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Securities Class Action Settlements

How corporate governance reform has played a role in the process

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SECURITIES fraud class actions continue to result in enormous cash settlements, even as the number and frequency of such lawsuits have declined.[1] Increasingly, however, these class action settlements have come to be viewed, particularly by public pension funds and other institutional investors, as an opportunity to impose systemic corporate governance reforms. One potential source of this trend has been the lead plaintiff provisions of the Private Securities Litigation Reform Act (PSLRA) of 1995,[2] which sought to encourage institutional investors to take a more prominent role in securities class actions.

This article will examine the potential conflicts of interest that arise when institutional investors seek to use securities class action settlements to pursue their corporate governance reform agendas. This article also discusses a recent development: institutional investor lead plaintiffs affirmatively seeking equitable relief in the form of specific corporate governance reforms in the class action complaint. This development is problematic, because class action plaintiffs presumably would not be entitled to such relief under the federal securities laws if the matter were contested, and because it appears that class actions are being utilized as a vehicle to circumvent the channels through which shareholders properly may seek corporate governance changes under state or federal law.

Lead Plaintiff Provisions

Over the past several years, shareholders have increasingly used securities class action settlements as a means of forcing public corporations to implement corporate governance reforms which, in many cases, the companies had refused to adopt voluntarily.[3] For example, in *In Re Cendant Corp.*, 264 F.3d 201, 227 (3d Cir. 2001), Cendant acceded to the lead plaintiff's settlement demand for "corporate governance changes, including putting a majority of independent directors on its Board of Directors; placing only independent directors on the Board's Audit, Nominating, and Compensation Committees; de-classifying the Board and providing for the annual election of all directors; and precluding the repricing of any employee stock option after its grant, except with the approval of a majority of voting shareholders."

The origins of this phenomenon can be traced, in part, to the PSLRA and the changes it made to the process for selecting lead plaintiffs in securities class actions. Before the PSLRA, lead plaintiffs and class counsel were typically appointed on a "first come, first served basis."[4] This encouraged a "race to the courthouse" among parties seeking lead plaintiff status, and spawned a "cottage-industry" of "specialized securities litigation firms."[5] This relatively small number of firms scoured the news wires and business publications for potential targets, and then enlisted "token" or "professional" plaintiffs with nominal holdings to file suit. These lawsuits were often controlled not by injured shareholders but by class counsel, and frequently culminated in cash settlements which reaped "huge profits for the law firms with only marginal recovery for the shareholders."[6]

In enacting the PSLRA, Congress sought to reform this system by placing control over securities class actions in the hands of shareholders with a genuine stake in the outcome of the litigation. To that end, the PSLRA replaced the "first to file" rule with a system whereby courts would "appoint as lead plaintiff the member or members of the purported class…most capable of adequately representing the interests of [the] class members."[7] The act also established a statutory presumption that the class member "with the largest financial interest in the relief sought" was "adequately" suited for the role of lead plaintiff,[8] and bestowed upon the lead plaintiff the primary authority to "select and retain counsel to represent the class."[9]

Congress expected that these provisions would encourage institutional investors with significant holdings in the target corporation to take a more active role in supervising the litigation and class counsel.[10] Institutional investors were favored because they have the resources, experience, and clout necessary to exercise effective control over the class' attorneys.[11] Further, compared to most individual shareholders, institutional investors tend to possess ownership interests in a broader array of U.S. corporations, and rarely have the option of "opting out" of the market altogether; they are therefore considered to have a more "balanced view" of the impact of securities class actions on the health and stability of the market as a whole.[12]

Conflicting Goals

The PSLRA seems to have achieved its intended effect. In 2000, institutional investors were the lead plaintiff in 14 percent of the settled securities class actions; by 2005, that figure had risen to nearly 38 percent.[13] However, as institutional investors have begun assuming more control over these lawsuits some of the same financial incentives which caused Congress to view them as ideal representatives of the shareholder class have given rise to a potentially significant conflict of interest.

Most class members in securities class actions, especially individual investors, often sell their holdings before the litigation is initiated. The objective of these "sell plaintiffs" is to secure the largest possible cash award.[14] In contrast, institutional investors are usually "hold plaintiffs" which retain a sizable financial stake in the target corporation even after a suit is filed. These investors understand that an increase in the size of the cash portion of the settlement is likely to be offset by a corresponding decrease in the value of their holdings,[15] and therefore possess an incentive to accept a reduced cash award in exchange for corporate governance changes aimed at deterring future fraud and protecting the long-term value of their investment.

Counsel faced with such a situation may find guidance from the decision by the U.S. Court of Appeals for the Third Circuit in *In Re Cendant Corp.*, 264 F.3d 201 (3d Cir. 2001), which was the first, and thus far the only, circuit court opinion to examine this potential conflict of interest in any detail. The *Cendant* opinion suggests that this divergence of interests between institutional investors and most individual shareholders could limit or prevent future efforts to utilize securities class actions as a means of achieving corporate governance reforms. Several individual investors, mostly former shareholders, in *Cendant* took issue with the corporate governance concessions, contending that such changes "benefited only institutional investors who continued to hold large blocks of Cendant stock"

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and resulted in a "settlement that provided an individual benefit to certain class members at the expense of more recovery for the Class overall."[16]

The Third Circuit ultimately dismissed the concerns of the objectors. The court reasoned that by establishing a statutory regime designed to encourage the selection of institutional investors as "lead plaintiffs," Congress had implicitly rejected the idea that such plaintiffs were "inherently" incapable of adequately representing the class.

The court's decision also sheds light on other factors that are important in analyzing such cases. The court looked to whether any specific evidence was produced that the lead plaintiff accepted less money in order to achieve corporate governance reforms.[17] Affidavits submitted in the case established that: (i) the corporate governance changes were negotiated after the monetary recovery was determined, and that (ii) Cendant was told that the money it paid into the settlement would not be decreased as an exchange for implementing the corporate governance changes. It is instructive that the court found these affidavits sufficient to establish that there was "no settlement-money-for-corporate-governance-changes exchange."[18]

The court noted that it was "entirely plausible" that the reforms were intended as a symbolic gesture designed to reassure prospective investors that the defendant corporation "was addressing the situation that allowed the fraud to occur in the first place."[19] The court did note that, although it found insufficient grounds to warrant overturning the settlement in the case before it:

> we call attention to an issue of potential intra-class conflicts with which district courts will need to grapple in future cases at the class certification stage….Properly understood, the issue is whether the conflict between the interests of Sell Plaintiffs and Hold Plaintiffs in a particular case is sufficiently severe so as to prevent a putative class action from satisfying Rule 23's requirements for class certification, regardless whether the problem is seen as one of commonality…or predominance. Because here no party on appeal objects to class certification based on conflicts between Sell Plaintiffs and Hold Plaintiffs, we need not decide whether this matter should have been certified as two separate classes or as a single class with sub-classes. We do, however, call these issues to the attention of district courts for future cases, and note that the use of separate classes or sub-classes is not inconsistent with the Reform Act because that statute deals with the identification of a lead plaintiff, and not with the proper means for defining a class in the first place.[20]

A Recent Twist

The *Cendant* opinion either anticipated or prompted the latest development in class action practice. Recently, institutional lead plaintiffs in class actions—rather than waiting to raise the issue of corporate governance reforms during settlement negotiations—have affirmatively sought in their complaints equitable relief in the form of specific corporate governance reforms.

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In May 2006, CalPERS, responding to published articles regarding the alleged backdating of stock options by companies in which it retained holdings, filed a securities class action lawsuit against UnitedHealth. CalPERS' amended class action complaint alleges various causes of action for monetary damages under the federal securities laws, but also seeks equitable relief including an order "[v]oiding all existing stock option plans" and an order requiring the implementation of "an increased disclosure mechanism for the transparency of UnitedHealth's stock option practices, including semi-annual or annual disclosure of all options granted and exercised detailing the grant and exercise prices, dates, etc."[21] The CalPERS amended class action complaint is the first complaint identified by the authors that affirmatively sought specific corporate governance reforms in the complaint.

Perhaps the CalPERS complaint, heeding the admonition of the *Cendant* opinion, was simply apprising the court up front of potential intra-class conflicts that might arise during the settlement phase that might necessitate appointment of separate classes at the inception of the case. Indeed, the CalPERS complaint alleges a common question of law and fact purportedly existing for all class members, of "whether equitable remedies are available to remedy defendants' allegedly negligent, improper and/or fraudulent conduct."[22]

Notwithstanding the motivation of the drafters, the CalPERS complaint raises immediate concerns because the federal securities laws do not afford private plaintiffs the equitable remedy of corporate governance reforms. While a court has the power to approve a settlement containing corporate governance reforms, it does not have the power to issue such an order in a contested proceeding. Further, the CalPERS complaint may be viewed in some quarters as an attempt to circumvent the time-tested legal channels through which a shareholder may seek to cause corporate governance reforms under state corporate law principles, or through the federal proxy solicitation and shareholder communication process.

To date, it does not appear that the UnitedHealth defendants have moved to contest the relief requested by CalPERS. However, the CalPERS complaint has been used as a template in at least one subsequent case that seeks the same corporate governance relief.[23]

Conclusion

Although courts have approved settlement agreements in federal securities class actions including both monetary awards and corporate governance reforms, courts have not foreclosed the possibility that "intra-class conflicts" between institutional investors and former individual shareholders could cause difficulties for unified class certification in future suits where it is apparent that the ultimate settlement of the case may include a mix of monetary relief and governance reforms. Furthermore, it remains to be seen what the courts' reactions will be to CalPERS' and similar complaints that affirmatively demand equitable relief in the form of specific corporate governance reforms.

1. Ronald I. Miller, Ph.D., Todd Foster, and Elaine Buckberg, Ph.D., "Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, Is Stabilization Ahead?" NERA Economic Consulting Report, available at www.nera.com/publication.asp?p_ID=2777 ("Recent Trends"); Corporate Board Member Magazine, May 2007, "Class-Action Suits: The Number of Filings Is Down…but the Cost of Settlements Sets a Record," available at www.nera.com/MediaCoverage.asp?pr_ID=3113.

Just 106 federal securities litigation class actions were filed in 2006, a 37 percent drop from 2005, a 10-year record low and the lowest number since passage of the Private Securities Litigation Reform Act in 1995. The total value of securities litigation settlements in 2006 was $6.17 billion, up 43 percent from the 10-year average of $4.33 billion. Out of 99 settlements in 2006, 28 cases settled for $20 million or more and 11 settled for over $100 million. See, PricewaterhouseCoopers 2006 Securities Litigation Study (Fall, 2007), available at http://10b5.pwc.com/public/default.aspx.

2. 15 USC §§77a et seq.
3. See, e.g., Bruce D. Angiolillo, "Settlement Issues in Securities Class Actions: The Defense Perspective in 2005," Practicing Law Institute, Corporate Law and Practice Course Handbook Series, 1505 PLI/Corp 379, September 2005; William S. Lerach, "Achieving Corporate Governance Enhancements Through Litigation," 24 T. JEFFERSON L. REV. 1 (2001).
4. S Rep No 104-98 (1995), reprinted in USCCAN 679.
5. *In re Cendant Corp. Litigation*, 182 F.R.D. 144, 145 (D. N.J. 1998) (quoting *Gluck v. CellStar Corp.*, 976 F.Supp. 542, 544 (N.D. Tex. 1997)).
6. Id.
7. 15 USC §78u-4(a)(3)(B)(i).
8. 15 USC §78u-4(a)(3)(B)(iii)(I).
9. 15 USC §78u-4(a)(3)(B)(v).
10. See, e.g., S. Rep. No. 104-98, at 11 (1995), reprinted in 1995 USCCAN 679, 690.
11. *In re Lucent Technologies, Inc. Securities Litigation*, 194 F.R.D. 137, 151-52 (D. N.J. 2000).
12. Keith Johnson, "Deployment of Institutions in the Securities Class Action Wars," 38 Ariz. L. Rev. 627, 629 (1996).
13. "Recent Trends," supra. While involved in only 35 percent of settlements in 2006, union pension funds and public pension funds as lead plaintiffs accounted for 81 percent of the total settlement dollars. Including all institutional plaintiffs, the numbers are slightly higher, at 53 percent of settlements in 2006, accounting for 94 percent of securities class settlement dollars. See, PricewaterhouseCoopers 2006 Securities Litigation Study.
14. *In re Cendant Corp. Litig.*, 264 F.3d 201, 244 & n. 25 (3d Cir. 2001); John Landry, "Possible Limitations on Securing Corporate Governance Reforms Through Class Action Settlements," Wall Street Lawyer, available at www.realcorporatelawyer.com/wsl/wsl0306.html.
15. *In re Cendant*, 264 F.3d 201, 244, n. 25.
16. Id. at 246.
17. Id. at 247.
18. Id.
19 Id.
20. Id. at 244 n.25 (citations omitted).
21. Consolidated Complaint at 177, *In re: UnitedHealth Group Inc. PSLRA Litig.*, No. 06-1691 (D. Minn. Dec. 8, 2006).
22. Id. at 122.
23. Complaint at 113, *United Food and Commercial Workers Union Local 880-Retail Food Employees Joint Pension Fund v. Sunrise Senior Living, Inc.*, No. 07-00102 (D. D.C. Jan. 16, 2007) available at http://securities.stanford.edu/1037/SRZ_01/2007116_f01c_07102.pdf <http://securities.stanford.edu/1037/SRZ_01/2007116_f01c_07102.pdf.