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THE MOTION TO DISMISS IN SECURITIES CLASS ACTION PRACTICE – FUNDAMENTAL CONSIDERATIONS FOR CORPORATE OFFICERS AND GENERAL COUNSEL

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Even many sophisticated companies and corporate officers are unfamiliar with the inner workings of class action securities claims. Plaintiffs in these cases seek large sums, sometimes hundreds of millions of dollars, on the theory that misstatements or omissions by a company and its officers caused investors to purchase the company's stock at an inflated price, causing those investors to then lose money when the stock subsequently reverts to its "true" value.

Because individual corporate directors and officers are often named as defendants along with the public companies they serve, the stakes in these large-dollar cases can be truly significant for both corporations and their leaders. Even worse, the process can take years to resolve while the litigants deal with legal uncertainty. A basic understanding of the fundamentals of securities class action litigation is therefore critical not just for General Counsel, but also for other key corporate officers and directors. A good place to start is with the fundamentals of motions to dismiss securities class action claims under Rule 12(b)(6) of the Federal Rules of Civil Procedure.

Securities class action lawsuits are regularly dismissed at the pleadings stage, based upon the unique requirements for plaintiffs in such cases. From 1997 through 2018, 43 percent of core federal class action filings were dismissed, 49 percent were settled, 7 percent remain live cases, and less than one percent have reached a trial verdict.[1] Data sets focused on more recent cases show even higher rates of dismissal, though every year is different. 2013 federal securities class action lawsuits had a 57 percent dismissal rate, and 2016 filings were dismissed at roughly a 49 percent rate.[2] While each case is unique, then, and while the potential success of a motion to dismiss always depends upon the underlying facts of the case, it is clear that the Rule 12(b)(6) motion to dismiss is a real opportunity for defendants in these cases. But how to maximize that opportunity? There are steps that defendant corporations and individuals should take at the outset of a securities class action to take the best possible shot at dismissal. Here are three big-picture considerations:

1. ***Each defendant should quickly begin to prepare an individual legal response to the lawsuit.*** Typically, the deadline for a defendant in federal court to "answer or otherwise move" is 21 days after service of process is accomplished. In class action cases, however, there is often a lengthy delay while various plaintiffs' law firms compete to be named the lead attorneys on the matter. Generally, the defendants are not called upon to actually answer the Complaint until after the lead plaintiff and counsel have been approved by the Court, and have then filed a new, "amended and consolidated" Complaint. Even then, the parties will often agree that the defendant will waive service under Rule 4 of the Federal Rules of Civil Procedure, which then provides them with 60 days to respond.

   It is critical during the time afforded during these early delays to consider the extent to which the interests of individual defendants (typically corporate directors/board members, the CEO, the CFO, etc.) may differ from the interests of the company, or from the interests of other individual defendants. In most cases, there are good reasons for each defendant to obtain individual counsel representing his or her unique perspective and interests. This is especially true when the plaintiffs make specific allegations about certain individuals, and different allegations about others. But it is equally key that each defendant obtain counsel who can work with co-counsel when appropriate to advance arguments that are generally beneficial to all defendants. "Directors-and-Officers" Policies on companies' liability insurance policies will often cover the cost of individual counsel for key personnel.

2. ***There is a well-established process for seeking the dismissal of class action lawsuits.*** A "12(b)(6) Motion" argues that even if the facts alleged by plaintiffs are true, the lawsuit should be thrown out of court because it fails to state a valid legal claim. In securities class action cases, the case will also be dismissed if the plaintiffs fail to plead facts with detail adequate to satisfy the provisions of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), which include stringent requirements for pleading both scienter ("intent" or "recklessness") and loss causation. If there are multiple defendants and multiple defense teams, some elements of each defendant's Motion to Dismiss may overlap with those filed by others. When that happens, the parties can usually incorporate certain sections of a "lead brief" by reference within their individual motions, leaving time and attention for each legal team to focus on the issues unique to each individual defendant. Often the "lead brief" will be the brief for the defendant company, while the briefs for individual defendants will focus on issues unique to them.

3. ***Typically, there are four main reasons why a securities class action is thrown out of court at the 12(b)(6) "Motion to Dismiss" stage.*** In order to survive a 12(b)(6) motion, plaintiffs must show the Court that they have alleged sufficient facts to prevail on at least four key points—*if* the facts alleged are eventually proven true by a preponderance of the evidence:

- First, plaintiffs must generally be able to make a showing that the defendant company and/or its officers made ***misstatements or omissions of fact*** about the company, its financial reporting, its business prospects, or related issues ("misstatement"). That means that the Plaintiffs must show that the defendants made some affirmative representation that was false, or omitted to share information that it had a duty to disclose, usually because it was essential to make the company's other statements "not misleading." The rules for determining whether a "duty to disclose" exists are complex and technical—so many defendants argue that the plaintiffs have not identified a real, misleading misstatement or omission.

- Second, the allegedly withheld or misstated information at issue ***must be "material"***—that is, it must be the sort of information that might have changed a reasonable investor's decision whether to buy or sell the company's stock, given the "total mix" of public information available ("materiality").

- Third, plaintiffs are required to show ***either an intent to deceive or extreme recklessness*** on the part of each defendant against whom they want to proceed ("scienter"). This showing must be "individualized"— the plaintiffs cannot just assume that a corporate officer knew everything by virtue of his position at the company, and the state-of-mind of one defendant cannot be imputed to another. Reasonable, innocent explanations for the defendants' state of mind must be considered along with the plaintiffs' theories. The Private Securities Litigation Reform Act ("PSLRA") makes this an especially challenging hurdle for plaintiffs to clear in securities class action cases: they must "'*specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading*, and, if an allegation regarding the statement or omission is made on information and belief, … state with particularity all facts on which that belief is formed.'" *Employees Retirement System v. Whole Foods Market*, 905 F.3d 892, 900 (5th Cir. 2018), quoting 15 U.S.C. § 78u-4(b)(1) (emphasis added).

- Fourth, plaintiffs must make a showing that ***the misstatement or omission actually caused investors' losses*** *("loss causation")*. That usually means that plaintiffs must plead that the stock price was artificially inflated by the allegedly false statements or omissions; then lost value when the truth came to light through one or more "corrective disclosures." The "damages" to investors come from the difference between the true value of their shares and the inflated price they paid. If there is not a clear connection between the stock price and the alleged falsehood, the claim can fail.

This means that the timing of relevant disclosures, and the historical stock price data during the relevant period, are key facts. The court can take judicial notice of historical share price records at the Rule 12(b)(6) stage. Moreover, the PSLRA contains a "90-day bounce back" rule that limits securities class action plaintiffs to nominal damages, as measured by the difference between actual purchase price and the mean trading price during the 90-day period beginning on the last applicable corrective disclosure date.[3] If a stock's value rebounded during this period (which can happen after a lawsuit is filed), that fact alone can end plaintiffs' chance at a meaningful recovery. This may be the fate of many securities class action lawsuits filed based upon stock price crashes caused by COVID-19 in 2020, since markets in many sectors rebounded quickly—minimizing or eliminating losses within the 90-day bounce-back window. Even for cases not dismissed at the pleadings stage, assessing damages is a critical part of any defense. The 90-day bounce-back rule is one of several key tools for doing so.

Final Considerations at the Pleadings Stage

In order to proceed past the "motion to dismiss" stage, every plaintiff in a securities class action claim must plead facts that, if proven at trial, would be adequate to establish all of these elements. As the statistics cited above demonstrate, these requirements are real hurdles that plaintiffs' lawyers must surmount to move into the lengthy discovery phase of a securities class action case. Of course, if a motion to dismiss fails, there are many subsequent opportunities for class action defendants to seek relief from the courts—including by challenging class certification itself, by bringing a motion for summary judgment, by prevailing at trial, or by limiting the damages that plaintiffs are entitled to recover, even after a settlement or judgment. But the motion to dismiss is the first, best opportunity for defendants to attempt to get out of the litigation at comparatively low cost.

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[1] Harvard Law School Forum on Corporate Governance Securities Class Action Filings – 2019 Year in Review, Securities Class Action Filings—2019 Year in Review. https://bit.ly/3fQ8ytN

[2] *Id*.

[3] See 15 U.S.C. § 78u-4(e)(2).

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