Wall Street Victory for Underwriters in IPO Laddering Cases: More Questions Than Answers

In the land of class actions (the US), the largest securities class action in the history of class actions was recently de-certified to the delight, dismay, acclaim and puzzlement of all parties involved and their insurance companies. Because potentially billions of dollars ride on this one decision, in this Alert we discuss its significance – both for this case and for all class action litigation going forward.

Background

This past December, in a decision considered to be a major victory for investment banks on Wall Street, the US Court of Appeals for the Second Circuit (or Appellate Court) ruled (in a case entitled In Re Initial Public Offering Securities Litigation [or, In Re IPO Securities Litigation] [see January, 2007 Executive Risks Alert Top 10 Court Awards and Settlements of 2006] http://www.willis.com/news/Publications/ExecutiveRisks_Alert_0107.pdf) that six test cases out of 310 consolidated class actions – which were themselves consolidations of thousands of separate class actions (a class action of class actions) – could not proceed as class action cases.

These cases allege securities law violations in connection with initial public offerings (IPOs). Often referred to as laddering1 claims, they were first filed back in 2001 when thousands of investors filed class action cases against 55 investment banks (acting as securities underwriters), 310 companies going public (the issuers) and hundreds of their individual officers. These suits alleged that the defendants manipulated the IPO market for internet and high-tech stocks during the 1990s through laddering.

The End Appeared in Sight: Behold – A Partial Settlement

In February 2005, the court approved a partial $1 billion settlement with the issuers and individual executive defendants in the consolidated actions. Notably, this left the investment banks still locked in litigation with the plaintiffs. This past April, another settlement was reached, with a major securities underwriter agreeing to pay $425 million to settle its part of the class action. Then came the recent opinion by the three-judge panel of the Appellate Court.

The Appellate Court’s decision (if not later overturned on appeal) may have far-reaching legal significance for all class action litigation. In thoroughly analyzing the class certification requirements for federal class actions (under Federal Rule of Civil Procedure Rule 23), the Second Circuit clearly rejected the more plaintiff-friendly and lenient “some showing” standard that had been applied by the lower district court while insisting a more stringent standard be applied.

For a group of plaintiffs to bring a law suit as a group, or class, procedurally, the court has to agree to grant certification (grant “cert”) to the group. If certification of a class is later revoked, the class is “de-certified.”
Overturning Lower Court Decision Means Higher Standards Apply

When the lower court first granted the class certifications, it applied a legal standard that required only “some showing” of the four prerequisites that every class action must meet (numerosity, commonality, typicality and adequacy of representation). But on appeal, the three-judge panel unanimously overturned the district court, rejecting the easy standard applied by the lower court. The panel held that “a district judge may not certify a class without making a ruling that each Rule 23 requirement is met and that a lesser standard such as ‘some showing’ for satisfying each requirement will not suffice.” In reaching its decision, the Appellate Court relied upon US Supreme Court precedent that a class action “may only be certified if the trial court is satisfied after a rigorous analysis.”

No Existing Market for IPO Means Fraud-on-the-Market Theory Unavailable

An important aspect of the Appellate Court decision was its conclusion that the laddering claims were “bristling with individual questions” respecting the issues of plaintiffs’ reliance, knowledge, and alleged payment of undisclosed compensation – such that the predominance of common issues over individual issues needed to justify class certification could not be met. In a critical decision, the Court found that the fraud-on-the-market presumption of reliance commonly used by securities class action plaintiffs (i.e., that all purchasers rely on the stock’s price as an accurate measure of a security’s value in an efficient market) was not available where, as here, the plaintiffs alleged fraud in connection with an IPO, because there is no (well-developed) market for the securities offered in an IPO. The unavoidable conclusion? There can be no class action in such an instance.

Where Are We Now?

In January, the plaintiffs filed a petition for a rehearing en banc, to have the entire Second Circuit reconsider the three-judge panel’s decision. We await the outcome of this petition: to hear or not to hear. However this is ultimately decided, this case may well end up before the highest court in the land, because there is a split in the circuit courts as to the standards a federal court should apply in determining class action status.

Ultimately, if the Second Circuit’s decision is not overturned on appeal, then thousands of individual plaintiffs will have to separately prosecute their claims. Could this create a glut in the federal court system and cause the defendants’ defense costs to skyrocket as they defend thousands and thousands of individual actions? Averting such outcomes is one of the reasons that the US has a class action process. Realistically, it is more likely that most of the class members will not pursue individual actions, because their claims may only amount to a few hundred or even a few thousand dollars, and the cost of litigation for them would be far too prohibitive. It is too early to count the plaintiffs’ bar out. Even their biggest detractors agree that, as a group, they are endlessly creative and inventive.

The long-term effects of this decision are harder to predict. It is easy to see that the two separate settlements, totaling $1.5 billion, could well fall apart – or not. This may depend on how the parties view the risk of continuing to litigate versus the value of their current settlements. For the issuers, the companies with the IPOs in this matter, their cases were valued at roughly $4 million each in the industry-wide settlement. Some might see this as a reasonable cost to achieve peace, while others, like their insurance carriers who had agreed to the settlement, might disagree.

While this decision is only binding in the Second Circuit, it is already being cited in cases in various circuits, in matters as diverse as antitrust and employment litigation. Potentially, it impacts all federal class action litigation: consumer, products, environmental, ERISA, etc. Most notably, the Ninth Circuit recently granted class action certification to the largest employment class action to date. It was the dissent, however, that referenced the IPO case – setting the stage for further appeals in Wal-Mart. While we await this decision and others, it is possible that forum shopping by the plaintiffs (selecting a jurisdiction that will provide them with the most favorable result) might be exacerbated as those seeking to bring class actions avoid those circuits that follow the In Re IPO Securities Litigation decision and its line of reasoning.
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