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MEDIATING SECURITIES CLASS ACTIONS: A VIEW FROM THE CAPTAIN'S QUARTERS

By The Honorable Nicholas Politan,
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In this issue of the Advocate, *we are pleased to publish an excerpt Judge Politan's speech at the October 20, 2005 Institutional Investor Forum in New York City.*

The Honorable Nicholas Politan is a retired Judge of the United States District Court for the District of New Jersey (1987 to 2002). Prior to his service as a federal judge, he was a lawyer in private practice, and also an owner and chairman of a banking institution. During his time on the bench and since retiring, he has overseen the successful settlement, mediation and arbitration of hundreds of securities class actions. In addition, he has been appointed Special Master by various Federal Courts in complex litigation. Judge Politan is the recipient of numerous awards for his service on the bench.

Today, the majority of, if not all, securities class actions wind up in mediation. Indeed, when the plaintiff and defendant analyze the risks of continuing litigation, there is a logic that forms which brings the parties' respective positions to certain points. The parties then come to mediation and the question arises, "how do we settle this case?" This is a big gray area, and that's where the mediator works. The mediator attempts to captain both parties to what the mediator thinks is their logical, reasonable position, and then works within that framework to develop a mutually agreeable compromise. This article provides insight into the process from the mediator's perspective — or from the "captain's quarters" — because in the end, it is the mediator's responsibility to navigate the parties towards settlement.

The Impact of the PSLRA and the Institutional Investor

The Private Securities Litigation Reform Act (the "PSLRA") has dramatically altered the landscape of securities mediation. Prior to the PSLRA, securities class actions were started by lawyers who represented a single individual or a small group of individuals. Plaintiff's lawyers raced to the courthouse, filed their actions and the litigation proceeded. Institutional investors were rarely, if ever, involved. This led to an interesting dynamic in the settlement process — an entirely different dynamic than the one that exists today. Prior to the PSLRA, the plaintiff's lawyer would prepare for and attend the mediation alone, without input from the client. In a typical pre-PSLRA mediation, the mediator would ask the plaintiff's lawyer to go out in the hall and speak to the client about a proposed offer. Perplexed, the plaintiff's lawyer would respond, "I don't have a client here." "Well then," the mediator would respond, "why don't you go to the restroom, look in a mirror, talk to yourself, and come back here and tell me whether you want to accept the settlement or not." Those are the days of old, the days of the "Wild West," and they are gone.

Now, thanks in part to the PSLRA, institutional investors are actively involved in the litigation and the settlement process. Two positive developments have come about as a result of the PSLRA, and as a result of the institutional investors serving as lead plaintiffs. First, as the statistics demonstrate, settlement values have risen. Second, the degree of involvement by the institutional plaintiff assists in the settlement process. When the defendants attend the mediation and see the actual lead plaintiff also in attendance, with its counsel or a couple of trustees, it helps a great deal. It provides the mediator a tool to use against the defendants to boost the settlement value. The institutional investor's substantial investment in the stock, and the presence of its representatives at the mediation, tend to resonate with the defendants.

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Insurance

Today, mediations are tri-partite and involve a whole cast of characters. Among those involved are: the plaintiff's lawyer; the institutional plaintiff, often represented by the fund's counsel and/or one or more trustees; defense counsel; a representative of the defendant; and the insurance companies – each of whom is present with their own lawyer for each layer of insurance.

This is one of the major problems facing the plaintiff: the layers of insurance and the mosaic rules of insurance. By way of example, assume there are five layers of insurance, $20 million each. The rule of exhaustion holds that level 2 is not required to pay until level 1 is exhausted; level 3 is not required to pay until level 2 is exhausted, and so on. In addition, if there is a "break" in coverage, meaning that one layer of insurance is insolvent or bankrupt, then the remaining layers are not required to pay unless the "break" is covered, usually by the defendant company. Now, assuming the case involves damages in excess of $1 billion, which in essence brings all the layers into play, one of the most difficult jobs facing the mediator is convincing each layer of insurance that they are involved and will have to fund their portion of the settlement. The level five insurer often says, "No way, we don't get touched until $80 million has been spent." The mediator must convince each level of insurance that the damages are such that its level is involved.

Damages

Once all parties and insurance carriers have agreed to mediate, the focus turns to damages. Each side engages experienced, highly qualified experts to make detailed projections as to damages. Plaintiffs should not, however, assume that the damage calculation represents the expected settlement value. In other words, don't assume that an expert comes in and says, "This is how much money was lost as a result of the actions of the defendant," and that is the amount of the settlement. Damages in securities class actions are complicated. Damage calculations are projections based upon statistical analysis and myriad other factors. The case will never settle for the amount of plaintiff's damage calculation.

Mediation of a securities class action is much more complicated than taking plaintiff's and defendant's respective damage numbers and splitting the difference.

Conversely, defendants' expert will value the case at zero, or next to zero. Of course, the case will never settle for that amount either. Today, defendants typically show up armed with Cornerstone or NERA damage studies or reports, indicating that most cases settle for roughly 2 percent of the plaintiff's damage model. In addition, the Cornerstone or NERA reports often dedicate four or five pages to settlement value and provide a recommendation of the proper settlement amount. However, providing a NERA study to the plaintiff will not get them to agree to the settlement recommendation. This is what mediation is all about — bridging that gap between what the defendant thinks the settlement value is and what the plaintiff thinks the settlement value is. Is there a magic formula? No. Each mediation is different, depending upon the personalities of the people involved, the viability of the company, what the insurance company is willing to pay, and various other case-specific factors.

Indeed, mediation of a securities class action is much more complicated than taking plaintiff's and defendant's respective damage numbers and splitting the difference. All parties, including the mediator, must analyze all of the factors which go into a settlement. The defendants' ability to pay is a primary focus. The ability to pay comes in the first instance from the insurance company. If the defendant is bankrupt, then the insurance proceeds are likely the only source of money available to fund a settlement. If the officers and directors are defendants, generally speaking, they will not have the resources to make anything other than a token payment.

To illustrate, assume plaintiff's case of securities fraud is well developed, but the defendant is in bankruptcy with $50 million in insurance. Regardless of the total damages, whether it is a billion or ten billion dollars, the plaintiff will never get that much because it simply is not there for the asking. Under these circumstances, the plaintiff wants to get whatever insurance proceeds are available. But, these insurance policies are "wasting" policies. The costs of defense counsel's fees and expenses are taken off the top and "waste" away at the policy. Therefore, as the litigation progresses, the defense lawyers are going through the $50 million, submitting their bills, and reducing the overall available money for settlement. Under these circumstances, it is important to keep in mind that the further the litigation progresses, the less and less money is available for settlement.

Well, this sounds easy. If the facts are excellent and there is $45 million left in insurance, one would expect the insurance companies to agree to settle. It is not that easy, however. The insurance companies have their own issues to dispute and are not eager to pay the policy limits. If the company is bankrupt, the insurance company is now in a situation where theirs is the only available money to fund a settlement. They will usually demand some consideration, putting the plaintiffs in a quandary of either agreeing to give some consideration — i.e., a lesser settlement amount — or continuing to litigate and allowing the policy to burn down by itself.

The Securities Lawyers

This is where practicality and experienced securities class action lawyers become so important. And while the plaintiff may feel that its case is strong and wants to litigate to the end, doing so would not be advantageous for the lead plaintiff or the class it represents. Determining the amount of consideration to be given to the carrier, if any, is far from an exact science. Securities class actions require expertise and individuals who truly understand what is happening — who feel the pulse of it, who are able to react to it, and who are able to deal with it in a settlement context.

Not every case, however, is a *WorldCom* or an *Enron*, where billions of dollars will be recovered for investors. If there is a viable company, there is a much higher probability of a larger settlement, but the majority of cases have much lower damage figures and a much lower ability to pay. The plaintiff, along with its lawyer, must work within the constraints of the facts of the particular case. Additionally, the uncertainty and unpredictability of trial is always a key factor. Trials are not simple matters of presenting one's case and assuring victory. Both sides must understand that, as good as their case may be, they can lose. Nothing is a "slam dunk." The plaintiff must counsel with its experienced lawyers — that is what they are there for.

The Mediator

It is important to remember that every mediator comes to mediation with his or her own style. Some like to sit around and exchange thoughts, have one side make a presentation, then the other. Then, after the parties have gotten mad at each other, the mediator splits them up into two separate rooms. Other mediators prefer to break the parties up into separate rooms at the outset, allowing each side to speak freely and openly with the mediator, but not with the other side. Regardless of style, the mediator has read the pre-mediation briefs and has a good sense of the facts and issues at hand. Based upon experience, and the information provided in advance by the parties, the mediator can usually sense where the case is going before the mediation begins. The mediator looks at the insurance proceeds, the viability of the company, the plaintiff's damages and demands, the defendant's reports, and the judicial decisions in the case. The mediator is not, however, prepared to try the case. Rather, the mediator views the case through a peephole, seeing only the parts the parties have revealed. It is from behind this "peephole" that the "captain" attempts to navigate the parties towards a mutually agreeable and beneficial resolution.

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There is one thing to always keep in mind in settling cases: it is not a victory. It is something which makes one side reasonably unhappy and makes the other reasonably happy. Or vice versa. The settlement is usually somewhere in the middle. Not necessarily right in the middle, but somewhere between what the parties and their attorneys believe the case is worth.

Mediating securities class actions is really quite unique. It is not regular law, it is not like regular settlements, it is not merely claims adjudication. It has evolved a great deal since the passage of the PSLRA and, to be effectively administered, requires experience and expertise — from the mediator, the parties and their counsel.

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