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# Recent Pro-Defendant Trends in Securities Class Action Litigation

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Securities class action filings increased from 116 filings in 2006 to 166 filings in 2007, with at least 32 of the 2007 filings (many of which were filed in the second half of the year) relating to the collapse of the subprime mortgage market.<sup>[FOOTNOTE 1]</sup> Although one would expect the subprime mortgage mess to create fertile ground for zealous securities class action plaintiffs, there have been a number of important countervailing factors at work, ensuring that it is ultimately the plaintiffs who have been drawing the short straw.

Recent pro-business, defendant-friendly legal precedent from both the U.S. Supreme Court and the influential 2nd U.S. Circuit Court of Appeals has significantly contributed to the anti-plaintiff atmosphere.

Also a factor is the jury verdict in only the second federal securities class action lawsuit to go to trial since the passage of the Private Securities Litigation Reform Act of 1995, in which the defendants got off scot-free.

Finally, there are the guilty pleas, prison sentences, fines and forfeitures arising from charges including conspiracy and federal racketeering lodged against four long-time partners of one of the nation's largest, most successful and most influential class action plaintiffs law firms.

The result – a defendant-friendly federal securities law environment even in the face of the collapse of the subprime mortgage market.

## RECENT PRO-DEFENDANT LEGAL PRECEDENT

**The federal securities laws prevented antitrust liability in the "IPO laddering cases."** In a big win for the defense bar, the U.S. Supreme Court ruled in June 2007 that several Wall Street firms were immune from a class action lawsuit brought under federal antitrust laws over alleged conduct concerning initial public offerings during the technology bubble. See *Credit Suisse Sec. (USA) LLC v. Billing*, 127 S. Ct. 2383 (2007).

The Court decided that the breadth of the federal securities laws prevented an antitrust suit brought against 16 major investment banks

and institutional investors allegedly engaged in a conspiracy to inflate the aftermarket stock prices for dot-com companies. In fact, the Court found that, "to allow an antitrust lawsuit [under these circumstances] would threaten serious harm to the efficient functioning of the securities markets" as it would hamper the ability of the Securities and Exchange Commission to regulate the financial markets and would have a "chilling effect on lawful joint activities of tremendous importance to the economy."

**The Supreme Court speaks on scienter pleading.** In another significant decision, in June 2007 the U.S. Supreme Court held that, in determining whether alleged facts give rise to a "strong" inference of scienter sufficient to state a claim for federal securities fraud, a court must take into account plausible opposing inferences. The inference of scienter must be "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499, 2510 (2007).

In their separate concurring opinions, Justices Antonin Scalia and Samuel Alito each advocated for a "strong inference" test that asks whether the inference of scienter is more plausible than the inference of innocence.

While in the eyes of some, the Supreme Court's decision in *Tellabs* did not go far enough, it did raise the pleading bar higher for plaintiffs than it had previously been set. Although this opinion was much anticipated and hailed as a decision rather unfavorable to the plaintiffs bar, given what generally appear to be the pro-business tendencies of this Court, in reality, the majority opinion did not set a particularly high bar for plaintiffs.

**No "scheme liability."** In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008), the U.S. Supreme Court dismissed the theory of "scheme liability," ruling that securities fraud claims against third parties who did not directly mislead investors but were business partners with those who did are not sustainable. Investors may only sue those who issued statements or otherwise took direct action upon which investors relied in buying or selling stock, whether such



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action involved public statements, omissions of material facts, manipulative trading or conduct that was itself deceptive. Without such direct action, the market would not know of the defendants' participation in the fraud, thereby precluding any showing of reliance and making a potential claim too remote to justify the imposition of liability. The *Stoneridge* decision takes away a pleading tool that plaintiffs having been trying to utilize in recent years.

**Liability of secondary actors.** In January 2007, the 2nd U.S. Circuit Court of Appeals addressed the liability of auditors, i.e., secondary actors, for fraud under the federal securities laws.[FOOTNOTE 2] In *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147 (2d Cir. 1007), the Court held that an auditor's review of the quarterly financial statement of a publicly traded company could not form the basis for primary liability for federal securities fraud if the auditor did not issue a report in connection with the quarterly filing, nor did the company's quarterly report contain any mention of the auditor's review.[FOOTNOTE 3] This decision provides significant protection to auditing firms that have, traditionally, been deep-pocket targets for securities class action plaintiffs.

**A jury verdict in defendants' favor.** In *In re JDS Uniphase Corp. Sec. Litig.*, No. 02-CV-1486-CW (verdict returned N.D. Cal. Nov. 27, 2007), a California jury unanimously held broadband telecommunications equipment maker JDS Uniphase not liable for defrauding investors when its share price fell from a high of \$146.32 per share to \$7.90 per share when the dot-com bubble burst. JDSU restated its third-quarter 2001 financials when it was forced to write down more than \$44 billion in goodwill and inventory. The defendants claimed that the losses were due to the unforeseeable meltdown of the Internet and telecommunications sectors during that time period. The jury agreed, awarding nothing to the plaintiffs.

This case is only the second such case to go to trial since the 1995 passage of the PSLRA. The defense verdict in the JDSU case may make other securities class action defendants a little more willing to go to trial in strong cases and may therefore reduce plaintiffs' settlement leverage.

**Milberg Weiss.** Four former partners of the plaintiffs class action law firm now known as Milberg LLP pleaded guilty to various criminal charges arising from the alleged kickbacks that Milberg offered to plaintiffs in more than 150 cases that brought the firm more than \$200 million over the past two decades. The deals commonly provided plaintiffs 10 percent of net attorney fees.[FOOTNOTE 4] The potentially wide-ranging impact of the decimation of the Milberg firm, which has been the bane of securities class action defendants for decades, is only beginning to be felt.

## CONCLUSION

The confluence of all the foregoing factors has clearly served to scorch the fertile ground created by the collapse of the subprime mortgage market. It remains to be seen what may grow anew in the clearing.

### ∴∴FOOTNOTES∴∴

FN1 See "Securities Class Action Case Filings, 2007: A Year in Review," Cornerstone Research, [www.cornerstone.com](http://www.cornerstone.com).

FN2 The decision of the U.S. Supreme Court in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994) marked the end of an implied right of action for private litigants under the federal securities laws for aiding and abetting liability. From then on, secondary actors, such as auditors, could only be held liable for federal securities fraud in a claim brought by a private litigant if all elements of a traditional securities fraud claim were met.

FN3 The *Lattanzio* court left open the possibility that there could be liability on the part of the auditor if a report was prepared and filed with the quarterly report and either the information was misstated or the auditor subsequently became aware of a misstatement. In *Overton v. Todman & Co., CPAs, P.C.*, 478 F.3d 479 (2d Cir. 2007), the 2nd Circuit held that an auditor could incur primary liability for federal securities fraud if the auditor learns or was reckless in not learning, subsequent to the issuance of an audit opinion, that the filer's financial statements were materially misstated when issued, if the auditor fails to take steps to withdraw the audit opinion or correct the financial statements (provided all other prerequisites for liability are satisfied). Without some communication of the auditor's opinion to the investing public, through an audit opinion or otherwise, the auditor is not subject to liability under the federal securities laws.

FN4 On July 9, 2007, David Bershad pleaded guilty to conspiracy charges and agreed to forfeit \$7.75 million, pay a \$250,000 fine and cooperate with the government in its investigation; he has not yet been sentenced. On Sept. 20, 2007, Steven Schulman pleaded guilty to racketeering and agreed to forfeit \$1.85 million and pay a \$250,000 fine; he is also awaiting sentencing. On Feb. 11, 2008, William Lerach, who had pleaded guilty to conspiring to obstruct justice and to making false statements under oath, was sentenced to two years in prison, forfeiture of \$7.75 million, fined \$250,000 and ordered to complete 1,000 hours of community service. Most recently, Melvyn Weiss, who had pleaded guilty to conspiring to obstruct justice, was sentenced to two years in prison and ordered to pay \$10 million in fines and forfeiture.

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