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COMPARING APPLES TO
SCREWDRIVERS: THE INHERENT
LIMITATIONS OF USING STATISTICAL
COMPARISONS TO PREDICT THE
SETTLEMENT AMOUNT OF A
SECURITIES CLASS ACTION

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During settlement talks, defendants in securities class actions frequently attempt to inject the notion of a statistical comparison of so-called comparable settlements. Relying on publications by industry consultants, like Cornerstone Research and NERA Economic Consulting, defendants attempt to characterize virtually all securities class action settlements as pennies on the dollar. To justify their low numbers, defendants usually measure each settlement amount in a pool of purported comparable cases as a very low percentage of the market-cap loss (rather than as a percentage of estimated damages, which are substantially lower than market-cap loss). The median settlement amount of such purported comparables then becomes the defendant's metric for determining settlement value. Not only are such approaches methodologically flawed, but statistical comparisons are too facile for the complexities of assessing what is a "fair, adequate and reasonable" settlement for a securities class action.

The problem with comparing any individual securities class action against the statistical median of a pool of class action settlements is that such comparison ignores the *countless* factors that determine the settlement amount in any particular case. Louis D. Brandeis said, "I abhor averages. I like the individual case. A man may have six meals one day and none the next, making an average of three meals per day, but that is not a good way to live."² Likewise, that a particular class action settled for an amount that equals 3, 5, 10, 15, or 90% of the total market-cap loss really says nothing about the settlement value of any other specific case.

When evaluating a potential settlement, each party must assess the probabilities of various litigation outcomes. One possible outcome is a conclusive defense victory either by dispositive motion or trial, resulting in zero damages. Another is a complete plaintiff's victory with judgment against the defendant on all counts and a ruinous damage award. Between these two potential outcomes are a range of possible outcomes based on the unique circumstances of each case. Myriad external factors will also affect decision making. For example, a solvent company's desire to eliminate a large, contingent liability to complete a business transaction (i.e., an acquisition or merger) may increase settlement value. Absent a substantial externality, however, the single most important factor affecting settlement evaluation is the strength of the claims and the corresponding assessment of the range of possible outcomes of trial. With this range of potential outcomes in mind, each party calculates settlement value based on its assessment of the risks of continued litigation through trial. Thus,

2. Louis D. Brandeis, <http://www.quotegarden.com/statistics.html>.

the settlement amount reflects the assessment by experienced counsel and informed clients of the strengths of the particular case, the amount of provable damages and the ability of the defendant to pay a judgment.

While the plaintiff's goal in performing its risk analysis is to maximize the class recovery, the court overseeing the case ultimately will carry out a similar analysis when deciding whether the proposed settlement falls within the range of what is "fair, reasonable and adequate." See *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277 (7th Cir. 2002); *Hanlon v. Chrysler Corp.*, 150 F.3d 1011, 1026 (9th Cir. 1998). Judge Posner's reasoning in *Reynolds* illustrates the shortcomings of a statistical comparison. In *Reynolds*, the Seventh Circuit reversed approval of a consumer class action settlement when the district court, which had approved the settlement based primarily on the uncertain outcome of litigation through trial, failed to take any steps "to quantify the net expected value of continued litigation to the class. . . . Determining that value would require estimating the range of possible outcomes and ascribing a probability to each point on the range." *Reynolds*, 288 F.3d at 285 (citation omitted). While a "high degree of precision cannot be expected in valuing litigation, especially regarding the estimation of the probability of particular outcomes," the adequacy of settlement most assuredly cannot be based on intuition alone. See *id.* The ranges of potential outcomes after trial should have been considered. *Id.*

For many years, very few major securities fraud class actions concluded in trial.³ Increasingly, however, securities fraud class actions are being taken to trial. In 2005, for example, trials reportedly started in at least six class actions.⁴ Many explanations exist for this trend, including the increased participation of institutional investors serving as the lead plaintiff and the concomitant rise in settlement amounts, both in terms of absolute dollars and as a percentage of estimated damages. A defendant may risk trial and a verdict rather than pay growing settlement demands. Plaintiffs, on the other hand, have reason to believe that they can win their

3. For years, one of the few major securities class actions to be tried was against Apple Computer. See *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989).

4. See Michael Tu, *Trial's Rewards Starting to Outweigh Its Risks*, NAT'L L.J., Oct. 10, 2005. (identifying trials in the following cases: *In re Clarent Corp. Sec. Litig.* No. 01-CV-3361 (N.D. Cal.); *Miller v. Thane Int'l*, No. SACV 03-1031 (C.D. Cal. 2005); *AT&T*, 00-CV-05364-GEB-JJH (D.N.J.); *In re Safety-Kleen Corp. Bondholders' Litig.*, No. 3:00-1145-17 (D.S.C.); *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC) (S.D.N.Y.); *In re Globalstar Sec. Litig.*, No. 01 CIV. 1748 (SHS) (S.D.N.Y.).

cases at trial. To be sure, jurors' attitudes have changed in the wake of highly-publicized frauds, such as WorldCom and Enron:

A study of juror attitudes in the post-Enron era shows that companies across the board will be paying the price in the courtroom for the corporate misdeeds that have dominated this year's headlines.

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"For the first time, jurors feel that they have been touched personally by the actions of the Enrons and WorldComs," Mr. Patterson said. "They have seen their 401[k] plans devastated and they attribute it to bad actions by corporate America."⁵

Against this backdrop, institutional investors serving as the lead plaintiff are quite willing to try a case if the defendant undervalues the matter during settlement negotiations. With this in mind, statistical comparisons drawn from a pool of all securities class actions settled over a given period of time have inherent limitations in serious settlement discussions.

Nonetheless, defendants (and their insurers) typically rely on studies that analyze settlements in all securities class actions during a given period. NERA, for instance, reports that "investor losses" (i.e., market-cap loss) in 2005 were generally the best predictor of settlement values.⁶ "High investor losses in recent years completely explain the high average settlements we have seen. On average, a 1.0% increase in investor losses results in an approximately 0.4% increase in the size of the expected settlement, meaning that as investor losses rise, the ratio of settlement to investor losses falls." *Id.* NERA acknowledges, however, that its measure of "investor losses . . . do[es] not take into account the specific facts of any case apart from the stock price movements. Actual damages claimed by the plaintiffs may be very different . . ." *Id.* at n.4.

NERA's "investor losses" include just losses incurred by purchasers of common stock; according to NERA, "[s]ettlement values increase dramatically in cases in which holders of other classes of securities—bonds, options, preferred stock—share in the settlement." *Id.* at 7. Also, NERA

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5. Tamara Loomis, *Business Scandals Rock Juror Attitudes*, N.Y.L.J., Oct. 16, 2002; see also *Poll Shows Most Americans Have Lost Trust in Leaders over the Last Four Years*, DECISIONQUEST, Sept. 9, 2004, http://www.decisionquest.com/press_center.php?NewsID=97; Gary Young, *Large Punitive Award in '02 May Be the Result of Enron and WorldCom*, 25 NAT'L L.J., Feb. 3, 2003 at C17; David Hechler, *Total Value of 2002's 100 Largest Awards More Than Triples The Previous Year's Value*, 25 NAT'L L.J., Feb. 3, 2003 at C3.
 6. See Dr. Ronald I. Miller, Todd Foster & Dr. Elaine Buckberg, *Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?*, NAT'L ECON. RESEARCH ASSOC., April 20, 2006 at 7.

observes that settlements tend to increase with the defendant company's ability to pay and also in cases with accounting firms as co-defendants. *Id.* at 8. The presence of allegations of accounting fraud also increases settlement values, as does the existence of a separate suit or investigation by regulatory agencies. *Id.* Moreover, "cases with an institutional investor lead plaintiff settle for a statistically significant one-third more." *Id.*

Cornerstone reports that settlement amounts in 2005 were approximately 3% of Cornerstone's "estimated damages."⁷ Cornerstone also states the median settlements were 1.2% of "maximum dollar loss" in 2005, which Cornerstone calculates as the dollar value decline in market capitalization from the trading day on which the trading price peaked during the class period to the trading day immediately following the end of the class period. *Id.* at 6.

It is a mistake, however, to compare market-cap losses that are unrelated to the fraud with legally-recoverable damages proximately caused by defendants' misstatements. In § 10(b) cases, damages are substantially lower than the market loss to account for loss causation. Measuring the loss from the highest stock price during the class period, in particular, exaggerates even the market losses accompanying disclosures.

Also, defendants may exacerbate the inherent limitations in statistical analyses by torturing the data in various ways to suit their needs for negotiations in a particular case. To create a pool of "comparable cases," defendants select certain filters to eliminate disfavored cases from the results. They may also remove "outliers" because they dislike the outcome of the larger settlements, like *Enron* (\$7.2 billion), *WorldCom* (\$6.2 billion), *Cendant* (\$3.2 billion), *AOL Time Warner* (\$2.6 billion), or *McKesson* (\$960 million). Defendants also may attempt to include in their pool only cases against companies with large losses of market capitalization, thus inflating the denominator and reducing the percent recovery in the sample.

7. See Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act Securities Settlements: 2005 Review and Analysis*, CORNERSTONE RESEARCH at 5. Cornerstone's measure of "estimated damages" is unclear. The report says the following: "For all cases involving Rule 10b-5 claims, damages are determined from a market-adjusted backward value line. For cases involving only Section 11 and/or 12(a)(2) claims, damages are determined from a model that caps per-share damages at the offering price. A volume reduction of 50% for shares traded on NASDAQ and 20% for shares listed on NYSE or AMEX is used. Finally, no adjustments for institutions, insiders, or short sellers are made to the float." *Id.* at 20 n.6.

Whether the pool contains just settlements selected by defendants or all settlements during a given period, the mix of “comparable cases” invariably includes settlements where bankruptcy or a limited ability to pay severely constrained the recoveries. Cases against near-insolvent defendants have reduced settlement value, despite strong evidence of liability and substantial damages, because the plaintiff will be unable to collect the full judgment even after prevailing at trial. In negotiations where the defendant claims a limited ability to pay, plaintiff’s counsel are well-advised to retain the services of a consultant, such as an investment banker, to assist in assessing the defendant’s actual ability to pay. Notably, while the inability to pay ordinarily reduces settlement amounts, it also creates a host of obstacles to settlement because of statutory provisions governing partial settlements. Under the Securities Exchange Act of 1934, the verdict against non-settling defendants will be reduced by *at least* the amount that corresponds to the settling defendant’s percentage of responsibility. 15 U.S.C. § 78u-4(f)(7)(B). Thus, the plaintiff may have no incentive to enter into a partial settlement *if* the settling defendant’s ability to pay is less than that defendant’s anticipated percentage of responsibility.⁸

Likewise, pools of supposedly “comparable cases” necessarily contain cases in different procedural stages, each with unique claims and litigation risks. By themselves, settlement statistics do not reveal the presence or combination of claims and facts that influence both sides’ assessment of settlement value in particular cases. The presence of § 11 claims, for example, tends to be an upwards driver because the statute imposes strict liability (with defendants having, as an affirmative defense, the burden to demonstrate the absence of negligence).⁹ Additional examples of factors that are absent from settlement statistics include: restated financial results; suspicious insider trading; spoliation or other attempts to cover up

8. See Alan Schulman, David Stickney and Timothy Delange, *Threading the Needle: Obstacles to Partial Settlements in Securities Class Actions*, 1505 PLI/Corp. 423 (Sep. 2005). In *WorldCom*, the partial settlement with WorldCom’s directors was contingent upon entry of an order which would have capped the judgment credit based on the net worth of the settling director defendants. See *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288, 2005 U.S. Dist. LEXIS 1805 (S.D.N.Y. Feb. 10, 2005). Denying preliminary approval of the settlement, Judge Cote recognized the dilemma facing plaintiffs in attempting partial settlements of securities class actions: “the difference between the percentage of damages for which the [settling defendants] are deemed responsible and the amount they could actually pay could be immense.” *Id.* at *31. The court further noted the inequities to the defendants who want to settle: “As a result, if the ‘deep pockets’ refuse to settle, it is likely that the plaintiff will refuse to settle with outside directors on terms they are able to meet.” *Id.* at *50.

wrongdoing; insiders' admissions of wrongdoing; unexplained termination or departure of management; and criminal indictments or regulatory enforcement actions. While these factors are relevant to the parties' assessment of a particular case, substantial settlements occur without them, including for example, *Raytheon* (\$460 million settlement without a restatement or a § 11 claim), *Waste Management* (\$457 million settlement without a restatement or a § 11 claim), *Oxford Health Plans*, (\$300 million settlement without restatement or § 11 claim), and *Electronic Data Sys. Corp.* (\$137.5 million settlement without restatement or § 11 claim).

During the course of the litigation, the parties continually evaluate and re-evaluate the strengths of their case as the court issues rulings and as the record is created through discovery. Incendiary documents uncovered during discovery are vastly more relevant than any statistical analysis. Likewise, inculpatory testimony from a single compelling witness, who can explain to the jury how the defendant defrauded investors, carries infinitely more weight than the median settlement amount of settlements in other cases. Drawing comparisons to the statistical median of other settlements says nothing about the strength of the evidence, the particular circumstances in any individual case or whether a given settlement is "fair, reasonable and adequate" in a particular securities class action.

9. See Securities Act of 1933, 15 U.S.C. § 77k (2006). Likewise, claims arising under Section 14 of the Securities Exchange Act of 1934 require proof of negligence, a lower mental state than the scienter requirement of Section 10(b). *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1264 (N.D. Cal. 2000).