" continues, based on a company's failure to predict adverse events in its underlying business, such as a data breach or environmental disaster. Legal experts are skeptical about the merits of these claims, but they are powerful weapons for coercing quick settlements because of the reputational harm from ongoing litigation and the high cost of defense.

Parallel State-Federal Filings

The number of federal securities class actions filed in state court continues to grow as a result of the Supreme Court's decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*,² ruling that class actions under the federal Securities Act may be brought in state court. Among other things, this dynamic forces some companies to defend against the same claim simultaneously in actions in state and federal courts.

Policymaker Action Needed

Policymakers need to act, including the Securities and Exchange Commission (SEC) and, ultimately, Congress, to correct the serious imbalances in the securities litigation system.

New Data Confirms It: The Securities Litigation Crisis Continues

Case filings remain at record highs for the third consecutive year. And there is new evidence of the real-world adverse consequences for investors in the form of dramatic increases in rates and reduction in availability of directors and officers (D&O) insurance. That means higher costs are ultimately borne by investors. In addition, small and medium-sized companies that are not able to obtain appropriate levels of D&O insurance will have trouble attracting the high-quality directors that they need—again, harming the very investors that the securities laws are supposed to protect.

Record Filing Levels for the Third Consecutive Year

Each of the studies tracking securities litigation filings found that 2019 saw the same high level of litigation as 2017 and 2018—in the words of one analyst, “it is clear that the recent elevated levels of securities class action lawsuit filings represent the new normal.”³

Cornerstone Research reported that “[p]laintiffs filed 428 new securities class actions across federal and state courts, the highest number on record and nearly double the 1997-2018 average.”⁴ “Filing activity in federal and state courts accelerated in 2019. Each of the

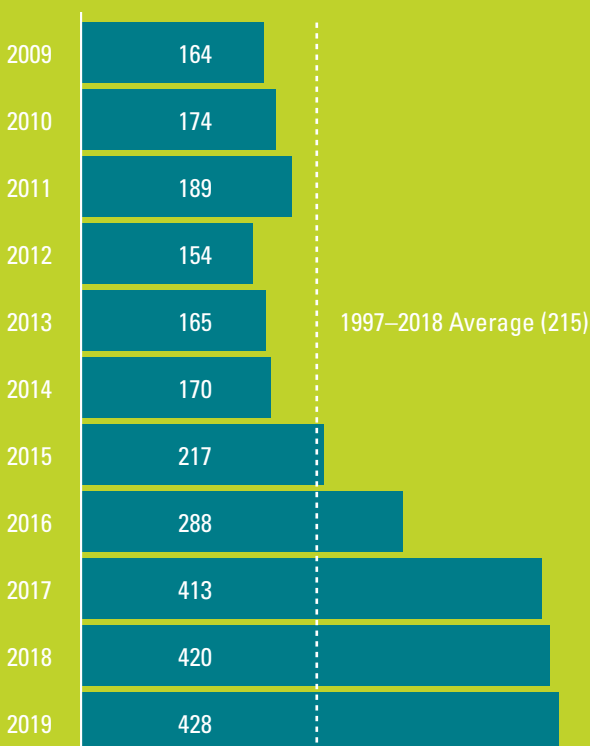
last three years—2017 through 2019—has been more active than any previous year.”⁵ Other studies reported similar results—for example, NERA Economic Consulting found 433 new cases in 2019, “the third consecutive year with more than 400 cases filed.”⁶

Even more important, “the likelihood of a U.S.-listed company getting hit with a securities suit is the highest it has ever been”—with one study finding “just under one out of every eleven U.S. listed companies was hit with a securities suit,” a litigation rate of 8.66 percent.⁷ Another study

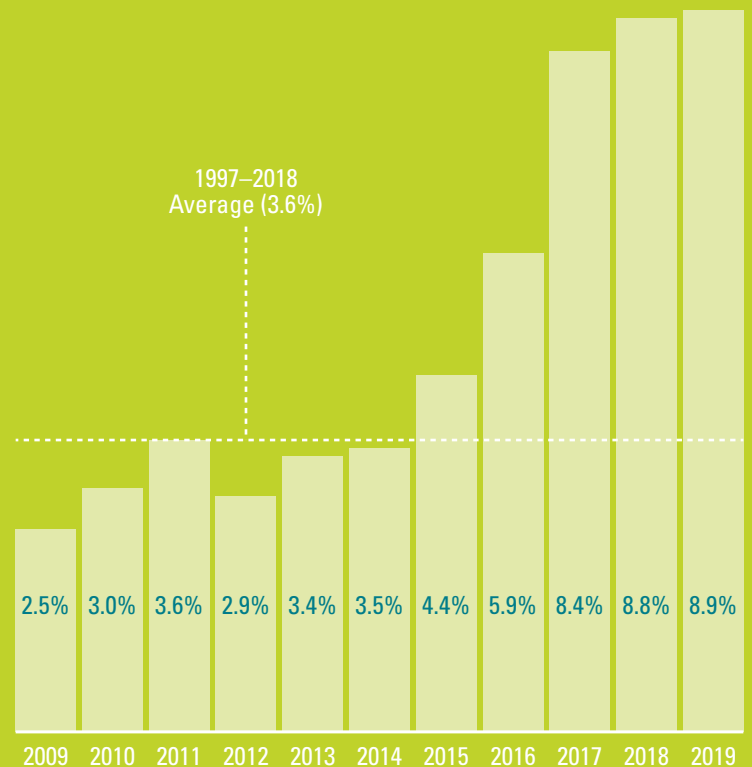
put the percentage higher at 8.9 percent—a record high and two and one-half times the 1997-2018 average.⁸

Finally, the size of the 2019 cases—although short of 2018’s record—remains very large by historical standards. Analysts measure the relative size of a case by examining the dollar-value change in a defendant company’s outstanding shares before and after the class period. The \$285 billion calculated for 2019’s cases is more than double the 1997-2018 average of \$130 billion.⁹

Securities Class Action Filings 2009-2019



Likelihood of U.S. Listed Company to Face Securities Litigation 2009-2019



Dramatic Increases in State Court Filings— and Some Relief for Delaware Corporations

The consequences of the Supreme Court’s *Cyan* decision are now being realized: 49 federal securities class actions were filed in state courts in 2019—more than four times the 2010-2018 average.¹⁰ Indeed, 2019 saw more claims under the federal Securities Act filed in state court than in federal court.¹¹ And these state claims are large—the cases filed in 2019 involved claims three times as large as the 2010-2018 annual average.¹²

Moreover, plaintiffs’ lawyers formerly focused these cases in New York and California state courts. But “[s]tate filings in states outside of New York and California almost tripled in 2019,” with cases filed in Florida, Illinois, Massachusetts, Michigan, Nevada, New Jersey, Pennsylvania, Rhode Island, Tennessee, Texas, and Wisconsin.¹³

Nearly half of the state court cases—22—involved claims that also were asserted in parallel federal court cases.¹⁴

One commentator observed that “the number of parallel state and federal lawsuits presents its own set of problems, as defense expenses are increased and as the claim management becomes complicated by duplicative and potentially conflicting

case processing and claims resolution.”¹⁵

Not surprisingly, state courts less familiar with securities class

2018 compared to 43 percent of Section 11-only federal filings.”¹⁶

Many Delaware corporations sought to protect themselves against abusive M&A litigation by including choice-of-forum provisions in their bylaws, requiring that the state-law causes of action invoked in M&A challenges be brought in Delaware state court (as opposed to federal court or other state courts). The Delaware courts upheld such provisions,¹⁷ and they subsequently were expressly validated by an amendment to Delaware’s corporate law.¹⁸

But the Delaware Court of Chancery held in 2018 that a Delaware corporation could not use a choice-of-forum provision in its articles of incorporation to protect itself against the consequences of *Cyan* by designating federal courts as

“ *When parallel state and federal actions are filed, no procedural mechanism is available to consolidate or coordinate multiple suits in state and federal court. The costs and inefficiencies of multiple cases being litigated simultaneously in both state and federal courts are obvious. The possibility of inconsistent judgments and rulings on other matters, such as stays of discovery, also exists.* **”**

actions dismiss fewer claims—which means that plaintiffs’ lawyers have a greater chance to force a settlement. The difference is significant: “[o]nly 26 percent of state Section 11 [of the federal Securities Act] filings were dismissed in 2010-

the forum for claims against the company under the federal Securities Act. In so doing, the court invalidated articles of incorporation provisions requiring such actions to be brought in federal court (and thereby avoiding the risk that the company would be subject to multiple claims in state and federal court, or in several state courts).¹⁹ The Chancery Court held the provisions invalid on the ground that the “constitutive documents of a Delaware corporation cannot bind a plaintiff to a particular forum when the claim does not involve rights or relationships that were established by or under Delaware’s corporate law.”²⁰

On March 18, 2020, the Delaware Supreme Court unanimously reversed that determination, holding these forum selection provisions facially valid under Delaware law.²¹ The court relied in large part on the harm inflicted on companies by multiple Securities Act lawsuits in different forums:

When parallel state and federal actions are filed, no procedural mechanism is available to consolidate or

coordinate multiple suits in state and federal court. The costs and inefficiencies of multiple cases being litigated simultaneously in both state and federal courts are obvious. The possibility of inconsistent judgments and rulings on other matters,

“With the Delaware Supreme Court giving a green light to forum-selection provisions relating to federal Securities Act claims, Delaware corporations now can protect themselves against the burdens of defending such lawsuits in multiple forums.”

such as stays of discovery, also exists. By directing 1933 Act claims to federal courts when coordination and consolidation are possible, [these forum-selection provisions] classically fit the definition of a provision ‘for the management of the business and for the conduct of the affairs of the corporation.’²²

The Delaware court further concluded that these provisions are consistent with federal law and policy and with federalism principles. It

recognized that a facially-valid articles of incorporation provision “will not be enforced if adopted or used for an inequitable purpose”—such as when enforcement would be “unreasonable and unjust” or where there is “fraud or overreaching”—but that sister states otherwise should enforce these choice-of-forum provisions because they relate closely to a corporation’s internal affairs and therefore “do not violate principles of horizontal sovereignty.”²³

With the Delaware Supreme Court giving a green light to forum-selection

provisions relating to federal Securities Act claims, Delaware corporations now can protect themselves against the burdens of defending such lawsuits in multiple forums. Of course, that does not help companies incorporated in other states (unless those states also permit forum-selection provisions), or foreign corporations—which is why congressional action to address the *Cyan* problem remains an urgent priority.



Coronavirus Claims are the Newest Category of Event-Driven Lawsuits

It was probably inevitable that the growing number of “event-driven” securities lawsuits would include claims based on the Coronavirus pandemic—after all, plaintiffs’ lawyers have already pointed to fires, a dam collapse, oil well explosions, and other disasters as the basis for securities claims.

Numerous legal experts, including Professor John Coffee of Columbia Law School, have expressed skepticism about these types of claims. As two litigators have explained, “[t]he inherent problem in all event-driven securities litigation is that just because something bad happened does not mean that the company or its directors and officers committed fraud. Because many of these events relate to business or operational risks that are known or already subject to a company’s risk disclosures, many of the event-driven suits are based on the tenuous theory that the occurrence or the event upon which the case is based was the materialization of an under-disclosed or downplayed risk.”⁴⁶

Notwithstanding the legal obstacles, these claims continue to be brought—following a pattern in which the complaint is filed very quickly after the adverse business event—because they typically have a large settlement value: the costs of defense are high and few companies want to risk the reputational damage that could result from prolonging the litigation of such claims.

It therefore is not surprising that two Coronavirus securities claims have already been filed.⁴⁷ And they likely are the first in what will be a long line of virus-related securities lawsuits.

D&O Insurance Becomes More Costly—and Less Available

The securities litigation explosion has created, in the words of one expert, a “disrupted insurance market.”

That means insurers “are seeking increased rates” and “many primary insurers are requiring increased retentions”—the “deductible” that a company must pay before insurance coverage is triggered.²⁴

Markedly Increased Premiums

These higher costs are substantial: “insureds are seeing markedly increased premiums, in some cases double (or even higher) than previous premiums, even for those insureds whose risk profile has not changed.”²⁵ And insurers “are increasing policy deductibles For example, a \$2.5 million deductible for securities claims might be increased to \$5 million or even higher. For companies going through the IPO process, deductibles may set at \$10 million or higher.”²⁶ Insurers are also lowering the amount of coverage offered, and “the current hardening market may mean that certain insurers simply decide not to renew their policies, or underwrite new ones, leading to a more limited pool of insurers for an insured to access.”²⁷

Little Relief in Sight

Another analyst expects “continuation of the high D&O insurance premium costs for public company issuers suffered in 2019. Given the limited underwriting capacity available in the D&O market today—after all, these levels of losses aren’t exactly making the D&O insurance market attractive to carriers—there is a very low probability that companies will see any relief in their premium costs in the near future, and, certainly not in 2020.”²⁸ Moreover, “rates for large-cap companies are increasing less than those of small-cap companies despite the significant losses being paid in the large-cap sector.”²⁹

Direct Impact on Investors

These higher costs directly impact investors—reducing companies’ profits and, to the extent coverage is not available, exposing companies and their directors to personal liability. Because the burden is greatest for smaller companies, qualified individuals will be reluctant to serve on those companies’ boards, which deprives investors of the experienced guidance that those companies need.

End of the *State Street* Saga—Plaintiffs’ Lawyer Fees Cut, Conduct Referred to Bar Disciplinary Body

Prior ILR research explained how the *State Street* case made visible the abusive practices by some plaintiffs’ law firms that frequently file securities class actions.³⁰

A special master appointed by the federal district court to investigate alleged misstatements in the \$75 million fee request (based on a \$300 million settlement) found “a troubling disdain for candor and transparency that at times crossed the line into outright concealment of important material facts” as well as “a web of concealment and highly questionable ethical practices by experienced attorneys who should have known better.”³¹

The district court rejected a proposed settlement that had been entered into between some of the law firms and the special master, reduced the attorneys’ fee award by 20 percent, found that the plaintiffs’ lawyers’ submissions in support of the fee request “were replete with material false and misleading statements,” and referred its findings of misconduct “to the Massachusetts Board of Bar Overseers for whatever action, if any, it deems appropriate.”³² The court’s opinion contains disturbing findings regarding the actions of several of the law firms representing the plaintiff class.

Violated Ethical Rules

The court highlighted the discovery of a payment of \$4.1 million to Damon Chargois, “a Texas lawyer who had done no work on these cases.”³³ The court found that “in 2007, [one of the law firms] had asked Chargois to find institutional investors in the Southwest that could hire [the firm] as monitoring counsel and to influence them to do so”³⁴—the term “monitoring counsel” refers to an arrangement under which a law firm monitors the institutional investor’s investments and “recommend[s] that [the investor] initiate certain class actions and retain [the law firm] as lead counsel if [the investor] succeeded in being appointed lead plaintiff.”³⁵

As the district court explained, “[s]erving as monitoring counsel for an institutional investor is potentially very lucrative. The opportunity for monitoring counsel to profit greatly creates a risk that firms will engage in questionable conduct to obtain such assignments. . . . [I]t would be far more consistent with the purposes of [federal law] if such monitors, who could provide the service to many funds that

would share the cost, were paid on a fee-for-service basis and did not have powerful financial incentives to recommend initiating a class action from which they would foreseeably benefit the most.”³⁶

The court found that “[n]either Chargois, nor his partner in Arkansas, Herron, had any relationship with any institutional investor. No institutional investor had ever asked either of them for advice generally or to find monitoring counsel particularly. However, Herron knew Steve Faris, an Arkansas State Senator on the Joint Committee on Public Retirement and Social Security Programs, which was responsible for oversight of [the Arkansas Teachers Retirement Fund (ATRS)]. Chargois arranged for [the law firm’s] partners . . . to meet Faris.”³⁷ Faris arranged for the law firm to be retained by the Fund, and Chargois wrote to the law firm:

Our deal with [the law firm] is straightforward—we got you ATRS as a client (after considerable favors, political activity, money spent and time dedicated in Arkansas) and [the law firm] would use ATRS to seek lead counsel



appointments in institutional investor fraud and misrepresentation cases. Where [the law firm] is successful in getting appointed lead counsel and obtains a settlement or judgment award, we split [the law firm's] attorney fee award 80/20. Period.³⁸

This arrangement was not disclosed to ATRS, the plaintiff class, or to the court. The court found that the law firm “violated the Massachusetts ethical rules ... in concealing its agreement to pay Chargois 20% of its fees in all ATRS cases in which [the other law firm] was Lead Counsel.”³⁹

Although neither the special master nor the court investigated the “favors” and “political activity” referred to by Chargois, they seem to involve what Professor John Coffee has called the “rather sordid market of buying and selling plaintiffs” in securities class actions through the use of political contributions, among other means.⁴⁰

The court’s opinion documents another example of political relationships being used to facilitate legal representations in class actions. One of the lawyers

confirmed that he had served in the Massachusetts Legislature with [Thomas J.] O’Brien, the Plymouth County

Treasurer who chaired the Plymouth County Retirement Board, and he was instrumental in obtaining the Board as a client for [two law firms]. [The lawyer] also confirmed that it was indeed his role to ‘drum up business’ for [the two firms]. More specifically, he testified that it was his job to get [a law firm] retained as a monitor for a fund and to represent it if the fund became a lead plaintiff in a class action. [His law firm] would then get up to 20% of

“ [T]his case demonstrates that not all lawyers can be trusted when they are seeking millions of dollars in attorneys’ fees and face no real risk that the usual adversary process will expose misrepresentations that they make.”

the fees awarded to [that law firm] in a class action in which [it] represented a client obtained by [the lawyer who served in the legislature], even if [his law firm] did not file an appearance or do any work on the case.⁴¹

In addition, lawyers from both firms made campaign contributions to O’Brien.⁴²

Material False and Misleading Statements

The district court also described in detail the facts underlying its

determination that “the submissions of [two of the plaintiffs’ law firms] in support of the request for an award of \$75,000,000 were replete with material false and misleading statements,”⁴³ some of which “led to the double-counting error that inflated their total [fee request] lodestar by over \$4,000,000.”⁴⁴

The court concluded: “The United States has a proud history of honorable, trustworthy lawyers. However, this case demonstrates that not all lawyers can be trusted when they are seeking millions of dollars in attorneys’ fees and face no real risk that the usual adversary process will expose misrepresentations that they make. Therefore, in making fee awards in class actions, it is important that judges

be skeptical, and do the hard work necessary to protect the interests of the class and the integrity of the administration of justice.”⁴⁵

The district court’s detailed explanation of the improper practices in *State Street* demonstrates the need for additional protections to prevent class members from being victimized by the attorneys designated to represent them.

Conclusion

Securities filings in 2019 continued the trends demonstrating that the system is out of control and in need of reform—and that investors are paying the price. Policymakers, particularly Congress and the SEC, should take action now.



Endnotes

- † *ILR, Briefly: An Update on Securities Litigation* was prepared by Andrew J. Pincus, Mayer Brown LLP.
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- 9 *Id.* at 7.
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- 11 *Id.*
- 12 *Id.* at 20.
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