# BARRACK BULLETIN

THE INSTITUTIONAL INVESTOR'S GUIDE TO SECURITIES CLASS ACTION LITIGATION
REPRESENTING INVESTORS' INTERESTS SINCE 1976

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**An·ni·ver·sa·ry (n.)**
**The annually recurring date of a past event, especially one of historical, national, or personal importance.**

*American Heritage Dictionary of the English Language (4th ed. 2000)*

In 2006, we celebrate the 30th anniversary of the founding of Barrack, Rodos & Bacine. This edition of the Barrack Bulletin examines that important milestone, as well as the 10th anniversary of the Private Securities Litigation Reform Act of 1995, the first major change to the federal securities laws since their enactment in the early 1930s, in the wake of the stock market crash in 1929.

We mark the 10th anniversary of the PSLRA with articles about the major changes brought by the legislation and the practical effects of those changes on the prosecution of securities fraud class actions. We also celebrate Barrack, Rodos & Bacine's 30th anniversary, with a look back at the firm's journey from a small new firm in an emerging field to the nationally recognized leader in securities litigation that it is today. ❖

## Barrack, Rodos & Bacine at 30


M. Richard Komins
*Partner, Barrack, Rodos & Bacine*


In the summer of 1976, Leonard Barrack and Gerry Rodos opened the doors of their offices at 2000 Market Street in Philadelphia for the first time. There was little fanfare and no ceremony. The vision shared by these young entrepreneurs was of a small "litigation boutique" specializing in the emerging areas of securities and antitrust class actions.

The commercial class action field had been born a mere ten years earlier, when the Federal Rules of Civil Procedure were amended to include the class action rules and procedures as we know them today. Philadelphia lawyers were among the first, and most successful, litigators to see the possibilities of using the class action device to provide a remedy for large numbers of persons affected by unlawful corporate acts. Leonard Barrack and Gerry Rodos learned the craft of class action litigation from the pioneers in the field, and in 1976 they embarked on a remarkable 30-year journey, joined by Dan Bacine in 1977, championing the rights of injured investors and vindicating the rights of businesses to operate in truly competitive markets.

*continued on page 2*

## The Private Securities Litigation Reform Act, Ten Years Later


Samuel M. Ward
*Attorney, Barrack, Rodos & Bacine*


The Private Securities Litigation Reform Act of 1995 ("PSLRA") was the most substantial change to the federal securities laws since their enactment in 1933 and 1934. The PSLRA had its origins in the 1994 Congressional elections with the introduction of the "Contract with America" -- legislative goals designed to reshape the federal government, which included a series of legal reforms designed to reduce the number of securities actions filed each year. After the 1994 elections, these reforms were introduced as the PSLRA.

The drafters of the PSLRA argued that it was needed to stymie what they characterized as the "explosive" growth of securities class action lawsuits. However, initial drafts of the PSLRA suggested that the underlying goals of its drafters had more to do with shielding public corporations and their officers from liability than from preventing the filing of "frivolous" lawsuits. These proposed provisions included:

*continued on page 4*

**BR&B's 30th Anniversary**

*continued from page 1*

**Early Successes**

The first case filed by the firm was a securities class action against the Singer Company. After three years of hard-fought litigation, the case settled for $4.4 million. A well-known class action lawyer testified as an expert in support of the settlement. He testified that the settlement amount was, at the time, "one of the highest ever achieved, not only in this district, but in the United States."

Leonard Barrack recalls the obstacles that had to be overcome in the early days of the firm: "There were a few well-established firms in the class action field in those days, and not many upstarts. The established firms were not very hospitable to newcomers." The firm fought hard to establish itself in the class action field on the basis of its quality work.

One of the partners' earliest successes was the Ninth Circuit's landmark decision in *Blackie v. Barrack*. This oft-cited opinion by the United States Court of Appeals for the Ninth Circuit was the first appellate recognition of the "fraud-on-the-market theory." This theory, which is at the very heart of securities fraud class actions, holds that when a stock trades in a well-developed, "efficient" market, fraudulent information is presumed to be assimilated by the market. The fraudulent information "artificially inflates" the market price of the stock paid by every purchaser during the period of time the information is in the public domain and anyone buying stock at an artificially inflated price is presumed to have relied on the integrity of the market price. By relying on the integrity of the market, each investor is presumed to have relied on the fraudulent information. Because these presumptions apply to everyone who unwittingly purchased stock at prices that were artificially inflated by fraud, *Blackie v. Barrack* paved the way for courts to grant class action status to securities fraud cases.

*M. Richard Komins*

**Developing a National Presence**

By the early 1980s, Barrack, Rodos & Bacine had established a reputation for careful, high-quality work, aggressive case management, and fair dealings with counsel on both sides of a case. Barrack attributes much of the firm's success to the partners' ability to anticipate trends in the practice. Barrack points to the decision to open an office in San Diego, California in1982 as an example: "We were able to anticipate the wave of securities litigation arising from the high tech industry on the West Coast and elsewhere, and having a presence on both coasts enabled us to have an effective national practice."

From the mid-1980s through the mid-1990s, Barrack, Rodos & Bacine served as lead counsel or played significant roles in numerous securities and antitrust cases. The more notable securities cases from that period involved the securities of Magic Marker, Bluebird, CGA, Data Access, Western Union, ITT, Craftmatic, RJR Nabisco, First Fidelity Bancorp, Centacor, Westinghouse, M.D.C. Holdings, Medstone, Wickes, Marion Merrell Dow, and Oak Industries. Notable antitrust cases from this period in which the firm played an important role include the *Folding Cartons, Corrugated Containers, Department Stores Women's Clothing, Fine Paper, Copper Tubing, Industrial Gas, Soft Drinks, and Carpet* cases.

*The firm's achievements have been ground-breaking.*

The firm was also at the forefront of developing law during this period. Lawyers from Barrack, Rodos & Bacine won a number of key victories in courts around the country, which helped define the requirements for pleading and proving securities fraud claims. These decisions included:

- *Herskowitz v. Nutri/System, et al.*, 857 F.2d 179 (3rd Cir. 1988) (defining when an opinion by an investment banker could be deemed to be "false" under the securities laws);
- *In re Control Data Corporation Securities Litigation*, 933 F.2d 616 (8th Cir. 1991) (defining the concept of loss causation in securities fraud cases);
- *Shapiro v. UJB Financial Corp.*, 964 F.2d 272 (3d Cir. 1992) (defining the pleading requirements in securities fraud cases);
- *In re Craftmatic Securities Litigation*, 890 F.2d 628 (3d Cir. 1990) (clarifying the distinction between claims of securities fraud and claims of corporate mismanagement); and
- *Kaplan v. Rose*, 49 F.3d 1363 (9th Cir. 1995) (clarification of grounds for liability for forward looking statements and standards for proof of scienter).

*continued on page 3*

**BR&B's 30th Anniversary**

*continued from page 2*

The firm tried a number of cases during this period, winning jury verdicts in 1987 in *Betanzos v. Huntsinger*, in the Central District of California involving H&H Tool Company; in 1990 in *Gould v. Marlon*, a case involving Sierra Health Services that was tried in the District of Nevada; and in 1996 in *Guitierrez v. The Charles J. Givens Organization*, a consumer case in the Superior Court of California, County of San Diego. Other cases settled during or after trial, included *Herskowitz v. Nutri/System, Inc.*, a securities case arising from the leveraged buyout of Nutri/System; *In re Control Data Corporation Securities Litigation*, a securities case tried in the District of Minnesota; and *Uniondale Beer Co. v. Anheuser-Busch, Inc., et al.*, an antitrust case against beer manufacturers tried in Central Islip, Long Island, New York.

**Securities Litigation After the Private Securities Litigation Reform Act**

After years of intense lobbying by insurance companies, high tech companies, public accounting firms, and other groups seeking to weaken private enforcement of the securities laws, Congress enacted the Private Securities Litigation Reform Act ("PSLRA") in late 1995. The PSLRA represented the first major legislative refinements of the securities laws in 60 years, and it brought about a sea change in the nature of the firm's practice.

Following the passage of the PSLRA there was great uncertainty as to how the statute would affect the future of securities litigation. No one could be sure whether the stricter pleading standards would merely filter out non-meritorious cases and allow meritorious ones to proceed, or whether they would pose so high a barrier that private enforcement of the securities laws would effectively end. Moreover, firms accustomed to obtaining leadership positions by reacting quickly to breaking cases could no longer rely on that skill.

*As the past ten years have shown, corporate fraud, if not constantly identified and fought, will be an enormous drain on our economic system and, in particular, on institutions like pension funds that depend on the integrity of the stock market to provide benefits for retirees.*

The securities bar reacted tentatively, and for about six months following the passage of the PSLRA, very few new securities class actions were filed. In retrospect, the hesitancy on the part of the private securities bar may have contributed to the feeling by some corporate executives that the PSLRA signaled an end to vigorous enforcement of the securities laws. As a result, the losses suffered by investors from corporate fraud in the decade following the enactment of the PSLRA have been unparalleled.

Once again, the firm's leadership successfully navigated these uncharted waters. Leonard Barrack saw that the key to success in this new environment would be to offer service to our clients, large and small, that they would not get elsewhere. In the first few years following the passage of the PSLRA, most courts permitted groups of unrelated individuals to serve as the lead plaintiffs if those groups, in the aggregate, had the largest financial interest in the litigation. Barrack, Rodos & Bacine was able to successfully aggregate large groups of individuals by giving its clients a level of personal attention they did not receive from other firms.

More significantly, Barrack, Rodos & Bacine was the first firm to represent public pension funds as lead plaintiffs in securities class actions under the PSLRA. Beginning in the spring of 1996, the firm filed cases on behalf of the retirement systems of the City of Philadelphia and the Commonwealth of Pennsylvania. Building on that experience, the firm has steadily grown its institutional client base by developing an array of innovative services for institutional investors, including the firm's web-based **B**arrack **E**valuation **A**nd **M**onitoring **S**ystem, or **BEAMS®**. The firm's extensive institutional client base ranges from several of the country's largest public pension funds to local Taft-Hartley labor unions. The firm has represented pension funds serving as lead plaintiffs in securities class actions, such as the New York State Common Retirement Fund

*continued on page 4*

## INSIDE THIS ISSUE

## BR&B's 30th Anniversary

*continued from page 3*

("NYSCRF"), the California Public Employees Retirement System ("CalPERS"), the Florida State Board of Administration, the Commonwealth of Pennsylvania Retirement System, and many others.

The firm's achievements have been ground-breaking. The $3.18 billion settlement of the *Cendant* securities litigation, in which the firm represented lead plaintiffs NYSCRF and CalPERS, was the first multi-billion dollar securities class action settlement and far exceeded the amount of the previous largest settlement. The firm's settlement of the *WorldCom* securities litigation for $6.133 billion in 2005, where NYSCRF again served as lead plaintiff, nearly doubled the amount of the settlement in *Cendant*. The court recently gave final approval to the partial settlement of the *McKesson HBOC* securities litigation of nearly a billion dollars.

### Looking to the Future

Although the challenges ahead for the firm are formidable, there are many reasons for optimism. No one can predict where the next huge corporate fraud will occur, but it is a reasonably safe bet that it will occur somewhere. Our economic system, which offers huge rewards to corporate managers who beat the competition and severe punishment to those who do not, offers ever-present temptations to break the rules. Even though well-litigated class actions, led by interested and able institutional investors, are a real deterrent, the best that can be expected is that they will reduce, but not eradicate, securities fraud and anti-competitive activities. As the past ten years have shown, corporate fraud, if not constantly identified and fought, will be an enormous drain on our economic system and, in particular, on institutions like pension funds that depend on the integrity of the stock market to provide benefits for retirees. BR&B is confident that its thirty years of experience in an ever-changing legal and economic environment has positioned the firm well to remain a leader in the coming decade. ❖

### *Claims Filing Deadlines*

*Barrack Rodos & Bacine provides up-to-date claims filing information online.*
*Visit the Investor Resources Center at*
*www.barrack.com*
*for detailed claims filing deadline information.*

## The PSLRA: 10 Years Later

*continued from page 1*

- Requiring plaintiffs to prove actual reliance on defendants' false or misleading statements. This requirement would have effectively voided the "fraud-on-the-market" doctrine enunciated in *Blackie v. Barrack*, and adopted by the Supreme Court in *Basic, Inc. v. Levinson* in 1988.

- Raising the pleading standard for knowledge, or "scienter," unattainably high by requiring plaintiffs to "allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred."

- Adopting the so-called "English Rule" which requires the losing party to pay the expenses of the prevailing party.

These draconian proposals elicited strong opposition from then-chair of the Securities and Exchange Commission, Arthur Levitt, who stated that "[p]roposals such as these, by severely limiting the private remedy against fraud and undermining the incentives for market participants to comply with disclosure laws, could fundamentally damage the integrity and discipline of our capital markets . . ." In the face of strong opposition from the SEC, the legislation was substantially revised and the objectionable provisions were removed entirely or greatly modified.

Even in its amended form, the PSLRA enacted sweeping changes. As adopted by Congress, the PSLRA:

- Established a procedure that strongly favors the appointment of institutional investors as lead plaintiffs.

- Established a new pleading standard for scienter.

- Instituted a stay of discovery during the pendency of any motions to dismiss.

- Provided safe harbors for forward-looking statements, including deliberately false statements accompanied "by meaningful cautionary statements."

President Clinton, still dissatisfied with several aspects of the bill, vetoed the PSLRA, but Congress overrode the president's veto and enacted the PSLRA on December 22, 1995.

*continued on page 5*

**The PSLRA: 10 Years Later**

*continued from page 4*

**Significant Provisions**

Before passage of the PSLRA, there was no concept of a "lead plaintiff." Courts generally selected the law firm that filed the first securities fraud class action to lead its prosecution. As a result, the filing of a securities class action lawsuit resembled a "race to the courthouse," as firms and their clients jockeyed to file the first complaint. The PSLRA ended the race with its requirement that, after the filing of a complaint, interested parties must seek appointment as the "lead plaintiff." The statute created the presumption that the party with the largest financial interest in the outcome of the litigation that seeks the position should be appointed lead plaintiff. The PSLRA demonstrated a clear preference for institutional investors as lead plaintiffs.

*Several studies of post-PSLRA settlements have shown that the median settlement amount in actions with one or more institutional lead plaintiffs is approximately 20% higher than the median value of settlements in which there are no institutional investors among the lead plaintiffs.*

The PSLRA also introduced a new standard for pleading scienter, or defendant's state of mind. The statute now requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). While the drafters of the PSLRA sought to create a consistent pleading standard for the consideration of securities cases, the resulting language has created a split among the circuits as to what constitutes a "strong inference" of scienter. Far from providing uniformity in the application of securities law, these differing standards have created anomalies; whether a case survives a motion to dismiss will often depend on where the case was filed.

Through the inclusion of a "safe harbor" provision, the PSLRA granted defendants protection from liability for projections of future financial data, future economic performance and management objectives for future operations. The PSLRA protects the makers of these forward-looking statements from liability absent a showing that: (1) the speaker believed the statement to be false; (2) the speaker had no reasonable basis to support the statement; or (3) the speaker was aware of non-public facts that contradict or undermine the statement. Companies now often use the "safe harbor" provision to intertwine protected forward-looking statements with statements of current fact in a manner that bolsters false and misleading statements while attempting to shield the speaker from liability.

The PSLRA also introduced a mandated stay of discovery during the pendency of any motions to dismiss. This stay continues to serve as a substantial hindrance to the prosecution of meritorious cases by both delaying the progress of cases and hampering access to evidence that is essential in meeting the PSLRA's heightened pleading requirements. Typically, it can take a year or more for all motions to dismiss in a securities class action to be heard and decided. This lengthy delay increases the cost of the litigation and provides more time (and opportunity) for documents to become lost or destroyed and more time for the memories of potential witnesses to fade. In combination with the heightened pleading standards of the PSLRA, the stay of discovery also threatens meritorious cases by making it exceptionally difficult to gather evidence regarding a defendant's state of mind, placing plaintiffs in a classic "Catch-22," as they often cannot gather the facts and evidence necessary to survive a motion to dismiss until after they have survived a motion to dismiss.

*Samuel M. Ward*

**Impact of the PSLRA**

In the first years following the passage of the PSLRA, institutional investor lead plaintiffs remained relatively rare. But by 1998, institutional investors began taking leading roles in prosecuting the egregious frauds that were coming to light. Notably, the institutional lead plaintiffs played a pivotal role in the landmark $3.18 billion settlement of *In re Cendant Corp. Securities Litigation* in 2000, which also included important corporate governance reforms. The trend has continued, and within the last year, institutional investors have led several of the largest securities class actions to settlement, including the $6.133 billion settlement of *In re WorldCom, Inc. Securities Litigation* and the $960 million partial settlement of *In re McKesson HBOC, Inc. Securities Litigation*. The leadership provided by institutional investors also appears to result in better results for class members. Several studies of post-PSLRA settlements have shown that the median settlement in actions with one or more institutional lead plaintiffs is approximately 20% higher than the median value of settlements in which there are no institutional investors among the lead plaintiffs.

*continued on page 6*

*continued from page 5*

The most frequently-cited goal of the PSLRA's drafters was to "combat the filing of abusive and meritless lawsuits." They suggested that American businesses were faced with an explosion of lawsuits and that by enacting the PSLRA, Congress would halt this growth. However, the years following the PSLRA have been marked by three dramatic trends, all of which suggest that the facts cited by the supporters of the PSLRA did not exist before its passage. First, the average number of securities class actions filed each year has steadily increased. Between 1991 and 1995, the years prior to the passage of the PSLRA, an average of 191 actions were filed each year. Between 1996 and 2004, that average increased more than 11% to 212 actions per year.

*The involvement of institutional investors in this important area of the law has been a benefit to all injured investors.*

The passage of the PSLRA has also seen consistent growth in the size of settlements, even after eliminating the mega-settlements in *WorldCom* and *Cendant*. In the era preceding the enactment of the PSLRA, the average settlement was $8.5 million. Between 1996 and 2001, the average settlement jumped to $13.4 million and, between 2002 and 2005 that average increased still more dramatically to $22.7 million. Finally, the years following the passage of the PSLRA have been marked by an explosion of corporate fraud on a scale that was unthinkable in the decades following the enactment of the federal securities laws in the 1930s. The highly publicized frauds involving WorldCom, Enron, McKesson, Schering-Plough, DaimlerChrysler, Global Crossing, Cendant, Tyco and Adelphia, among others, have shaken the faith in our capital markets and inflamed public mistrust of corporate executives.

Ten years after its enactment, it is clear that the PSLRA re-shaped the prosecution of federal securities class action lawsuits. These changes were not all negative. While a number of the legal "reforms" of the PSLRA have been detrimental to the interests of injured investors, as discussed in the accompanying articles, the involvement of institutional investors in this important area of the law has been a benefit to all injured investors. During this first decade of the PSLRA, Barrack, Rodos & Bacine has been at the forefront of the fight to protect the interests of those injured investors and it will continue to fight on their behalf into the future. ❖

# Who's In Charge? Lead Plaintiff Decisions Under the PSLRA

**Mark R. Rosen**
*Partner, Barrack, Rodos & Bacine*

One of the most significant changes brought by the adoption of the PSLRA was the change in the way that securities fraud class actions are filed and organized. Before the PSLRA, courts frequently decided who would direct a securities class action based solely upon which plaintiff filed the first complaint. No special weight or consideration was given to the identity of the plaintiff or size of the plaintiff's loss covered by the suit. This generated fierce competition as investors and their counsel raced to file complaints as soon as evidence of securities fraud emerged. Often investors who had purchased only a handful of shares, and the lawyers who represented them, were selected to lead the litigation because they had filed their complaints only a few hours, or even minutes, before the next injured investor. Many of the same small investors became "frequent filers" who were named in dozens of different securities suits brought by the same attorneys.

Following the lead of certain academics who advocated a radically different approach, Congress adopted a new system in the PSLRA. The investor or group of investors who had suffered the largest loss (and was willing to serve) was presumed to be the "most adequate plaintiff," and would be selected the "lead plaintiff," provided that this investor or group otherwise satisfied the requirements of Federal Rule of Civil Procedure 23. In shifting from the old "first to file" approach to a new emphasis on who suffered the largest loss, Congress intentionally sought to encourage institutional investors to seek appointment as lead counsel. To make sure that institutional investors and other potential class representatives had an adequate opportunity to investigate the facts before deciding whether to seek appointment as lead plaintiff, Congress also required the first plaintiff who filed a new securities class action complaint to publish a notice of the suit. The PSLRA notice advises all injured investors of their opportunity to seek appointment as the lead plaintiff under these new statutory criteria. No special consideration would be given to the investor or attorney who filed the first complaint. Instead, everyone would have 60 days from the time that the notice was issued to investigate the case before seeking to lead the lawsuit. Congress also decided that the court-appointed lead plaintiff should then select the lead counsel for the class, but tempered that power by expressly requiring judicial approval of the proposed counsel.

*continued on page 7*

**Who's In Charge?**

*continued from page 6*

Now, ten years after the passage of the PSLRA, there is still fierce competition for leadership of securities class actions. The leadership battle is often fought among institutional investors such as government and union pension funds, who are more likely to appreciate the importance of aggressively pursuing cases of securities fraud and who are prepared to play an active role in partnering with their lawyers in the pursuit of wrongdoers. As investors have aggressively exercised their rights to seek leadership of securities class actions, a number of new issues have arisen. While many issues remain unresolved, a few interesting patterns have emerged.

o Most courts have concluded that the statute expresses a clear preference for institutional investors. Congress believed "that increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Conf. Rep. No. 104-369 at 34 (1995). However, there is still a disagreement among the courts concerning whether and how this should affect their consideration of the merits of competing requests for appointment as lead plaintiff. Based upon this preference, many courts are favorably inclined to appoint an institutional investor that has a real stake in the litigation and has a track record of effectively prosecuting other securities class actions. For example, one court expressly chose an institutional investor to serve as lead plaintiff over other individual investors prescisely because it was an institution and a large shareholder. *In re Critical Path, Inc. Securities Litigation*, 156 F.Supp.2d 1102, 1112 (N.D.Cal. 2001). Congress also gave courts the discretion to conclude that an institutional investor need not be subject to the PSLRA's presumptive restriction on the number of cases in which an investor can be appointed lead plaintiff (five cases in a three-year period), stating: "Institutional investors seeking to serve as lead plaintiff may need to exceed the [five-in-three] limitation and do not represent the type of professional plaintiff this legislation seeks to restrict." H.R. Conf. Rep. No. 104-369 at 35 (1995).

*Mark R. Rosen*

o Disputes have emerged concerning *how* the courts should determine which investor has the "largest financial interest" in the litigation, because, as one court noted: "[t]he PSLRA does not provide any guidance concerning the method of calculating which plaintiff has the 'largest financial interest.'" *In re Cable & Wireless, PLC, Securities Litigation*, 217 F.R.D. 372, 375, n. 4 (E.D.Va. 2003). In making this determination, many courts do not simply look at the price that the investors *paid* for their securities. Instead, they also consider the price that the investor *received* for any securities sold during the class period and often reject the lead plaintiff applications of such investors "who profited from purchases and sales of…shares during the class period." *Cable & Wireless*, 217 F.R.D. at 378.

o This, in turn, raises the question of how best to measure the loss. Courts have disagreed concerning whether to use the first-in-first-out ("FIFO") or last-in-first-out ("LIFO") method for calculating losses. The FIFO method first matches class period sales with stock purchased before the class period and the gain or loss on those sales is excluded from the calculation of class period losses. FIFO thus reflects an investor's injury on every purchase during the class period made at an inflated price. In contrast, "under the LIFO approach, a plaintiff's sales of [] stock during the class period are matched against the last shares purchased, resulting in an off-set of class-period gains from a plaintiff's ultimate losses." *Thompson v. The Shaw Group Inc.*, 2004 U.S.Dist. LEXIS 25641, at *14 (E.D.La., Dec. 15, 2004).

The choice of methodology can lead to significant differences in the loss calculations, especially where the investors had significant holdings of the company's securities at the beginning of the class period and sold securities during the class period before the disclosures caused the prices to fall. As explained by one court:

> [R]ecently, courts have preferred LIFO and have "generally rejected FIFO as an appropriate means of calculating losses in securities fraud cases." Moreover, in a number of instances where courts have used FIFO to calculate financial loss, they have done so reluctantly. LIFO, by contrast, has been used not only for lead plaintiff calculations, but also to determine compensation amounts for stockholders suffering losses due to securities fraud.
>
> The main advantage of LIFO is that, unlike FIFO, it takes into account gains that might have accrued to plaintiffs during the class

*continued on page 11*

# The Proportionate Liability and Judgment Reduction Credit Provisions of the PSLRA: A Major Reform Has Perverse Consequences

**Chad A. Carder**
*Attorney, Barrack, Rodos & Bacine*

Lead plaintiffs and their counsel are often faced with the following situation. As trial approaches, the judge recommends that the parties discuss settlement. Plaintiffs analyze the potential liability of each defendant, which may include the company (if it has not entered bankruptcy proceedings), corporate officers and directors, an outside auditing firm, and investment banks that served as financial advisors and/or underwriters for the company's offerings of stock and bonds. Plaintiffs also analyze the ability of each of these defendants to pay a judgment. In the course of events, it becomes clear that a "global" resolution may not be possible and plaintiffs conclude that they should seek to settle with the corporate directors, who have certain defenses that other defendants do not have and who simply may not have the ability to pay a significant judgment.

*"[P]erhaps perversely, the [PSLRA] does not protect the interests of outside directors to the extent that may have been intended by the drafters."*
*Judge Denise L. Cote, In re WorldCom, Inc. Sec. Litig.*

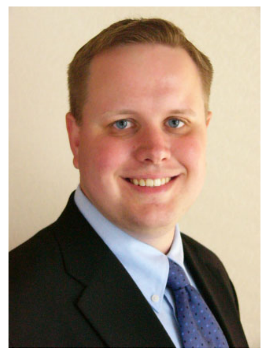
But there is a problem. And that problem stems from provisions of the Private Securities Litigation Reform Act of 1995 ("PSLRA") that were intended to reduce the potential liability of non-management corporate directors, commonly known as the "outside directors." These provisions of the PSLRA – which significantly changed the apportionment of damages for actions brought under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), but which also provided for judgment reduction credits for non-settling defendants – have made separate settlements with outside directors much less likely than they were before passage of the PSLRA.

**Pre-PSLRA Liability**

Before the PSLRA, persons found to have violated section 11 of the Securities Act and section 10(b) of the Exchange Act were, with certain exceptions, jointly and severally liable for all damages that plaintiffs could prove at trial. Thus, if five defendants were found liable and the jury determined plaintiffs' damages to be $400 million, plaintiffs could generally seek satisfaction of the entire $400 million judgment from any one of the five defendants (with one limitation under section 11). The defendants tapped by plaintiffs to satisfy the judgment could then file cross-claims for contribution against the other defendants.

**PSLRA Reforms: Comparative Liability Emerges**

Responding to arguments that joint and several liability was unfair to those who were not the primary perpetrators of a fraud, and were therefore less "culpable," Congress created a comparative liability scheme to protect certain types of defendants, including outside directors, from paying more that their "fair" share. That scheme may work when all defendants go to trial. In a settlement context, however, the PSLRA also provided: (1) a "judgment reduction credit" to be granted to non-settling defendants in the event plaintiffs reached a settlement with some, but not all, of the defendants; and (2) a bar prohibiting claims for contribution by non-settling defendants against settling defendants. The judgment reduction credit was meant to ensure that the plaintiffs' total recovery does not exceed the total amount of their damages. Thus, if plaintiffs settle with fewer than all defendants, the remaining defendants are entitled to a reduction in a judgment against them by the *greater of*: (1) an amount that corresponds to the percentage of responsibility of the settling defendant(s); or (2) the amount paid by the settling defendant(s). The PSLRA's judgment reduction provisions place the burden of settling too cheaply on the plaintiffs' shoulders, and compensates non-settling defendants for the bar that prohibits them from pursuing cross-claims against settling defendants.



*Chad A. Carder*

**The PSLRA's Fallout**

While all of this appears to make sense on the surface, the judgment reduction credit provisions have had the unintended consequence of making it very difficult for outside directors and other "peripheral defendants" to reach settlements with plaintiffs unless "wealthier" defendants have settled first. Because an outside director usually lacks the financial resources to enter into a large settlement,

*continued on page 12*

# Did the Private Securities Litigation Reform Act Change the Standard for Pleading Scienter?

**Beth Targan**
*Attorney, Barrack, Rodos & Bacine*

Much legal commentary and debate has focused on whether the Private Securities Litigation Reform Act of 1995 ("PSLRA") changed the law with regard to the standard for and the pleading of scienter – the defendant's state of mind – in an action under the federal securities laws. Many commentators believe that Congress had created a heightened, uniform scienter requirement, but did the PSLRA really change the law on this subject? While much has been written about this topic, the answer often depends on the court in which the case is brought.

Fraud claims under the federal securities laws are, in the first instance, governed by the heightened pleading standard of Rule 9(b) of the Federal Rules of Civil Procedure, which states that fraud must be pleaded with "particularity," but permits allegations of "malice, intent, knowledge, and other condition of mind of a person" to be pleaded "generally." The United States Supreme Court has defined scienter as a "mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Scienter is a necessary element of every securities fraud action brought under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 adopted by the Securities and Exchange Commission, but until the PSLRA, a plaintiff did not need to plead scienter with "great specificity." But what qualifies as adequate pleading of scienter as part of a claim under the federal securities laws?

Before passage of the PSLRA, the standard for pleading scienter in the Second Circuit, which includes federal courts in New York, Connecticut and Vermont, was recognized as the most stringent. In *In re Time Warner Inc. Securities Litigation,* 9 F.3d 259 (2d Cir. 1993), the Second Circuit Court of Appeals stated that a plaintiff had to allege facts in the complaint that would "give rise to a strong inference of fraudulent intent." *Id.* at 268. A plaintiff could adequately plead scienter either by alleging facts that show a motive to commit a fraud and the opportunity to do so or by "alleg[ing] facts constituting circumstantial evidence of either reckless or conscious behavior." *Id.* at 269.

In contrast, in the Ninth Circuit (encompassing courts in California, Oregon, Washington, Idaho, Montana, Nevada, Arizona, Alaska and Hawaii) before the PSLRA, conclusory allegations of scienter were sufficient. "With respect to scienter, the plaintiffs need 'simply …say [] that scienter existed' to satisfy the requirements of 9(b)." *Fecht v. The Price Company,* 70 F.3d 1078, 1082 n. 4 (9th Cir. 1995).

*Despite Congress's intention to create a uniform standard for pleading scienter, uniformity is still elusive.*

In the Conference Committee Report on the PSLRA, Congress acknowledged that "distinctly different standards [existed] among the circuits" and identified "the need to establish uniform and more stringent pleading requirements *to curtail the filing of meritless lawsuits.*" H.R. Conf. Rep. No. 104-369, at 41 (emphasis added). The PSLRA included a new requirement for pleading scienter, "based in part on the pleading standard of the Second Circuit…and specifically written to conform the language to Rule 9(b)'s notion of pleading with 'particularity.'" *Id.* Congress adopted the following language:

> in any private action arising under this title…in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall…*state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind*.

15 U.S.C. §78u-4(B)(2) (emphasis added).

Congress did not, however, define "required state of mind" nor did it provide guidance for pleading this essential element of a securities fraud claim. Despite Congress's evident intent to create a uniform standard for pleading scienter, uniformity is still elusive as different interpretations of scienter still exist among the circuits. Courts disagree on the degree of recklessness and the specificity with which it must be pleaded in order to overcome a motion to dismiss. A debate among the circuits currently exists as to whether the provision in the PSLRA was created to codify the Second Circuit's pleading requirement or whether Congress intended to create a more stringent pleading standard.

For example, in *Press v. Chemical Investment Services Corp.*, 166 F.3d 529 (2d Cir. 1999), the Second

*continued on page 10*

## Pleading Scienter

*continued from page 9*

Circuit stated that the PSLRA had not changed the standard used within the Second Circuit. The *Press* court stated: "[t]he Private Securities Litigation Reform Act of 1995 heightened the requirement for pleading scienter to the level used by the Second Circuit." *Id.* at 537-38.

The Third Circuit (encompassing Pennsylvania, New Jersey, Delaware and the Virgin Islands) essentially adopted the Second Circuit's pleading standard. In *In re: Advanta Corp. Securities Litigation,* 180 F.3d 525, 534 (3d Cir. 1999), the Third Circuit held that "it remains sufficient for plaintiffs [to] plead scienter by alleging facts establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior." The court decided that recklessness "remains a sufficient basis for liability" and promotes the PSLRA's "policy objectives of discouraging deliberate ignorance and preventing defendants from escaping liability solely because of the difficulty of proving conscious intent to commit fraud." *Id.* at 535.

> *"[T]he best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish [a strong inference of scienter]."*
> *Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d at 601*

The Third Circuit recently applied its *Advanta* analysis of scienter in *In re Suprema Specialties, Inc. Securities Litigation.,* 438 F.3d 256, 2006 U.S.App. LEXIS 4307 (3d Cir. 2006). In *Suprema*, the Third Circuit reversed the district court's dismissal of plaintiffs' section 10(b) claims against the company's officers, finding sufficient allegations of motive and opportunity and of a strong inference that the officers knew the statements they had made were materially false and misleading (*id*., at *43-*48); and against the company's outside auditor, finding that "[t]he accounting violations set forth here surpass an inference of ordinary negligence; they reasonably suggest that [the auditors] either knew of, or willfully turned a blind eye to, the fraud" and further finding "readily available indicator[s] of fraud." *Id.*, at *54-*55. However, the court affirmed the dismissal of the fraud claims against the company's outside directors, including audit committee members, finding that allegations that these directors had access to unspecified business records and a duty to review them does not give rise to the inference that they individually knew of or recklessly disregarded the alleged wrongful accounting (*id.* at *55-*57) and against the company's underwriters, finding that plaintiffs' allegations amounted, at most, to claims of negligence against them. *Id.,* at *59-*60.

The Ninth Circuit took a different approach after passage of the PSLRA and now requires an even stricter pleading of scienter. That court has held that only *deliberate* recklessness satisfies the "strong inference of the required state of mind" under the PSLRA. *See In re Silicon Graphics Inc. Securities Litigation,* 183 F.3d 970, 977 (9th Cir. 1999). The Ninth Circuit now requires that a plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of deliberate reckless or conscious misconduct.

*Beth R. Targan*

The Second and Ninth Circuit's standards are at the opposite ends of the spectrum. Other courts of appeals have taken a more centrist position. For example, the First, Sixth and Tenth Circuits have held that although motive and opportunity can be considered "as part of the mix of information" in determining whether a plaintiff has adequately pleaded scienter, pleading motive and opportunity alone is insufficient to satisfy the PSLRA. *See, e.g., City of Philadelphia v. Fleming Companies, Inc.,* 264 F.3d 1245, 1261-62 (10th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001); *Greebel v. FTP Software, Inc.*, 194 F.2d 185 (1st Cir. 1999). Just recently, the Seventh Circuit also adopted the middle ground, concluding "that the best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish [a strong inference of scienter]." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 601 (7th Cir. 2006).

What does all of this mean? Despite Congress's intention to create a uniform standard for pleading scienter, uniformity is still elusive. While the PSLRA's pleading standard may have achieved the goal of "curtail[ing] the filing of meritless lawsuits," it certainly has not established a "uniform and more stringent pleading" standard for scienter. What is clear, however, is that application of the PSLRA's pleading standards has caused more than one meritorious lawsuit to be dismissed, leaving injured investors without a remedy, but that is the subject for another day.❖

## Who's In Charge?

*continued from page 7*

> period due to the inflation of the stock price. FIFO…ignores sales occurring during the class period and hence may exaggerate losses.

*In re eSpeed, Inc. Securities Litigation*, 232 F.R.D. 95, 101 (S.D.N.Y. 2005).

o Many courts have employed a multiple factor test to determine which investor has the largest financial interest, comparing (1) total shares purchased; (2) *net* shares purchased (total shares purchased during the class period less total shares sold during the class period); (3) *net* cash investment (total dollar amount spent during the class period to purchase the securities less the proceeds from any class period sales); and (4) *net* loss. This "four factor" test, first developed in *Lax v. First Merchants Acceptance Corp.*, 1997 WL 461036, at *5 (N.D.Ill., Aug. 11, 1997), has been utilized by courts across the country, as it "reveals whether plaintiffs actually profited during the Class Period from the inflated stock prices." *In re Cardinal Health, Inc. Securities Litigation*, 226 F.R.D. 298, 303 (S.D.Ohio 2005). However, at least one court has rejected the multiple factor test to determine which lead plaintiff candidate has the largest financial interest in the action. In *In re Bally Total Fitness Securities Litigation*, 2005 U.S.Dist.LEXIS 6243, at *14-*15 (N.D.Ill., March 15, 2005), the court characterized the problem with a multiple factor test as follows:

> It is not self-evident, though, what weight these facts should be given in relation to the amount of loss, or even why we should consider them at all…. We believe that the best yardstick by which to judge "largest financial interest" is the amount of loss, period. The inquiry need not and should not be complicated by also considering the number of shares or the net expenditures involved because those statistics do not advance the ball.

Because Congress did not explain how to determine which lead plaintiff candidate has the greatest financial interest in a case, the courts will continue to address this complex subject and likely will continue to arrive at diverse conclusions.

o Courts have also disagreed about whether more than one investor can join together in a group to seek appointment as lead plaintiff. Given the PSLRA's presumption that the investor with the greatest financial interest should be appointed lead plaintiff, there is an obvious incentive for investors to band together to tally their collective losses to show a greater financial loss. Not all courts have permitted such aggregation.

*Institutional investors now have a greater opportunity to provide leadership in the direction of securities litigation for the benefit of all investors.*

Most courts have focused on the number of members in the proposed group and whether the members of the group had a relationship that pre-dated their involvement in the securities action at hand, and have come to varying conclusions. For example, in *In re Versata, Inc. Securities Litigation*, 2001 U.S.Dist.LEXIS 24270, at *6-*7 (N.D.Cal., Aug. 20, 2001), the court appointed a lead plaintiff group composed of unrelated investors because, among other things, the group had offered evidence that its members had established "a regular meeting calendar, a mechanism for emergency meetings and a procedure to resolve disagreements between members and avoid impasse." The SEC has weighed in on the matter, endorsing "a small number capable of effectively managing the litigation and exercising control over counsel." *In re the Baan Company Securities Litigation*, 186 F.R.D. 214, 219 (D.D.C. 1999) (Appendix A, Memorandum of the Securities and Excahnge Commission, *Amicus Curiae*).

In contrast, the *Bally* court rejected groups of unrelated investors, noting "[w]here the members of the group do not share business or other relationships independent of the lawsuit, however, this court concludes that appointment of such an artificial group of persons as lead plaintiffs should be rare under the PSLRA." *Bally*, 2005 U.S.Dist.LEXIS 6243, at *8. Another court concluded that "[t]he majority of courts considering the issue have taken an intermediate position, allowing a group of unrelated investors to serve as lead plaintiffs when it would be most beneficial to the class under the circumstances of a given case." *In Re Star Gas Securities Litigation*, 2005 U.S.Dist.LEXIS 5827, at *12 (D.Conn., Apr. 8, 2005).

One thing is certain: the old approach to organizing securities class actions is gone with the wind. Courts are becoming very pro-active in selecting as lead plaintiff the investor who will best represent the class of injured investors in seeking recovery. Institutional investors now have a greater opportunity to provide leadership in the direction of securities litigation for the benefit of all investors.❖

## Proportionate Liability

*continued from page 8*

plaintiffs can ill afford to settle with such an outside director and take the chance that a jury may apportion a large percentage of the fault to that settling director. If that happened, the PSLRA would require a very substantial reduction in any final judgment against non-settling defendants who may have a greater ability to pay a judgment in the full amount of the plaintiffs' damages.

This was precisely what occurred in the securities class action involving WorldCom. On January 6, 2005, lead plaintiff New York State Comptroller Alan Hevesi, as sole trustee for the New York State Common Retirement Fund, represented by co-lead counsel Barrack, Rodos & Bacine, reached a settlement with ten directors and seven insurers that would have required the directors to personally contribute $18 million (approximately 20% of their collective net worth) to the settlement along with another $36 million contributed by their insurers. The parties to the settlement recognized, however, that a jury finding that the settling outside directors had a significant degree of culpability would severely diminish the amount of a judgment that lead plaintiff might obtain against the wealthier, non-settling defendants. To save the class from this potential outcome, the lead plaintiff sought an order modifying the judgment reduction formula of the PSLRA by allowing the court to take into account the settling directors' ability to pay a judgment in calculating the amount of a judgment reduction to be granted to the non-settling defendants at trial. This made sense because, had the case gone to trial against all of the defendants, the wealthier defendants would still have been limited in the amount they could seek as contribution from the less-wealthy defendants based on those defendants' relative inability to pay a significant judgment.

Judge Cote noted the logic of the ability to pay modification that the parties to the settlement sought, but ultimately found that the modification to the judgment reduction provision of the settlement agreement was inconsistent with the text of the PSLRA and rejected the settlement. Remarking that the PSLRA's judgment reduction credit makes it "extraordinarily difficult for outside directors to settle Section 11 claims before all deep-pocket defendants facing joint and several liability have done so," Judge Cote concluded that: "perhaps perversely, the [PSLRA] does not protect the interests of outside directors to the extent that may have been intended by the drafters." However, while this "destructive set of incentives may deserve to be remedied … the remedy must be legislative."

### Conclusion

In *WorldCom,* the lead plaintiff eventually reached settlements with each of the underwriter defendants in the weeks and days preceding trial in March 2005, and the lead plaintiff and the outside directors were able to resurrect the settlement without requiring the modification of the judgment credit provision. However, Judge Cote's January 2005 ruling made it clear that the PSLRA's proportionate liability and judgment reduction credit provisions – which were intended to protect outside directors and other so-called "peripheral defendants" – had in fact made it next to impossible to settle with the outside directors before settling with other, financially larger defendants. However, as Judge Cote noted, this is a flaw in the PSLRA that Congress, rather than the courts, must remedy.❖



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Barrack, Rodos & Bacine
3300 Two Commerce Square
2001 Market Street
Philadelphia, PA 19103
Phone: 215.963.0600
Fax: 215.963.0838