Threading the Needle: Obstacles To Partial Settlements In Securities Class Actions

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Settling defendants, who are paying to obtain peace, logically insist that any settlement of a securities class action finally resolve the settling defendant's liability arising from the litigation. Just as defendants want peace, plaintiffs require a settlement that the district court will approve and that presents a low risk of reversal on appeal so that the recovery can be promptly distributed to the class. Partial settlements present unique challenges to the settling parties in achieving these objectives. Prior to the passage of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), a body of caselaw had developed to guide settling parties when faced with the complications of partial settlements.

When enacting the PSLRA, Congress codified certain aspects of the partial settlement caselaw. To protect a settling defendant from potential claims for contribution by

non-settling defendants, the PSLRA requires, upon entry of the judgment, the entry of a mutual bar order discharging the settling defendant from all claims for contribution brought by or against any other person. 15 U.S.C. § 78u-4(f)(7)(A). To compensate non-settling defendants for the loss of such contribution claims, the PSLRA reduces the judgment or verdict against non-settling defendants by the *greater* of (1) the percentage of responsibility of the settling defendant; or (2) the amount paid to the plaintiff by that settling defendant. 15 U.S.C. § 78u-4(f)(7)(B).

In practice, uncertainty over application of these provisions has greatly complicated negotiations for partial settlements. Prior to passage of the PSLRA, settling parties would ask courts to enter orders barring future claims against the settling defendants for contribution *and indemnity.* Because the PSLRA's mandatory bar order discharges contribution claims, but not indemnity claims, non-settling defendants routinely object to any settlement that also bars indemnity claims on the grounds that Congress, by its

silence, intended to prohibit bar orders broader than that expressly mandated by the PSLRA. While most district courts hold that the PSLRA did not limit the scope of permissible bar orders, such objections inject uncertainty and may cause delay.

The PSLRA's judgment credit provision further complicates negotiations. Not only does it increase plaintiffs' settlement risks by giving non-settling defendants a judgment reduction credit that is the "greater of" two alternate methodologies, but the "proportionate fault" method alone discourages settlement. By way of example, assume a securities class action against the chief executive officer of a bankrupt company and the solvent investment banks who advised the company. Damages are $1 billion, and the CEO is willing to pay $20 million – virtually his entire net worth – to get out of the case. While settlement would benefit both sides because the CEO wants out of the case and $20 million is the most plaintiffs would expect to recover from the CEO if plaintiffs prevailed at trial, settling with the CEO

profoundly reduces the value of the case against the non-settling investment banks. If the jury assigns 50% fault to the settling CEO, a $1 billion verdict against the investment banks would be reduced to $500 million.

In this manner, the PSLRA erects obstacles to partial settlements.

I. Bar Orders Under the PSLRA

While the scope of the bar order is important for a settling defendant, the bar order only concerns plaintiffs insofar as plaintiffs require a valid settlement agreement that the court will approve without undue delay. Prior to the passage of the PSLRA, courts uniformly approved orders barring claims for contribution *and indemnity* against settling defendants.[2] Barring indemnity claims is justified by the policy against indemnification for violations of the federal securities laws:

> The underlying goal of securities legislation is encouraging diligence and discouraging negligence in securities transactions . . . These goals are accomplished by 'exposing issuers and underwriters to the substantial

> hazard of liability for compensatory damages.'"

Eichenholtz, 52 F.3d at 483-84 (quoting *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1289 (2d Cir. 1969)). *See also Franklin*, 884 F.2d at 1232 (invalidating indemnification provision in underwriting agreement); *Stewart*, 845 F.2d at 200; *Laventhol*, 637 F.2d at 676; *In re Wilshire Tech. Sec. Litig.*, 887 F. Supp. at 239 (indemnification claim by an underwriter previously dismissed from the action barred; indemnification provision of underwriting agreement held to be void as against public policy); *Globus*, 418 F.2d at 1288 (affirming district court's order setting aside verdict on cross claims for indemnification of Securities Act violation because "to tolerate indemnity under these circumstances would encourage flouting the policy of the common law and the Securities Act").

The PSLRA incorporates aspects of the existing caselaw. The statute expressly protects settling defendants from future contribution claims by mandating that a

defendant "who settles any private action at any time before final verdict or judgment shall be discharged from all claims for contribution brought by other persons." 15 U.S.C. § 78u-4(f)(7)(A). The PSLRA also mandates mutuality, requiring the bar order to bar "all future claims for contribution arising out of the action – by the settling covered person against any person." 15 U.S.C. § 78u-4(f)(7)(A)(ii); *see In re MTC Elec. Tech. S'holder Litig.*, No. MDL 1059, 2005 U.S. Dist. LEXIS 10312, at *16 (E.D.N.Y. May 31, 2005) (concluding that a mutual bar order is appropriate); *In re Rite Aid Corp. Sec. Litig.*, 146 F. Supp. 2d 706, 726 (E.D. Pa. 2001) (the PSLRA "supports, and indeed *requires*, our entry of an order barring contribution claims both by and against 'settling covered persons'"); *Gerber*, 329 F.3d at 309 ("the PSLRA has resolved this dilemma in favor of mutual bar orders").

The PSLRA, however, makes no mention of indemnity, and the legislative history provides little guidance on what Congress had in mind.[3] Arguably, however, it was unnecessary for Congress to include indemnification claims

in the PSLRA's bar order provision because, unlike the right to contribution, there is no right to indemnification under the federal securities laws. *See Lucas v. Hackett Assocs., Inc.*, 18 F. Supp. 2d 531, 535 (E.D. Pa. 1998) ("there is a logical explanation for Congress' omission. '[T]here is no express right to indemnification under the 1933 or 1934 [Securities] Acts.'") (*citing Eichenholtz*, 52 F.3d at 483).

Companies entering into partial settlements continue to insist upon bar orders broader than the contribution bar mandated by the PSLRA. Now, as before the PSLRA, barring contribution claims alone will not eliminate the threat to settling defendants of continued litigation arising from the underlying action.

Non-settling defendants predictably object to entry of such bar orders. With one exception, however, district courts overwhelmingly find the authority to enter bar orders that exceed the mandatory bar of the PSLRA. *See In re MTC Elec. Tech. S'holder Litig.*, 2005 U.S. Dist. LEXIS 10312, at *16 (approving order barring claims for contribution and

indemnity); *In re Worldcom, Inc. Sec. Litig.*, No. 02 Civ. 3288, 2005 U.S. Dist. LEXIS 3791, at *37-*40 (S.D.N.Y. Mar. 15, 2005) (approving order barring claims for contribution, indemnity and contractual contribution); *Wisconsin Inv. Bd.*, 300 F. Supp. 2d at 1216-1217 (noting that prior to the enactment of the PSLRA courts routinely approved broad bar orders, and concluding that nothing in the statute or its legislative history indicated that Congress intended to divest courts of their power to impose bar orders extinguishing claims other than those for contribution); *In re Rite Aid*, 146 F. Supp. 2d at 726 (approving a bar order broader than the language of the PSLRA and holding that the statute does not limit the scope of a bar order); *Neuberger v. Shapiro*, 110 F. Supp. 2d 373, 381 (E.D. Pa. 2000) (approving settlement that proposed an order barring claims for indemnification among other claims); *Lucas*, 18 F. Supp. 2d at 535 (same).

In *Rite Aid*, the court explained that the PSLRA "does not include any explicit language stating that the order

therein described is the *only* bar order that [courts] may entertain." 146 F. Supp. 2d at 726. Indeed, the PSLRA "was enacted against a background of prior decisional law under which orders barring indemnification claims had been entered" and neither the statute nor its legislative history addressed these cases. *Id.* at 726-27 (*citing Eichenholtz*, 52 F.3d at 487). The PSLRA left these pre-PSLRA cases barring indemnification claims untouched and did not negate the use of indemnification bar orders in federal securities cases. *Id.* at 727 n.32 (extending *Eichenholtz*, 52 F.3d at 483, to post-PSLRA cases).

In *Rite Aid*, the non-settling defendants argued that the original proposed language of Section 21D(f)(7)(A) included both a bar for contribution claims and a bar for indemnification claims. *Id.* at 726. The non-settling defendants contended that because the final text of the PSLRA mandated only a bar on contribution claims, Congress must have intended to prohibit orders barring claims other than contribution. *Id.* The court rejected this

interpretation of the PSLRA and its legislative history, noting a proposed amendment adopted by the House, but which was not included in the final statute, which would have expressly *prohibited* courts from barring indemnification claims. *Id.* Although the court denied the bar order in question, it rejected the argument that "the text of the PSLRA prevents the entry of a bar order that precludes indemnification claims." *Id.* According to the *Rite Aid* court, since the PSLRA "contains no provision that explicitly limits [a court's] ability to enter a bar order that precludes indemnification claims," courts are free to consider the reasonableness of bar orders that deal with indemnification and other claims. *Id.* This approach is consistent with pre-PSLRA law and the federal policy of encouraging settlement.

One court, however, rejected a proposed bar order that was broader than that expressly mandated in the PSLRA. In *In re Initial Pub. Offering Sec. Litig.*, 226 F.R.D. 186 (S.D.N.Y. 2005), the court concluded that it had "no authority" to deviate from the express wording of the PSLRA

in approving a bar order. *Id.* at 201. The settling parties submitted a proposed bar order seeking to allow the Lead Plaintiff to pursue the claims assigned by the settling defendant against the Underwriter, but barred any claim raised by the Underwriter. *Id*. The court granted preliminary approval of the proposed settlement, but ordered the settling parties to modify the proposed bar order to enjoin only claims for contribution. *Id*. Notably, the court did not cite any other decisions supporting its conclusion, nor did the court address any of the published decisions that had previously held that the PSLRA does *not* limit the scope of bar orders that may be approved by the court.

The decision in *IPO*, albeit in the distinct minority, shows the uncertainty of entering into a settlement that is contingent upon entry of a bar order that exceeds the PSLRA. At the very least, the non-settling defendants' objections can delay the approval of the settlement, especially given the possibility of appeal. Such uncertainty and delay are factors when negotiating partial settlements.

The non-settling defendants may be objecting solely in an attempt to improve their own bargaining position. To undercut such an attempt, plaintiffs can either refuse to agree upon a bar order that exceeds the PSLRA, or the settling parties can carve-out any appeals that are based solely on the scope of the bar order from the conditions to finality of the settlement.

II. The PSLRA's Judgment Reduction Credit

When a settlement extinguishes the contribution rights of non-settling defendants, such non-settling defendants are entitled to a set-off against the judgment. *Franklin*, 884 F.2d at 1231; *In re Masters Mates & Pilots Pension Plan*, 957 F.2d 1020, 1031 (2d Cir. 1992). Put differently, the non-settling defendants must receive a judgment credit that "adequately compensates the non-settling defendants for their" lost claims. *Gerber*, 329 F.3d at 306; *Eichenholz*, 52 F.3d at 486 (non-settling defendants entitled to judgment set-off to "harmonize the equitable

objectives of contribution with the encouragement of settlement").

Before passage of the PSLRA, courts employed various methods for reducing a judgment against a non-settling defendant. Courts were divided among three methods: the *pro rata* method; the *pro tanto* method; and the proportionate fault method.[4]

When enacting the PSLRA, Congress incorporated aspects of the two leading methods for providing judgment credit to non-settling defendants: the "proportionate share" approach employed by the Ninth Circuit in *Franklin v. Kaypro* prior to passage of the PSLRA, and the *pro tanto* approach favored by other circuits, such as the Second Circuit. *See, e.g., Singer*, 878 F.2d at 600. According to the PSLRA, "[i]f a covered person enters into a settlement with the plaintiff prior to final verdict or judgment, the verdict or judgment shall be reduced by the greater of –

(i) an amount that corresponds to the percentage of responsibility of that covered person; or

(ii) the amount paid to the plaintiff by that covered person."

15 U.S.C. § 78u-4(f)(7)(B).

This rule was designed to be pro-defendant by maximizing the amount of the judgment credit. One consequence of the rule, however, is its tendency to discourage settlements.

A. The Proportionate Fault Credit

The first of the PSLRA's alternative methods for calculating the size of the judgment credit, the "proportionate fault" method, is a significant factor when negotiating a partial settlement with a defendant facing potential liability for all or most of the damages. The claims against non-settling defendants will be discounted by the amount that corresponds to that settling defendant's percentage of responsibility.

The difficulty is illustrated by *In re Worldcom, Inc. Sec. Litig.*, No. 02 Civ. 3288, 2005 U.S. Dist. LEXIS 1805 (S.D.N.Y. Feb. 10, 2005). In *Worldcom*, the settlement with Worldcom's directors was contingent upon the entry of an order which would have altered the express language of the judgment credit of the PSLRA "to reflect any limitation on the financial capability of the [settling defendants] to pay their proportionate shares of liability" had a non-settling defendant obtained a contribution or equitable indemnification judgment against them. *Id.* at *29. Capping the reduction based on the net worth of the settling director defendants was clearly within the best interests of the plaintiffs, who had fought for the largest possible payment from the directors' own pockets, and the directors who faced ruinous liability.

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.

The reasoning in the *Worldcom* decision shows how the PSLRA can discourage settlements. The PSLRA creates "a destructive set of incentives [that] may deserve to be remedied, but because the statutory language is clear, the remedy must be legislative." *Id.* at *50-51.

B. The *Pro Tanto* Credit

The alternative to the PSLRA's proportionate fault credit – known as the *pro tanto* credit – can also complicate negotiations in certain partial settlements by inviting objections and exacerbating the plaintiffs' settlement risk. Under the PSLRA's *pro tanto* credit, non-settling defendants receive credit for "the amount paid to the plaintiff by [the settling defendant]." 15 U.S.C. § 78u-4(f)(7)(B)(ii). This

alternative applies when the amount corresponding to the settling defendant's proportionate fault is less than the amount paid to the plaintiff in settlement.

In certain partial settlements, the exact monetary amount to be paid in the settlement is not fixed at the time the settling parties seek court approval of the settlement. This opens the door to objections by non-settling defendants who, relying on the PSLRA, will insist on knowing the size of the *pro tanto* credit. In *In re IPO*, for example, the exact amount that the settling defendants would pay in a partial settlement depended on the plaintiffs' total recovery from the non-settling defendants. 226 F.R.D. at 192. Objecting, the non-settling defendants contended that the PSLRA precluded such settlements and required certainty. *Id.* at 203. The court disagreed: "the [non-settling defendants'] argument is predicated on the baseless notion that, under the PSLRA, a partial settlement must predict the future – *i.e.*, it must tell any non-settling defendants precisely the value of a credit against their future liability, well before anybody knows the

extent of that liability. Such a position makes little sense." *Id.; see also Gerber*, 329 F.3d at 304-305 ("We find no error in the district court's decision to leave the determination of the actual amount of the judgment credit for calculation at trial because the non-settling defendants will get at least the full settlement amount as a credit, unless the settlement damages are not common, an issue which is obviously contingent on the outcome of the trial.").

Even for partial settlements in which the amount being paid is certain, unresolved questions about how to apply the PSLRA's *pro tanto* credit can complicate partial settlements. The PSLRA is silent on how to apply the credit when "the amount paid to the plaintiff by [the settling defendant]" and the amount of the judgment against the non-settling defendant do not represent common damages. This may arise, for example, when investors in the class have different types of claims, and the non-settling defendant is liable for only one such claim. If, for instance, the class includes investors with § 10(b) claims and investors with

§ 14(a) claims, *and if* the settling defendant pays the class $1 billion to settle all claims, it would be absurd to give the non-settling defendant a credit for the full $1 billion if the judgment against the non-settling defendant is for only § 14(a) liability.

Such absurd results would discourage settlements. Given the PSLRA's silence on this situation, courts considering the amount of the credit following a partial settlement should look to guidance from analogous pre-PSLRA precedent.[5] Before passage of the PSLRA, courts employing the *pro tanto* method uniformly gave non-settling defendants a credit against the judgment for the amount paid in settlement that was *common* to damages in the judgment.[6] Accordingly, while there is no published decision on this point, non-settling defendants should still receive a credit *only* for the amount of the settlement that represents common damages. Nevertheless, uncertainty over application of the PSLRA's *pro tanto* credit provision can complicate negotiations and delay approval of the partial settlement.

III. Conclusion

Increasingly, Courts are sustaining securities complaints against issuers and additional participants in the fraud – such as auditors, financial advisors, underwriters and others. In the course of litigation, some of these defendants may seek to enter into partial settlements with plaintiffs, and such settlements may be advantageous for both sides. The PSLRA, however, complicates negotiations and can make it difficult for both sides to achieve their settlement goals.

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[2] *See, e.g., Gerber v. MTC Elec. Tech. Co.*, 329 F.3d 297, 306 (2d Cir. 2003) (bar order may be issued in a partial settlement to preclude non-settling defendants from asserting contribution and indemnity claims); *Eichenholtz v. Brennan*, 52 F.3d 478, 487 (3d Cir. 1995); *Franklin v. Kaypro Corp.*, 884 F.2d 1222, 1232 (9th Cir. 1989); *Stewart v. American Int'l Oil & Gas Co.*, 845 F.2d 196, 200 (9th Cir. 1988); *Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F.2d 672, 676 (9th Cir. 1980); *In re Wilshire Tech. Sec. Litig.*, 887 F. Supp. 236, 239 (S.D. Cal. 1995).

[3] *See Wisconsin Inv. Bd. v. Ruttenberg*, 300 F. Supp. 2d 1210, 1217 (N.D. Ala. 2004) (rejecting the non-settling defendants' "argument that the PSLRA's legislative history 'makes it evident that Congress consciously decided not to expand the scope of the bar order beyond contribution claims arising out of the action'"); *In re Cendant Corp. Sec. Litig.*, 166 F. Supp. 2d 1, 6 n.1 (D.N.J. 2001) (the "court's own review of testimony at various congressional hearings fails to uncover any

discussion which would shed light on the specific purposes behind the contribution bar").

[4] Under the *pro rata* method, a plaintiff's damages would be allocated equally among all settling and non-settling defendants and any judgment against a non-settling defendant would be reduced by the settling defendant's *pro rata* share of the damages. *See, e.g., In re Masters Mates*, 957 F.2d at 1028. Under the *pro tanto* method, a judgment against a non-settling defendant is reduced by the amount paid in settlement by the settling defendant. *See, e.g., Singer v. Olympia Brewing Co*., 878 F.2d 596, 600 (2d Cir. 1989). Under the proportionate fault method, a judgment against a non-settling defendant is reduced by the proportionate liability of the settling defendant. *See, e.g., Franklin*, 884 F.2d at 1231-1232.

[5] "[C]ourts are inclined to interpret a statute in conformity to common-law concepts where the letter of the statute is silent in regard to certain consequences which are analogous to situations governed by common-law principles." 2B Singer, Sutherland Statutes and Statutory Construction § 56:3 (6th ed.) (citations omitted); *see also Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 562 (1991) ("Because these decisions were part of the 'contemporary legal context' in which Congress enacted [the statute] . . . we may presume that Congress intended to codify these principles"); *Lorillard v. Pons*, 434 U.S. 575, 581 (1978) ("[W]here, as here, Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute.").

[6] *See, e.g., Gerber*, 329 F.3d at 304 (affirming the district court's holding that the judgment reduction shall not necessarily be calculated by using the full amounts of the settlements, "as only the portion of the settlement attributable to common damages will be credited"); *U.S. Indus., Inc. v. Touche Ross & Co*., 854 F.2d 1223, 1236 (10th Cir. 1988) ("where two or more defendants are responsible for separate injuries, an amount received in settlement from one defendant for one of the injuries may not be used to reduce the liability of the other defendant for the other injury"); *FDIC v. Geldermann, Inc*., 763 F. Supp. 524, 530 (W.D. Okla. 1990) ("'[w]hen a plaintiff receives an amount from a settling defendant…it is normally applied as a credit against the amount recovered by the plaintiff from a non-settling defendant, provided both the settlement and the judgment represent common damages.'" (quoting *U.S. Indus., Inc.*, 854 F.2d at 1236)).