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CORPORATE LITIGATION WEBSERIES

Stock Drop Litigation: Recent Developments and Emerging Trends

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Upward Trend in Securities Litigation Since Mid-2007

- More security class action filings in second half of 2007 and first half of 2008
- Cornerstone Research:
  - 2006 First Half: 62
  - 2006 Second Half: 53
  - 2007 First Half: 66
  - ***2007 Second Half: 107***
  - ***2008 First Half: 110***
    - About half related to subprime/credit crunch
    - Financial sector: 63 (more than other sectors combined)

The Western Front

- Not just Wall Street (source: *Securities Litigation Hotspot* by Jonathan Shapiro, *Daily Journal*, Nov. 7, 2008)
- 56% increase in investor suits in Western States
  - Subprime and options-backdating cases
  - 9th Circuit seen as favorable
- Good defense results
  - *Apollo Group Inc. Sec. Lit.*—$277.5M jury verdict reversed
  - JDS Uniphase defense verdict
  - In 2007, 2/16 options-related cases in 9th Cir. made it past MTD phase

Recent Pro-Defendant Rulings

- *New York State Teachers' Retirement Sys. v. Fremont General*, No. CIV 07- 05756 (C.D. Ca. Oct. 28, 2008)
  - Plaintiffs: Fremont misrepresented quality of underwriting, loan quality and loan performance
  - MTD granted: no link between company's statements and any explanation why they were misleading when made (scienter) or why they were material
- Similar ruling in *Pittleman v. Impac Mortgage Holdings*, No. CIV 07-0970 (C.D. Ca. Oct. 6, 2008) (re company's statements about quality of Alt-A borrowers)
- *In re 2007 Novastar Financial, Inc., Securities Litigation,* No. CIV 07-0139, 2008 U.S. Dist. LEXIS 44166 (W.D. Mo. June 4, 2008)
  - Plaintiffs: Novastar, a REIT, lacked adequate internal controls and, thus, misstated its financial results and coniditon
  - MTD granted:
    - Falsity of statements: "ultimately, Plaintiff fails to identify a single false entry in the Company's financial statements, nor does he identify the 'truth' that should have been disclosed." Complaint "reads more like a cautionary tale from a treatise on business management than a charge of knowing misstatements and concealments." Companies "are not expected to be clairvoyant and bad decisions do not constitute fraud."
    - Scienter: allegations are "more consistent with a company and executives confronting a deterioration in the business and finding itself unable to prevent it than they are with a company and executives recklessly deceiving the investing community."

Recent Pro-Defendant Rulings (cont'd)

- *Gold v. New Century Financial Corp*., No. CV 07-00931, 2008 U.S. Dist. LEXIS 43466 (C.D. Ca. Jan. 31, 2008)
  - Plaintiffs: lack of internal controls; financial statements misstated allowance for repurchase losses and failed to properly write down impaired assets
  - MTD granted: complaint "does not clearly identify the allegedly false statements or which of the factual allegations support and inference that particular statements are false or misleading." Required Plaintiffs to amend and include chart of each allegedly misleading statement and explain why it was false.
- *Tripp v. IndyMac Bancorp,* No. CV 07-1635, 2007 U.S. Dist. LEXIS 95445 (C.D. Ca. Nov. 29, 2007)
  - Plaintiffs (as summarized by the court): "despite the downturn in the national housing and mortgage markets, Defendants maintained that they were well-positioned, contrary to the other players in the markets." IndyMac had "inappropriately loosened its underwriting guidelines such that it had extended far riskier loans that were going into default at an increasing rate" and had "inadequate internal controls."
  - MTD granted:
    - in light of *Tellabs*, court found these allegations, rather than supporting an inference of scienter, supported "an even stronger inference...that Defendants were simply unable to shield themselves as effectively as they anticipated from the drastic changes in the housing and mortgage markets, and once that inability became evident, Indymac's financials were changed accordingly."
    - No scienter (insider trading): two individual defendants didn't sell; other sold small amounts

What the Future Holds?

- Loss causation
- Continued focus on scienter at time statements were made and falsity of statements
- Decrease in institutional-investor suits?
  - Burden of litigation v. decreased likelihood of substantial settlement
  - Targets themselves of fiduciary-duty claims?
- Death by a thousand cuts: individual actions

Overview

- ERISA “Stock-drop” litigation is increasing, driven by the sub-prime meltdown. Plaintiff lawyers focus on cases where companies have suffered substantial losses.
- Recent decisions add to the hurdles plaintiffs face in “Stock-Drop” litigation, including both prudence and disclosure claims.
- Although recent cases improve chances of early disposition, fiduciaries can take other steps to limit their potential risk.

ERISA Stock Drop Cases: What They Are

What They Are

- Action on behalf of defined contribution plans (e.g., 401(k), ESOP)
- Based on loss to plan as a result of plan investment in company stock

Typical Allegations

- Breach of fiduciary duty of prudence for offering employer stock as plan option
- Breach of fiduciary duty by misleading participants into investing in company stock (Enron)
- Breach of fiduciary duty for failing to inform participants of material information related to company
- Other Alleged Breaches: Monitoring, Loyalty

Over a Dozen Sub-Prime Stock-Drop Cases Filed Over Past Year

Defendants Include:

- AIG
- Beezer Homes
- Bear Stearns
- Citibank
- Countrywide
- Fifth Third
- Fremont General
- Huntington BancShares
- IndyMac
- Lehman Brothers
- MBIA
- Merrill Lynch
- Morgan Stanley
- Regions Financial Corp.
- UBS
- Washington Mutual
- Wachovia
- Wells Fargo

- Many actions related to companies caught in sub-prime market correction
- ERISA cases represent perceived benefits to Plaintiff counsel (including lower pleading threshold, access to discovery, second bite at apple)
- Targets are companies with substantial stock-drops/bankruptcies

Example Allegations in Subprime Stock-Drop Cases

Citigroup

- Plan's Investment in Citigroup was imprudent due to mismanagement and poor business practices, including:
  - Failing to disclose liabilities from off-balance sheet SIVs
  - Causing SIVs to issue debt based on misleading statements
  - Extending "low documentation" loans without considering risk
  - Failing to adequately disclose Citigroup's subprime exposure
  - Understating loan loss reserves

Bear Stearns

- Plan's Investment in Bear Stearns was imprudent because:
  - Bear spent billions buying subprime loans despite increasing delinquency rates
  - Bear failed to adequately disclose subprime loan loss exposure
  - Bear understated its loan loss reserves
  - Bear operated without requisite internal controls

Typical Merits Defenses Raised In Stock-Drop Cases

Prudence Claims

- Presumption of Prudence Based on 404(a)(2)
- Procedural Prudence
- Substantive Prudence

Disclosure Claims

- No Disclosure Obligation
- No Loss Caused by Alleged Disclosure Violation
- Misstatements Not Made in Fiduciary Capacity

Class Certification

- Individualized Issues Raised by 404(c)
- Individualized Issues Raised by Disclosure Claims

Recent Case Law on Presumption of Prudence: *Avaya*

Source of Presumption

- **Statutory exemption**: Section 404(a)(2) exempts certain plans from ERISA "diversification requirement . . . and the prudence requirement (only to the extent it requires diversification)."
- **Trust Law:** Trustee has duty to conform to terms of the trust.

Cases Applying Presumption

- **Moench v. Robertson (3rd Cir.)**
- **Kuper v. Iovenko (6th Cir.)**
- **Wright v. Oregon Metallurgical Corp. (9th Cir.)**

Avaya

- **Applies Presumption to EIAP**: EIAPs subject to ERISA exemptions; place employee retirement assets at greater risk.
- **Applies Presumption at Pleading Stage**: 25% stock-price drop not type of dire circumstances that require removal of company stock

Recent Case Law on Procedural Prudence: *USAirways* and *IPALCO*

	USAirways	IPALCO
Situation	• US Airways sliding into bankruptcy after 9/11	• Small utility merged with AES; stock declined 90% after merger
Procedures Taken	• Fiduciaries considered whether to offer company stock at each of 4 annual meetings • On 2 occasions, sought outside legal opinions • Appointed independent fiduciary when company considering reorganization • Fiduciary belief in company supported by market, stock price, bond ratings, and analyst reports	• Company stock was design feature of plan • Corporate due diligence conducted before merger found merger to be in best interests of shareholders • No separate meeting of plan committee to consider prudence of AES stock • Fiduciaries sold their individual positions before merger (because not going to be with AES after merger)

Recent Case Law on Disclosure Claims: *IPALCO, Reliant Energy* and *AVAYA*

Disclosure Obligation Limited

- **IPALCO** (7th Cir): Plaintiffs allege that fiduciaries should have disclosed own sales of stock.
  - Court finds no duty to disclose non-material information; inside sales were disclosed and did not move market, therefore immaterial

Statement Not Made in Fiduciary Capacity

- **Reliant Energy** (5th Cir): Securities filings were required to be made in corporate capacity; they were not fiduciary statements even though incorporated in S-8 and 10a Prospectus

No Harm From Lack of Disclosure

- **Avaya** (3rd Cir): Plaintiff argues that adverse information should have been disclosed earlier
  - Court finds that under efficient market hypothesis, market would have adjusted to disclosure of adverse information before Plan or participants could have sold shares

Strategies to Minimize Risk and Expense

Limit Executive Liability

- Clearly demarcate responsibilities in Plan documents, including appointment and oversight
- Remove senior executives and board members from committees with administrative responsibilities
- Consider using independent fiduciary

Revise Plan

- Revise plan to hard-wire company stock as option within plan; or
- Remove company stock from plan options

Procedural Steps

- Review investment options on regular basis
- Implement regular monitoring process over investments

What Happens During a Government Investigation?

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