

# A PRIMER ON SECURITIES FRAUD CLASS ACTION LITIGATION

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***Disclaimer:***

*This article is intended to provide a thorough background on securities fraud class action litigation. However, it is not intended as a substitute for legal advice with your chosen counsel and discussions as to the merits of each particular action you may consider.*

- *All citations are omitted, but available upon request*

# A Primer on Securities Fraud Class Action Litigation

## Introduction

Kessler Topaz Meltzer & Check, LLP (“Kessler Topaz”) is pleased to provide this primer on securities fraud class action litigation. The goal of this primer is to briefly explain litigation under the federal securities laws of the United States. We believe these laws should be viewed as tools that allow investors, among other things, an opportunity to recover investment losses suffered as a result of fraud or other illegal conduct. The information contained herein provides a general overview of various substantive and procedural issues that may arise in connection with pursuing a securities fraud class action, and is intended to assist investors in gaining a general understanding of the rights and remedies available under the federal securities laws, particularly the ability to serve as a plaintiff in a class action. We hope this primer will assist the reader in becoming familiar with this area of the law while providing an understanding as to how an investor may use these laws to safeguard the value of their investments and potentially recover losses if misconduct is involved.



## Table of Contents

	Page
I. Securities Fraud Class Action Litigation .....	1
A. The Class Action Mechanism .....	1
B. The PSLRA and the Lead Plaintiff Application.....	1
C. The Benefits of Serving as a Lead Plaintiff and the Lead Plaintiff Duties .....	2
1. Overseeing the Litigation.....	2
2. Costs and Expenses.....	3
3. Settlement Discussions .....	3
4. Attorney Fees .....	3
D. Determining Your Financial Interest in the Litigation.....	3
1. Calculating Out of Pocket Losses (LIFO) .....	4
2. Matching Shares.....	5
3. Valuing Retained Shares.....	5
E. Litigating Securities Fraud Class Actions .....	5
1. The Amended Complaint and Motion to Dismiss .....	5
2. Merits Discovery.....	7
3. Class Certification.....	7
4. Trial.....	8
F. Conclusion .....	9

## **I. Securities Fraud Class Action Litigation**

### **A. The Class Action Mechanism**

The class action mechanism is a powerful procedural tool to hold wrongdoers accountable for widespread damages caused to a large number of victims, who individually may not have sufficient damages to support the cost of prosecuting individual claims. This scenario is especially true when it comes to securities violations where individual investor damages will likely be dwarfed by class-wide damages. The class action mechanism also allows a defendant to settle all applicable claims on a class-wide basis and, in the process, limit its exposure by obtaining a class-wide release. This procedural tool serves a useful social function because it provides remedies for all persons in a class who have suffered damages stemming from the same misconduct.

In the United States, class actions are governed by Rule 23 of the Federal Rules of Civil Procedure. This rule permits one party or a group of parties (the “Lead Plaintiff”) to file a class action complaint on behalf of a “class” of similarly situated persons and entities when certain requirements under Rule 23 are met.

The Lead Plaintiff is responsible for prosecuting claims on behalf of the class and has the power to settle and release claims of all class members, with due process and notice being provided to the class to weigh in on any such decision to resolve a class action. When a Lead Plaintiff files a lawsuit as a representative of a class of similarly situated victims, a federal court judge must, at an early practicable time, determine whether to certify the action as a class action. This procedure is commonly known as “class certification” and is a critical hurdle in a securities case. The Lead Plaintiff is also charged with selecting and supervising attorneys to represent the class (“Lead Counsel”).

## **B. The PSLRA and the Lead Plaintiff Application**

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 (“PSLRA”) which fundamentally changed the requirements for pleading violations under federal securities laws. Specifically, the PSLRA requires a Lead Plaintiff to meet a heightened pleading requirement without the benefit of reviewing any information produced by defendants through the discovery process, such as document production, interrogatory responses or deposition testimony. As a result, a Lead Plaintiff’s claims often must be supported by facts developed through private investigations conducted by counsel, government investigations and other public sources.

The PSLRA also changed the organization and leadership of federal securities fraud class action lawsuits. The PSLRA requires a Court overseeing a federal securities fraud class action lawsuit to adopt a rebuttable presumption that the most adequate plaintiff to represent a class as Lead Plaintiff is the investor or small group of investors who suffered the largest financial loss.

Before appointing the Lead Plaintiff, however, the plaintiff filing the first class action lawsuit must publish notice of the filing of the action via a wire service or widely circulated publication, advising investors of the pendency of the action to inform investors that any class member may apply to the Court to serve as the Lead Plaintiff. A Lead Plaintiff application must be made within sixty (60) days of the publication of the notice. The purpose of the initial notice and the 60-day period that follows is to alert potential class members to the commencement of the litigation and to provide investors with time to measure their losses and consider whether they would like to move to be appointed Lead Plaintiff. An investor does not need to file a complaint to be appointed Lead Plaintiff; rather, any investor within the class may move the Court by filing a motion for appointment as



Lead Plaintiff. The motion must be accompanied by a PSLRA certification which, among other things, provides that: (i) the plaintiff did not purchase the subject security at the direction of counsel in order to participate in the action; (ii) the plaintiff is willing to serve as a representative party on behalf of a class; (iii) all transactions in the subject security during the Class Period are set forth therein; (iv) all other securities class actions in the past three (3) years in which the plaintiff is serving (or sought to serve) as a representative party are identified; and (v) the plaintiff will not accept any payment for serving as a representative party beyond his or her pro rata share of any settlement or award.<sup>1</sup>

After evaluating the Lead Plaintiff applications, including any arguments or briefs in support or in opposition, the Court will appoint a Lead Plaintiff or Lead Plaintiff group. The PSLRA requires a Court to appoint as Lead Plaintiff the movant or movant group with the “largest financial interest” in the case (often measured as the largest loss), so long as they are also adequate and typical to lead the class.

### **C. The Benefits of Serving as a Lead Plaintiff and the Lead Plaintiff’s Duties**

One of the leading misconceptions with regard to securities fraud class actions is that there are no advantages to assuming the role of the Lead Plaintiff. While taking on the role of Lead Plaintiff requires careful consideration, it is important to note that the majority of investors do not understand what is entailed. Indeed, most believe that it is much more burdensome than it truly is, and do not fully understand the benefits or the impact that the Lead Plaintiff’s decisions have on all investors. This section will detail

the responsibilities of a Lead Plaintiff and the advantages to serving as Lead Plaintiff when the circumstances are right for you.

In order to have a representative of the plaintiff class overseeing the litigation, the Court will appoint a single investor or a small group of investors as the Lead Plaintiff. As noted above, this selection is based primarily on which plaintiff or plaintiff group has suffered the largest financial loss. While nearly all Courts allow small groups of plaintiffs to come together to represent the class, the size of these groups generally does not exceed five members so that they are able to work together in an efficient manner. The Court will then typically approve the Lead Plaintiff’s selected attorneys as Lead Counsel. This organization is usually established by the Court within the first several months after the lawsuit is initiated.

#### **1. Overseeing the Litigation**

The Lead Plaintiff is responsible for managing the litigation primarily by overseeing and monitoring the progress of the action and the efforts of Lead Counsel. Specifically, a Lead Plaintiff will review and comment on important filings and other documents pertaining to the prosecution of the action. Lead Counsel is responsible for litigating the action and, at the same time, keeping the Lead Plaintiff well-informed so that the Lead Plaintiff can effectively monitor all progress and provide comments and suggestions. Kessler Topaz works with all of its clients to establish a reporting system that they determine to be effective, yet not overwhelming.

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<sup>1</sup> If the Lead Plaintiff movant did file a complaint, the certification must also state that the Lead Plaintiff reviewed the complaint and authorized its filing.



## 2. Costs and Expenses

There is no financial risk in serving as a Lead Plaintiff. Kessler Topaz advances all costs and expenses incurred in the prosecution of the case and will be reimbursed only if there is a successful settlement or judgment recovery on behalf of the class. This reimbursement comes from the money recovered on behalf of the class and, thus, there is never a time when the Lead Plaintiff would have to pay anything out of his or her own pocket. Furthermore, unlike many other countries, in U.S. class action cases, the Lead Plaintiff is not responsible for the legal costs or expenses of the defendants in the event that a case does not resolve favorably for the class. In addition, fees earned by Kessler Topaz are contingent upon a successful recovery and are ultimately determined by the Court, based on the complexity of the lawsuit, the duration of the litigation and the quality of work performed.

## 3. Settlement Discussions

Once discussions aimed at resolving an action commence, the Lead Plaintiff will have an opportunity to be active in all negotiations relating to the size of the financial recovery, the makeup of the consideration (i.e., cash and stock, cash and options, etc.), and the proposed plan of allocation for distribution of the recovery to the class. Moreover, the Lead Plaintiff must approve any settlement before it is presented to a Court. It is important to note that a Lead Plaintiff is a fiduciary to the class, thus these decisions must be made based upon what is in the best interests of the class and not based upon the Lead Plaintiff's own personal interests.

## 4. Attorney Fees

A common complaint directed at class actions is that plaintiffs' attorneys are awarded too large a portion of the recoveries they achieve. The reality, however, is that attorneys' fees by percentage have been dramatically reduced in the last several years. As a result, the class is benefited by a return of a larger portion of the settlement. Further, even if counsel and the Lead Plaintiff agree on an appropriate fee, all fees must ultimately still be approved by the Court as fair and reasonable.

### D. Determining Your Financial Interest in the Litigation

As discussed above, the PSLRA creates a rebuttable presumption that the plaintiff with the largest financial interest (of the movants seeking appointment) in the litigation should be appointed as Lead Plaintiff. While the PSLRA requires a financial interest analysis to identify the movant with the most at stake in the litigation, the PSLRA does not define "financial interest" or otherwise guide Courts on how to calculate an investor's "financial interest" for the purposes of selecting a Lead Plaintiff. As a result, determining how to calculate an investor's financial interest, or financial loss,<sup>2</sup> remains the subject of some debate among the Courts. That said, the first and most commonly used method involves calculating the out-of-pocket financial loss experienced by the lead plaintiff movant under the LIFO (last-in, first-out) share matching methodology.<sup>3</sup>

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<sup>2</sup> Courts look at several factors when assessing financial interest, including, for example, net shares purchased, net funds expended, total funds expended, and loss. Loss is considered to be the most important factor.

<sup>3</sup> Another method involves calculating the lead plaintiff movant's losses utilizing the principles set forth by the United States Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342-43 (2005), which limits recovery to losses tied to the disclosure of fraud. *Dura* excludes non-fraud (or general market) related losses, whereas LIFO tends to capture fraud and non-fraud movements in the analysis.



It is important at the outset to note that the Class Period – the time period during which the defendants’ false and misleading statements inflated the price of the security – determines which purchases and sales of the security at issue factor into a plaintiff’s financial interest. Consequently, when an investor elects to pursue appointment as Lead Plaintiff, counsel will first request the client’s transactions in the security during the

by the Lead Plaintiff candidate. Out-of-pocket losses are a measure of the actual financial impact of a series of transactions on an investor regardless of the reasons (fraud or market factors) for the losses. Currently, LIFO is the majority rule in many key jurisdictions in the United States. Courts favoring LIFO do so because this methodology takes into account gains that might have accrued to plaintiffs resulting from sales during the Class

<b>Sample Client</b> <b>LIFO Loss Calculation in Sample Company</b> Class Period: 3/2/2018 – 7/30/2019 Retained Shares valued at : \$21.00									
<u>Transaction</u>	<u>Date</u>	<u>Shares</u>	<u>Price</u>	<u>Cost</u>	<u>Transaction</u>	<u>Date</u>	<u>Shares</u>	<u>Price</u>	<u>Proceeds</u>
Open Balance		1,000			Sale	11/1/2018	500	\$144.00	\$72,000.00
					<i>Sales Offsetting opening balance: 500</i>				\$72,000.00
Purchase	11/5/2018	1,000	\$150.00	\$150,000.00	Sale	1/18/2019	500	\$159.00	\$79,500.00
Purchase	12/16/2018	1,000	\$156.00	\$156,000.00	Sale	7/8/2019	1,000	\$171.00	\$171,000.00
Purchase	5/6/2019	500	\$162.00	\$81,000.00	Retained		1,500	\$21.00	\$31,500.00
Purchase	7/7/2019	500	\$168.00	\$84,000.00					
		3,000		\$471,000.00			3,500		\$282,000.00
									<i>LIFO loss: (\$189,000.00)</i>

Class Period, as well as any shares of the security the client held immediately prior to the beginning of the Class Period and all post-Class Period transactions. Using this data, counsel will calculate the client’s financial interest in the litigation.

### 1. Calculating Out of Pocket Losses (LIFO)

Historically, many Courts have equated financial interest with the out-of-pocket financial loss experienced (either as owner of the stock or on behalf of the actual owners)

Period due to the inflation of the stock price. LIFO, on the other hand, is more likely to account for Class Period gains because early Class Period sales are not netted out against pre-Class Period purchases.

Once shares are matched, counsel then calculates the value of the remaining (or retained) shares using the stock’s average closing price for the 90 days after the end of the Class Period.



## 2. Matching Shares

Under the LIFO methodology, the last shares purchased are considered the first shares sold. For example, as demonstrated in the chart above, if an investor owns 1000 shares of Sample Company stock at the start of the Class Period, and then purchases 3000 more shares during the Class Period while also selling 2000 shares during the Class Period, 1500 of the 2000 shares sold during the Class Period would be offset against the 3000 more shares purchased during the Class Period, thereby leaving a net balance of 1500 shares purchased during the Class Period. Because 500 shares were sold prior to any purchases (the sales on 11/1/2018), such shares could not be matched against purchases and thus are matched against the pre-Class Period holdings.

## 3. Valuing Retained Shares

After netting all Class Period transactions, counsel determines a set-off value for the shares retained at the end of the Class Period to calculate the loss related to those shares. Under the PSLRA, the set-off value is equal to the mean trading price of the security during the 90-day period beginning immediately after the end of the Class Period ("hold price").<sup>4</sup> The use of the hold price is intended to reduce the impact of temporary stock price declines following the disclosure of corrective information that are erased if the stock price rebounds. After it is calculated, the hold price is multiplied by the number of shares purchased during the Class Period and still retained at the end of the Class Period – in the

above example 1500 under LIFO. That product is then netted with the out-of-pocket cost of the shares held at the end of the Class Period to calculate a movant's out-of-pocket loss.

It is important to recognize and understand that calculating the greatest financial interest for purposes of determining which investor is best suited (or which group is best suited) to serve as Lead Plaintiff *is very different than calculating how much of the loss incurred is actually compensable under the securities laws, i.e., the damages*. Ultimately, damages will only be awarded under the securities laws for the portion of the loss that was due to misconduct, as opposed to general market movements that could occur in any given stock during any given time period.

### E. Litigating Securities Fraud Class Actions

This section provides a general overview of the typical stages in prosecuting a securities fraud class action after the Lead Plaintiff is appointed.

#### 1. The Amended Complaint and Motion to Dismiss

As noted above, the PSLRA provides specific procedures for the appointment of a Lead Plaintiff in a securities fraud class action. Following the Lead Plaintiff appointment, the Lead Plaintiff and defendants typically agree upon a schedule to file an amended complaint and for defendants to file responsive pleadings.

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<sup>4</sup> If the investor sells the shares after the end of the Class Period, but before the end of the 90-day period, the actual sale price is not always utilized. Instead, counsel must use the greater of the actual sale price or the mean trading price from the end of the Class Period through the date of sale. Alternatively, if the investor sells after the 90-day period, the 90-day hold price must be used.



The amended complaint is one of the more important steps in prosecuting a securities fraud class action because it sets forth the relevant facts and pleads causes of action that the Lead Plaintiff intends to establish at trial.

Complaints typically assert claims against issuers and officers who issued materially false statements. The complaint may also name directors who signed documents, underwriters who assisted in selling securities, and accountants who issued unqualified audit opinions as defendants.

Securities fraud complaints must be pled with particularity pursuant to Rule 9(b) of the Federal Rules of Civil Procedure and the PSLRA. The failure to comply with these stringent pleading standards may provide a basis for dismissal of the action. Accordingly, Lead Plaintiff's counsel (Lead Counsel) will promptly undertake a thorough investigation of the factual circumstance that underlies the fraud, including researching all of the defendant's SEC filings, press releases, and other company statements to determine which information was falsely stated or omitted. For purposes of pleading scienter for claims brought under the Exchange Act, the state of mind of the defendant, the Lead Plaintiff must plead and ultimately prove that defendants acted intentionally or recklessly in making their false statements or omitting material information. One way in which such "state of mind" evidence is pled is through circumstantial evidence of motive, which is typically pled by analyzing any insider sales by officers and directors, or acquisitions that the issuer may have made with inflated stock which may expose a motive for the fraud.

Depending on the nature of the fraudulent statements, Lead Counsel may also engage investigators to identify and contact potential witnesses, such as customers, suppliers/

vendors, former employees, non-defendant companies, or retain industry experts who help better understand the industry and the fraud. Kessler Topaz typically utilizes the firm's renowned Investigative Services Division, which includes former law enforcement agents known for their relentless pursuit of evidence, to conduct these tasks. Lead Counsel may also engage accounting experts to analyze the issuer's financial statements and identify violations of generally accepted accounting principles. All of these efforts go towards attempting to plead and ultimately prove that defendants knew their statements were false at the time they were made or acted recklessly in making their statements.

Once the Lead Plaintiff files the amended complaint, defendants will invariably move to dismiss the complaint on any number of grounds in order to continue the automatic stay of discovery that is mandated by the PSLRA until a decision on the motion is rendered by the Court. Motions to dismiss typically argue that the alleged false statement was immaterial to investors, that the defendants did not know the statement was false when made, that the complaint fails to satisfy the heightened pleading requirements of Rule 9(b) and the PSLRA, and that the false statements did not cause the Lead Plaintiff's losses.

Lead Plaintiff's counsel will file a brief in opposition to the motion to dismiss and the Court will issue an opinion and order that either grants or denies the motion to dismiss, or parts thereof. This process can sometimes take an exceedingly long period of time based upon the complexity of the issues or the schedule of the Court deciding the motion. It is also not uncommon for a Court to give the Lead Plaintiff another chance to plead their theory, even if the first motion to dismiss is successful in causing the Court to dismiss the complaint.



## 2. Merits Discovery

Once the defendant has either answered the complaint or the Court has denied the defendant's motion to dismiss, the discovery stay, which is automatically in force under the PSLRA, is lifted and discovery begins.

Under the Federal Rules of Civil Procedure, before the discovery process begins, the parties must confer to discuss, and ideally to agree upon, a comprehensive discovery plan. The plan may address: (i) the scope and timing of discovery; (ii) the number of depositions and their length; (iii) the number of written questions (or interrogatories) each party may serve on another party; (iv) expert discovery including exchange of reports and scheduling of expert depositions; (v) issues concerning access to and retrieving documents; and (vi) obtaining document or deposition discovery from third parties. Following the meeting, the parties must provide the Court with the proposed discovery plan for its approval, or if agreement is not reached, each party may submit their own proposed schedule. The Court will often make modifications to the plans depending on its own schedule.

Within fourteen (14) days of the parties meeting, each party must provide the other parties to the action with their "initial disclosures." These disclosures include basic information concerning: (i) the parties' claims and defenses; (ii) identification of witnesses and contact information; (iii) identification of documents that support a party's claim or defense; and (iv) the identification of applicable insurance coverage. The Lead Plaintiff will generally be required to provide copies of his or her trading records to demonstrate their holdings in the defendant company, as well as any other information the Lead Plaintiff possesses concerning the issuer of the securities or his/her decision to invest in the securities.

After the parties have provided initial disclosures, they may then serve discovery requests. These requests are made in the form of document requests and interrogatories (which are written questions), directed to parties in the action. The Lead Plaintiff will receive document requests and interrogatories relating to the claims asserted, and Lead Counsel will review the requests to ensure they are appropriate, and assist in the preparation of any responses.

The Lead Plaintiff may also be notified of the need for deposition testimony. The parties must give reasonable advance notice of any deposition and in general, the Lead Plaintiff need only sit for a few hours on a single day and counsel is generally able to schedule the deposition for a time convenient to all parties. Lead Counsel will prepare with the Lead Plaintiff prior to the deposition to ensure that the Lead Plaintiff is familiar with the deposition process and is adequately prepared to respond to defendant's questions.

## 3. Class Certification

Rule 23 of the Federal Rules of Civil Procedure provides that "as soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be maintained." Class certification is an important procedural requirement that allows the Lead Plaintiff to maintain the action through trial on behalf of the Lead Plaintiff and all other similarly-harmed investors (the "Class"). Motions for class certification are typically filed several months after a Court denies defendant's motion to dismiss.



A fundamental prerequisite to the maintenance of any class action is that there is an identifiable Class, that the Lead Plaintiff is a member of that Class, and that there are common issues of law or fact between Class members such that a class action would be superior over any other available procedures for adjudicating the controversy.

Although class certification is a procedure distinct from the merits of the action, a Court may nonetheless probe behind the pleadings before coming to rest on the certification issue. In making its class certification determination the Court will consider various prerequisites mandated by Rule 23, including: (i) numerosity of the parties; (ii) commonality of legal and factual issues; (iii) typicality of the claims and defenses of the class representative; and (iv) adequacy of representation. The party seeking certification (Lead Plaintiff) bears the burden of establishing that all prerequisites are met.

Once the Class is “certified,” the Court will direct that appropriate notice be made to the Class members, generally through publication and individual notice to all members who can be identified through reasonable effort. The notice must concisely and clearly state in plain, easily understood language: (i) the nature of the action; (ii) the definition of the Class certified; (iii) the Class claims, issues, or defenses; and (iv) that a Class member may enter an appearance through counsel if the member so desires. Importantly, Class members have the right to affirmatively opt-out of the Class and to pursue a separate (but likely coordinated) action on their own behalf.

If a Class is not certified, each plaintiff is responsible for litigating its own individual claim in its own action. As such, defendants are highly motivated to defeat Lead Plaintiff’s efforts to certify a Class.

#### **4. Trial**

While securities fraud class actions rarely go to trial, the possibility does exist. Since the passage of the PSLRA, less than fifteen (15) cases have gone to trial and reached a verdict. The purpose of a trial is to adjudicate contested issues of fact. In this regard, before the trial commences, the Court may require Lead Counsel to draft a series of statements of fact that they believe will be established at trial. Defendants then indicate which of the proposed facts are admitted, or will not be contested, and which are disputed, specifying the nature of the disagreement, as well as drafting narrative statements of additional facts that they believe can be established. This process helps to narrow the factual issues in dispute.

Courts sometime place certain limits to avoid trials of excessive length, but without hampering counsel’s ability to present their case or jeopardizing the fairness of the trial. Limits may be imposed in a variety of ways, including limiting the number of witnesses or exhibits to be offered on a particular issue or in the aggregate, controlling the length of examination and cross-examination of particular witnesses, limiting the total time allowed to each side for all direct and cross-examination, and narrowing issues by order or stipulation.



The Lead Plaintiff is not required to attend a trial if one were to occur, but may be required to appear and present limited testimony related to the investment at issue in the litigation. Kessler Topaz is one of only a few law firms in the United States that has tried a securities fraud class action lawsuit to verdict.

## **F. Conclusion**

Kessler Topaz hopes this primer has helped to show that securities fraud class action litigation can be a tool to recover losses. We also hope this information will assist investors when assessing whether to come forward and serve as a Lead Plaintiff in the right circumstances. Considering what is at stake, it is crucial that an investor who understands the value that can be achieved through this type of litigation be the one overseeing counsel in these actions. Kessler Topaz is committed to serving the investment community and providing the best possible results for our clients and the classes they represent.





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