

Class Action Settlements: A New Era is Upon Us

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“There can be no settlement of a great cause without discussion, and people will not discuss a cause until their attention is drawn to it.”

- William Jennings Bryan

Introduction

What better way to focus a corporations mind then to sue it? Class actions serve several useful purposes: they conserve social resources by consolidating several similar cases in a single proceeding, enable persons with small claims to obtain a hearing on their grievances that would otherwise not be economically feasible, and facilitate compensation for large numbers of injured persons.³ Despite these benefits some argue that some class actions are merit-less litigation filed solely to obtain a settlement offer, and that much of the settlement value depends on the lawyers and their fee expectations. We disagree. Several studies have found an increase in large securities class action settlements by some of North America’s larger corporations as a result of higher investor losses brought by some of the largest investors in the capital market. This small paper will look some issues that arise during class action settlements, with a focus on the risk/reward equation.

The Settlement Debate

Undoubtedly the foremost motivation for all of the parties involved in the settlement of a securities class action is the significant cost and risk involved with prosecuting or defending a class action. The Statement of Claims in securities class actions often

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³ Geoffrey Miller and Lori Singer, “*Non Pecuniary Class Action Settlements*” Law and Contemporary Problems, Vol. 60 No 4.

necessarily seek large amounts of damages making the litigation process costly and complicated, as appeals and interlocutory motions are often used as a stalling technique by Defendants. From the Plaintiffs perspective settlement is favorable because if the case is defeated at the common issue stage then the claims of the entire class will arguably be defeated because a securities class for small investors the time value of the settlement monies is significant.⁴ Moreover, there have been several recent class actions where substantial costs awards have been made against unsuccessful plaintiffs that may encourage Plaintiffs to try to settle at an earlier stage of the process.⁵ For the Defendants class action settlements may avoid large damage awards, and allow the company particularly to move ahead with its business and affairs.

Some of the obstacles to an early settlement are that neither party has a full grasp of the full merits of the case as the majority of settlements occur prior to examinations for discovery, leaving the parties unaware of the full class size, estimated damages suffered by the class members and the Defendants' proportional damages.⁶

What stage of the process is most appropriate to settle a class action?

Pre-Filing Stage

This almost never happens in our experience for several reasons. It is unlikely that the parties will have enough information at this stage to determine a reasonable settlement offer. Often the class size and amount of damages is difficult to ascertain this early on. If however the class size is small and easily identifiable then settlement at this stage could be the most cost-effective for the parties and this could then lead to a consent certification.

⁴ This is because while a class action is brought by a representative plaintiff the common issue trial applies to the entire class; see Ontario Act s 5. Branch, MacMaster, Kleefeld, "*Class Action Settlements: Issues and Approaches*" May 2002.

⁵ See for example, *Pearson v. Inco Ltd.*, [2000] OJ No. 3532 (SCJ).

⁶ Lisa Munro, "YBM Case Study: Anatomy of a Securities Class Action Settlement", Lerners LLP, September 2003.

After Filing, Before Certification

It is at this stage that several class settlements have been reached. The Plaintiff's now have shown that they are serious about bringing a claim and the Defendants still have the bargaining chip that the Plaintiff's might not be able to attain certification. Moreover, settlement before certification may bring less exposure to large defendant corporations. At the certification hearing it is also possible for the class and the defense counsel to join in a motion to certify the class at the same time as approving the settlement.⁷ The benefits to settlement at this stage are that the Defendant obtains a res judicata judgment from the court (for those class members that do not opt out of the settlement) and the Plaintiffs obtains a judgment without having to argue certification or establish the full merits of the case.

After Certification

Inevitably the cost of settlement for the Defendants increases dramatically after Certification, because the risk that the Plaintiffs may not be certified no longer exists.

The Effect of the Lead Plaintiff on Class Action Settlements

A recent trend has been that large institutional investors, unions, and public pension funds have increasingly become the lead plaintiff in securities class actions particularly in the United States. Of the total value of \$6.17 billion settlements reached in the United States in 2006, 81% were associated with cases in which unions or public pension funds were lead plaintiffs.⁸ 56% of the cases filed in 2006 had large institutional investors acting as lead plaintiffs.⁹ The effect of these large investors acting as lead plaintiffs is greater settlement amounts and more defendant interest in settlements.

⁷ Branch, MacMaster, Kleefeld, "Class Action Settlements: Issues and Approaches" May 2002.

⁸ Price Waterhouse Coppers Advisory, "2006 Securities Litigation Study"

⁹ Ibid.

What is the best way to determine the amount of a fair securities settlement?

The vast majority of securities fraud class actions settle before trial, and the settlement amounts are usually substantially less than the amounts that the plaintiffs' damage models estimate. Nevertheless these damage models provide a useful starting point for settlement negotiations because the estimated damage amount is the single most important factor explaining the settlement amount.¹⁰

Damages in fraud-on-the-market class action cases are a function of per share price inflation that results from the fraud as well as the volume and timing of the shares traded. The damages depend on two key determinants¹¹:

- 1) what is the impact of the fraud on the issuers share price? Specifically, by how much and over what time period is the share price inflated?
- 2) How much damage was caused by the price distortion? How many shares were bought and sold at distorted prices, and what was the net effect of the purchases and sales at distorted prices on the plaintiffs?
- 3) There is also the third key factor and that is how many shares (held by insiders, for example, will be excluded from the calculations.

As such, the proper determination of damages in market fraud class actions requires an accurate measure of the distortion of the share price that directly results from the fraud and an accurate model of shareholder trading behavior to calculate the impact of the distortion in the share price on securities purchasers.¹² This latter factor is where different damage models for securities class actions often arise.

¹⁰ John Finnerty and Gautam Goswami, "Determinants of the Settlement Amount in Securities Fraud Class Action Litigation" *Hastings Business Law Journal*, October 7, 2006.

¹¹ *Ibid*, page 457

¹² *Ibid*.

The two models below are the most commonly used methods to estimate the damage amount. The different methods used to calculate damage for settlement purposes can lead to the plaintiff's damage estimate being more than double that of the defendants.¹³

Types of damage models

The Economic Model¹⁴

According to this model the parties make decisions about settlement amounts based on rational estimates of the expected economic value of the case, including the cost of litigation. This model assumes that the settlement outcome depends in large part on the strength of the merits of the case, as this is the primary factor in determining the likelihood and the amount of the Plaintiff's potential judgment. However, the underlying characteristic of settlements are that they are not based on merit but on a middle ground established by the parties. Under this model, the settlement amounts could be approximated without knowing any information other than the number of shares sold in the offerings and the stock price at the beginning and end of the period.

The negatives of this model are that it does not appear to consider other factors such as: the defendant's opportunity to reduce the claimed damages by proving that some portion of the decline was due to factors other than the alleged fraud, punitive damages in connection with state laws, or technical refinements to damage calculations. Taking these factors into account would require a determination about the merits of the case, and would consequently introduce the possibility of disagreement about the amount at stake.

Moreover, as the settlement amount is not based on the merits of the case, this model leads to the common belief that if there is a sharp decline in the price of a stock then the mere filing of a complaint to begin a class action can lead to guaranteed recovery for the

¹³ Jay Eisenhofer, Geoffery Jarvis and James Banko, "Securities Fraud, Stock Price Valuation, And Loss Causation: Toward a Corporate Finance- Based Theory of Loss Causation" *The Business Lawyer*, August 2004, Vol 59, No 4.

¹⁴ Janet Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions" *Stanford Law Review*, Vol. 43: 475 (1991).

shareholders. It has been said that the regime of non-merit-related settlements “provides indirect but automatic insurance against market losses through the federal courts, in a context where insurance against stock market losses is generally unavailable in the private market.”¹⁵

Despite their criticisms of the Economic Model, academics concede that the total recoveries under the model may be no less than under a merit-based system. However, they insist that a Plaintiff with a strong case can likely recover more from trial than the Economic Model would provide at settlement.

“Backwards Induction” Method¹⁶

This method, which is said to be the most commonly used method in 10b-5 (securities fraud) class actions in the United States, is based on the “out-of-pocket-measure”. This measure awards the Plaintiffs the difference between the price they paid for the stock at its fair market value, adjusted for any gains made or fraud-related losses suffered on resale. In calculating settlement amounts, this method begins by determining when the issuer’s ‘true’ financial situation became public, or in other words, when they corrected the misrepresentation. The stock price at the end of that day is assumed to reflect the stock’s true value once investors have reacted to the new information. Next, one estimates the total damages for the class period by extrapolating the post-disclosure value backwards for every day the misrepresentation went uncorrected. Thus, in this model, the price drop induced by the disclosure sets the benchmark for calculating damages.

The problems with this model is that several economic studies have concluded that the decrease in share price is to a large degree disconnected from the intrinsic, fundamental worth of the company, or the true value of its net assets in terms of future cash flows. Accordingly, immediately after a negative corporate announcement, and sometimes for several days afterwards, share price may not reflect the companies true value, as

¹⁵ As outlined in: Janet Alexander, “*Do the Merits Matter? A Study of Settlements in Securities Class Actions*” Stanford Law Review, Vol. 43: 475 (1991), p. 570.

¹⁶ As outlined In: Baruch Lev and Meiring de Villiers, “*Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*” Stanford Law Review, Vol. 47: 7, (1994).

extraneous factors also greatly affect the stock price.¹⁷ As a result of Plaintiffs using the stock price immediately after the price crash settlement results in claimed amounts that will sometimes be excessive.

The authors of the article propose that the appropriate way to estimate the fundamental base price of a security in the midst of a price crash is to predict the future cash flows to the issuer, taking into account the newly released negative information, and then to discount the cash flow to the present value. However, in practice it would appear that valuations based on discounted cash flows are very sensitive to the expert's underlying assumptions, resulting in expert estimate varying widely.

The Use of Event Studies in Estimating Damages

An event study is a statistical regression analysis that examines the effect of an event on a dependant variable, such as a corporation's stock price.¹⁸ This approach assumes that the price and value of the security move together except during days when disclosures of company-specific information influence the price of the stock. In estimating the damages the analyst will then look at the days when the stock moves differently, other than the disclosure day, than determine whether these movements were caused by market or industry factors or by the alleged misconduct. The majority of courts in the United States have recognized the value of the event study methodology in the securities context and have begun to require experts to include an event study in their damage report.¹⁹

As a result of several U.S. cases²⁰ defendants have no required that a plaintiff's damage analysis comply with basic principles of corporate finance and include as damages only

¹⁷ Examples of factors include: type of people investing in the market, how much information they have, the prevalence of automatic trading mechanisms and hedging, and the ability of specialists on the trading floor to provide liquidity. (From Baruch Lev and Meiring de Villiers, "Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis" Stanford Law Review, Vol. 47: 7, (1994).)

¹⁸ *RMED Int'l Inc. v. Sloan's Supermarkets, Inc.*, No. 94 Cir. 5587 RKL, 2000 WL 310352, at 6.

¹⁹ Jay Eisenhofer, Geoffery Jarvis and James Banko, "Securities Fraud, Stock Price Valuation, And Loss Causation: Toward a Corporate Finance- Based Theory of Loss Causation" The Business Lawyer, August 2004, Vol 59, No 4.

²⁰ For example *Re Executive Telecard, Ltd. Securities Litigation* 979 F Supp 1021 (SDNY 1997).

those factors related to the fraud.²¹ Therefore, an event study is required to exclude factors related to the specific company that are not fraud related. In fact, many defence experts have used this to their advantage by grammatically analyzing every announcement by a company to attempt to isolate factors that negatively impact the stock price but are not related to the fraud. Conversely, Plaintiff experts generally define the fraud as broadly as possible so that all of the company's announcements that harmed the stock price are deemed to be fraud-related.²²

Percentage of Damages Agreed to in Settlement

Current the trend appears that the “going rate” of settlement in securities class actions is approximately one quarter of the potential damages.²³ According to one study conducted of eight large class actions in 1983, five of the cases settled for between 24.5% and 27.5% of the amount at ‘stake’, or the per share market loss multiplied by the number of shares in the offering, a sixth settled for 20.6%.²⁴ The two remaining actions in the study settled outside of this range because in one case the company simply did not have the money to pay more, and in other the stock drop nearly 30% and there was a fear that a trial judge may have been receptive to defense claims that plaintiff damages were too high.²⁵

According to NERA Economic Consulting, a frequent consultant and witness for Defendants in securities cases, the median settlement value to investor losses was stabilized in 2006 after a declining trend: in the early 1990s the median share was in excess of 5%, but since 2002 it has hovered between 2.5% and 3%.²⁶ Moreover, in 2004,

²¹ *Re Worldcom, Inc. Sec. Litig.*, 219 FRD 267, 299 n.42 (SDNY 2003).

²² Jay Eisenhofer, Geoffery Jarvis and James Banko, “*Securities Fraud, Stock Price Valuation, And Loss Causation: Toward a Corporate Finance- Based Theory of Loss Causation*” *The Business Lawyer*, August 2004, Vol 59, No 4., page 5.

²³ Janet Alexander, “*Do the Merits Matter? A Study of Settlements in Securities Class Actions*” *Stanford Law Reivew*, Vol. 43: 475, (1991), p 500.

²⁴ *Ibid*, p 517-519.

²⁵ *Ibid*.

²⁶ Ronald Miller, Todd Foster, Elaine Buckberg, “*Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, it Stabilization Ahead?*” NERA, April 2006.

the median percentage of investor losses paid in settlement was 2.3%, compared to 7.2% in 1996.²⁷ Despite this, NERA also makes it clear that a pre-trial settlement equal to little more than 2% of investor losses does not mean that Plaintiff's are leaving on the table 98% of the damages that could potentially be awarded to them at trial. Recovery rates are understated because the legally compensable loss is often substantially less than the investor losses relative to the S&P 500.²⁸ Comparably, the Cornerstone Research Figures for 2006 state that the median settlement as a percentage of "damage estimates" was 2.4%.²⁹

Court Approval of Settlements

In most cases class action settlements must be approved by the court. In Quebec and Ontario the court has to approve a settlement, discontinuance or abandonment, whether it occurred prior to or following certification. However, in British Columbia, Newfoundland and Saskatchewan, only post certification settlements must receive court approval. Ontario's Class Action Act requires court approval of a class action settlement at a 'fairness hearing'. Provincial legislation does not specify criteria for approving a settlement but the Supreme Court of Canada held that the settlement must be "fair, reasonable and in the best interests of those affected by it."³⁰

To meet the burden that the settlement meet or exceed these requirements, Affidavit evidence is usually used by the parties proposing the settlement. The court is not required to determine that the settlement is perfect, the goal instead being that it falls in a 'zone of reasonableness' having regard to the risks inherent in carrying the matter through to trial.³¹ This range of reasonableness is "not a static valuation with an arbitrary application to every class proceeding, but rather it is an objective standard which allows for variation

²⁷ Ibid.

²⁸ Elaine Buckberg, Todd Foster, Ronald Miller, Stephanie Plancich, "Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements", NERA, February 2005.

²⁹ Laura Simmons, Ellen Ryan, "Securities Class Action Settlements: 2006 Review and Analysis" Cornerstone Research.

³⁰ *Parsons v. Canadian Red Cross Society*, [1999] OJ No 3572 (SCJ), at para 69.

³¹ *Ontario New Home Warranty Program v. Chevron Chemical Co.*, [1999] OJ No. 2245 (SCJ) at para 89.

depending upon the subject matter of the litigation and the nature of damages for which the settlement is to provide compensation.”³² In *Dabbs*³³, the court stated that the following factors were useful in assessing if a settlement is reasonable:

1. Likelihood of recovery, or likelihood of success;
2. Amount and nature of discovery evidence;
3. Settlement terms and conditions;
4. Recommendation and experience of counsel;
5. Future expense and likely duration of litigation;
6. Recommendation of neutral parties if any;
7. Number of objectors and nature of objections; and
8. The presence of good faith and the absence of collusion.

The court in *Parsons* noted that two other factors might be useful in considering a settlement approval: (i) the degree and nature of communications by counsel and the representative plaintiff with class members during the litigation; and (ii) information conveying to the court the dynamics of, and the positions taken by the parties during, the negotiation.³⁴ The court said, however, that these factors are no more than a guide in the process.³⁵

In order to obtain court approval at the ‘fairness hearing’ the court may also consider the method that the proposed settlement payments will be paid out, as well as the means of notification to the class members, the appointment of an administrator, the process for opting out, the costs of administering the settlement and legal fees.

Court approval is similar for class actions in the United States, as the courts are required to determine if the proposed settlement is fair, adequate, reasonable and not the product

³² *Parsons v. Canadian Red Cross Society*, [1999] OJ No 3572 (SCJ), at para 70.

³³ *Dabbs v. Sun Life Assurance* (1998), 40 OR (3d) 429 (Gen Div) at para 13.

³⁴ *Parsons*, at para 70.

³⁵ *Ibid*, at para 73.

of collusion. It has also been stated that the courts role is to “act as a fiduciary” to ensure that the settlement is fair to the absent class members.³⁶

Conclusion

There is a clear trend that more and more securities class actions are concluding in settlements instead of litigation. The court approval of various economic models used by the Plaintiffs in estimating aggregate damages also suggests that class actions are likely to become easier to certify in Ontario.³⁷ Consequently, Defendants, facing extremely large alleged but certifiable damage claims, may be more inclined to participate in serious settlement negotiations. As a result, the merits and pitfalls, as well as the ways to arrive at a fair value for settlement, will become increasingly important for the courts to consider in their ultimate control over whether or not to approve securities class action settlements.

³⁶ Andrew Edison, “*Judicial Oversight of Class Action Securities Fraud Settlements*”, Legal Backgrounder, Vol 20, No 11.

³⁷ Paul Webster, “*Financial Class Actions on an Upswing in Ontario*”, Investment Executive, May 2008.