Settling Securities Class Actions

Despite a rise in securities class action filings in recent years, most of these lawsuits have settled before reaching trial. While settlement may allow parties to avoid the burdens associated with protracted litigation, the unique attributes of securities class actions raise various procedural and strategic concerns that can affect the settlement process. It is critical for companies and their counsel to understand these issues and continuously evaluate their settlement options from the outset of a case through the final approval of the settlement.

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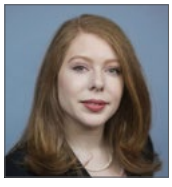

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Courts and parties have long recognized the complexity and uncertainty inherent in securities class actions and the typically large amount of potential damages at stake. As a result, they generally favor settlement for most cases that survive dismissal, with around one percent of such cases or less going to trial (see, for example, *Guevoura Fund Ltd. v. Sillerman*, 2019 WL 6889901, at *19 (S.D.N.Y. Dec. 18, 2019) (quoting *In re Michael Milken & Assoc. Sec. Litig.*, 150 F.R.D. 46, 53 (S.D.N.Y. 1993) (stating that securities class actions are "notably difficult and notoriously uncertain," making compromise particularly appropriate)); Cornerstone Research, Securities Class Action Filings: 2019 Year in Review (Cornerstone 2019 Review), at 16, available at *cornerstone.com*).

Given the predominance of settlements, securities litigators must understand the intricacies and unique features of the securities class action settlement process. This article provides guidance for litigators on the process, procedure, and strategic considerations involved in settling securities class actions, including:

- The legal framework for securities class action settlements.
- The importance of early case assessment.
- The optimal timing to begin settlement discussions with the opposing party.
- The key settlement terms to negotiate.
- The settlement approval process.
- The confidentiality concerns raised when filing a proposed settlement agreement.
- The grounds for objecting to a settlement.
- The prevalence of opt-outs in securities class actions.
- The use of *cy pres* distributions.

Search Settling Class Actions: Process and Procedure for more on class action settlements generally.

LEGAL FRAMEWORK FOR SECURITIES CLASS ACTION SETTLEMENTS

The Securities Act of 1933 (Securities Act) (15 U.S.C. § 77z-1) and the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. § 78u-4) govern most of the federal securities litigation in the US. The Securities Act protects investors by requiring full and fair disclosure in connection with the public offerings of securities, including primarily for initial public offerings. The Exchange Act regulates the securities marketplace by identifying and penalizing improper conduct in subsequent securities transactions, including sales on the open market, proxy solicitations, and tender offers. The Securities Act and the Exchange Act contain liability provisions allowing private plaintiffs to seek relief for injuries based on a range of violations.

Search Securities Act and Securities Exchange Act Liability Provisions: Overview and Private Actions Under US Securities Laws Chart for a comparison of the main civil liability provisions for suits brought by private plaintiffs under the Securities Act and the Exchange Act.

Along with the Securities Act and the Exchange Act, key rules and requirements that apply to securities class actions include:

- **Federal Rule of Civil Procedure (FRCP) 23.** FRCP 23 governs class actions generally and subsection (e) governs class action settlements. Unlike in an individual action, in which the parties may settle on their own terms without the court's approval, under FRCP 23(e), the court must approve a proposed class action settlement as fair, reasonable, and adequate. If the parties reach a settlement before class certification, the court must determine whether to approve any settlement class that the parties propose as party to the settlement. (See below *Settlement Approval Process*.)
- **The Class Action Fairness Act of 2005 (CAFA).** CAFA is a federal statute that significantly expanded federal diversity jurisdiction over most class actions and mass actions (28 U.S.C. § 1332(d)). CAFA contains provisions related to class action settlements, including notice requirements (for example, CAFA requires notice to certain government officials) and rules concerning attorneys' fees in connection with coupon settlements (that is, settlements in which class plaintiffs receive coupons or other promises for services instead of cash) (28 U.S.C. §§ 1712-1715). (For more information, search Class Action Fairness Act of 2005: Overview on Practical Law.)
- **The Private Securities Litigation Reform Act of 1995 (PSLRA).** The PSLRA is a federal statute enacted in response to the perceived profusion of frivolous class actions alleging securities fraud. Among other key provisions, the PSLRA includes rules governing notice (15 U.S.C. § 78u-4(a)(3), (a)(7)) and requiring parties that want to file the terms and provisions of a settlement agreement under seal to bring a motion showing that publication of the term or provision would cause direct and substantial harm to a party (15 U.S.C. § 78u-4(a)(5)). Additionally, the PSLRA contains heightened pleading standards requiring plaintiffs asserting securities fraud claims to:
  - identify each specific statement or omission alleged to be false or misleading and explain why it is misleading (15 U.S.C. § 78u-4(b)(1));
  - state particularized facts giving rise to a strong inference that each defendant made the allegedly misleading statement knowing that it was false at the time it was made (15 U.S.C. § 78u-4(b)(2)); and
  - allege that the information in the false or misleading statement, or omission of information, was the cause

Counsel should lay the groundwork for settlement discussions as part of their early case assessment, especially because securities class actions are often more complicated and involve higher stakes than many other types of cases.

of the actual loss the plaintiff suffered (15 U.S.C. § 78u-4(b)(4)).

(For more information, search Securities Litigation Involving the Private Securities Litigation Reform Act on Practical Law.)

EARLY CASE ASSESSMENT

Settlement discussions may occur at any time during the course of a securities class action proceeding. Therefore, counsel should lay the groundwork for settlement discussions as part of their early case assessment, especially because securities class actions are often more complicated and involve higher stakes than many other types of cases.

When conducting an early case assessment, counsel should ensure that they understand the important facts of the case and the applicable law to determine the potential merits of the case. Whether representing a defendant or plaintiff, counsel should, among other things:

- Conduct interviews of available individuals necessary to understanding the facts of the case.
- Gather necessary documents from clients.
- Engage an expert early on to conduct at least a preliminary damages analysis and assist in understanding potential liability in the case (see below *Damages Models*).

Early case assessment has many advantages. In addition to helping counsel set realistic expectations for clients and prepare for later stages of the case, it allows counsel to evaluate whether to try to settle a case or continue to litigate, including:

- Whether and when to engage in mediation.
- The role of directors and officers (D&O) liability insurers.
- The potential impact of parallel proceedings.

MEDIATION

Securities class actions are often difficult to settle due to the substantial amounts at stake and the multiple parties involved in the settlement process. In addition to plaintiffs and defendant issuers of securities, others involved in securities class actions, and therefore often part of settlement discussions, may include:

- Individual defendants.
- Securities underwriters.
- D&O insurers (usually several of them).
- Accounting firms.

Counsel to any one party may find it difficult to manage the multi-party negotiations necessary to settle most securities class actions. Therefore, counsel may want to engage an independent mediator familiar with class actions to help resolve the dispute. An experienced mediator can:

- Provide expertise, impartiality, and credibility in dealing with all parties.
- Help foster constructive consideration by all parties of the issues at the heart of a negotiation and support the parties in achieving a favorable outcome.

Search Mediation Toolkit for a collection of resources on the use of mediation to help parties work toward a negotiated settlement of their dispute.

ROLE OF D&O INSURERS

Insurance carriers in a securities class action play a critical role in achieving a settlement. Frequently, multiple insurers have potential liability for claims and, as a result, are key participants in settlement discussions, including at mediation.

A company's relevant coverage usually consists primarily of D&O insurance provided by multiple insurers in several separate layers of coverage. These layers, often referred to as towers of insurance, consist of:

- A primary insurer that covers the first layer of liability, for example, the first $3 million.
- A first excess layer covering the next $3 million.
- Successive layers of $3 million up to the total amount purchased.

Depending on their place in the tower, different insurers may have differing interests with respect to various settlement amounts and structures. Therefore, it is not uncommon for several insurers to have interests that cause them to participate in settlement discussions.

Common types of D&O insurance coverage include:

- **Side A coverage.** This indemnifies individual directors and officers against losses, typically for claims made against them for wrongful acts. Side A coverage also protects directors and officers in the event the company becomes insolvent.

- **Side B coverage.** This may provide reimbursement to the company when it indemnifies its officers and directors.
- **Side C coverage.** This insures the company for its own liabilities. Some policies limit coverage to securities claims, which can be defined in a variety of ways.

Search Directors and Officers Liability Insurance Policies for more on D&O insurance.

Although the interests of insurers and those of the parties sometimes diverge, defendants and insurers share a common goal of minimizing the cost of settlement to the extent possible. Moreover, insurers often supply all or a substantial amount of settlement funds. Therefore, defense counsel should cultivate a good working relationship with insurers to help achieve a favorable resolution whenever possible. While actual disputes between defendants and insurers are sometimes impossible to avoid, they are at other times an unnecessary distraction and expense. Where a constructive partnership exists, defense counsel, their clients, and the insurers can rationally discuss the issues, problems, and decisions that may arise during the lawsuit and more effectively achieve a reasonable outcome.

PARALLEL PROCEEDINGS

Counsel should consider the impact that a settlement may have on other litigations or investigations when their client is involved in:

- Parallel regulatory and civil proceedings.
- Parallel federal and state litigation.

Parallel Regulatory and Civil Proceedings

Public disclosure of investigations by the Securities and Exchange Commission or the Department of Justice, or entry into a deferred prosecution agreement with the government, often generates parallel civil class action proceedings. Conversely, private securities litigation can help trigger regulatory investigations and enforcement actions when a civil lawsuit reveals allegations previously unknown to regulators. In some situations, different types of civil litigation may be based on the same fact pattern.

When deciding whether to settle one or more of multiple proceedings, defense counsel must consider:

- **The strength of the claims.** If a party is defending against weak claims that are likely to fail, it may decide to continue litigating both the criminal and civil actions.
- **The cost of settlement.** Similarly, an excessively costly settlement demand may cause a party to continue litigating both the criminal and civil actions.
- **How settlement will impact any related proceedings.** Depending on the specific facts and procedural posture of the proceedings, and the terms of the resolution, resolving a criminal matter first may hamper a defendant's ability to defend itself in related civil proceedings. For example, if a company settles with the government, any admissions connected to that settlement may impact civil litigation. Even if the company enters into the settlement on a "neither admit nor deny" basis, it risks that a court will admit the settlement agreement for purposes other than to prove liability or damages. On the other hand, resolving a civil case first may provide criminal prosecutors access to discovery they might not have asked for. Nevertheless, a defendant may find it advantageous to put the civil case behind it before dealing with a related regulatory matter.

There are often no textbook right answers on the best approach in parallel proceedings. Counsel should give careful thought to the possible outcomes, make reasonable strategic choices, and be flexible enough to deal with unexpected issues.

Search Settling Securities Cases with Regulators for more on the issues counsel should consider before reaching a settlement with a regulator.

Search Defending Parallel Proceedings: Key Considerations and Best Practices for more on how companies can prepare for and navigate parallel proceedings.

Parallel Federal and State Suits

In *Cyan, Inc. v. Beaver County Employees Retirement Fund*, the US Supreme Court held that:

- State courts have concurrent jurisdiction over cases arising exclusively under the Securities Act and that plaintiffs can continue to bring class actions asserting only Securities Act claims in state court.
- Defendants cannot remove class actions asserting only Securities Act claims to federal court.

(138 S. Ct. 1061, 1075-78 (2018).)

Since the *Cyan* ruling, the number of state court actions asserting solely Securities Act claims has increased, in part because state courts do not always apply the PSLRA's stringent requirements to those claims, which leads plaintiffs to expect more favorable outcomes in state courts (see above *Legal Framework for Securities Class Action Settlements*). Plaintiffs filed 13 Securities Act class actions in state courts in 2017, 35 in 2018, and 49 in 2019 (Cornerstone 2019 Review, at 19).

Additionally, after *Cyan*, defendants in Securities Act class actions face an increased risk of having to manage parallel state and federal litigation or litigation in multiple states. The ruling poses the potential for unique complexities in ongoing duplicative litigation of Securities Act cases, which may result in more difficulty in reaching settlements of individual cases.

Notably, in *Salzberg v. Sciabacucchi*, the Delaware Supreme Court recently upheld a provision in the certificates of incorporation of several Delaware

corporations calling for claims under the Securities Act to be brought in federal court (227 A.3d 102, 120 (Del. 2020)). Other state courts may follow (see, for example, *Wong v. Restoration Robotics*, 2020 WL 6050540 (Cal. Super. Ct. Sept. 20, 2020) (holding that a federal forum provision contained in the defendant Delaware company's charter was enforceable and, pursuant to that forum provision, granting the defendant company's motion to dismiss Securities Act claims)). Ultimately, congressional reform is needed to uniformly remedy the issue of parallel state and federal proceedings for claims brought under the Securities Act.

Search Expert Q&A: Securities Act Claims and SLUSA After Cyan for more on *Cyan* and its impact on securities litigation.

DETERMINING WHEN TO BEGIN SETTLEMENT DISCUSSIONS

Defense counsel often prefer to bring a motion to dismiss and await a decision on it before commencing settlement discussions due to:

- **The high dismissal rate for securities class actions.** The PSLRA's stringent pleading standard for securities cases has resulted in an increase in successful motions to dismiss and higher dismissal rates for securities class actions than for most other types of cases. Indeed, most securities class actions are dismissed or settled, and only rarely do the cases go to trial. A recent study found that, from 1997 to 2018, 49 percent of core federal filings (that is, securities class actions excluding M&A cases) were settled, 43 percent were dismissed, and overall, less than one percent reached a trial verdict (Cornerstone 2019 Review, at 16).
- **The PSLRA's discovery stay.** Except in unusual circumstances, the PSLRA stays all discovery until the resolution of the motion to dismiss (15 U.S.C. §§ 77z-1(b), 78u-4(b)(3)(B)), requiring plaintiffs to show a sufficient factual basis for asserting their claims before defendants incur the burden of costly discovery (for more information, search Securities Litigation Involving the Private Securities Litigation Reform Act on Practical Law).

If a motion to dismiss is denied in whole or in part, then counsel can explore various junctures for trying to settle, including:

- After the court decides the motion to dismiss.
- After unexpected developments in discovery.
- Before the court decides a motion for class certification.
- After the court decides a motion for class certification.
- Before the court decides a motion for summary judgment.

Additionally, in some cases, the parties may consider a very early settlement before a motion to dismiss is decided. Those cases tend to involve:

- Unusual sets of facts (especially where the facts are not public at that point in the proceeding) suggesting to the defendants that the plaintiffs' case may get stronger over time.
- Defendants that need to resolve the litigation because of external business or financial factors.

By conducting a thorough early case assessment, and updating it on a regular basis, counsel will be better able to include that information in what should be an ongoing process of analysis of when is the best point to engage in settlement talks. Counsel should make sure to involve insurers in the development of the settlement strategy, both because of the standard policy provision requiring cooperation of the insured with the insurer for settlement and the increased likelihood that an insurer that is included in this process will contribute to a settlement (see above *Role of D&O Insurers*).

NEGOTIATING SETTLEMENT TERMS

Counsel negotiating a securities class action settlement must carefully consider the proposed settlement amount they have been offered or intend to offer and other key provisions of the agreement.

SETTLEMENT AMOUNT

Parties should generally retain a damages expert to assist with determining the settlement amount. Factors that affect the settlement amount analysis include:

Counsel should make sure to involve insurers in the development of the settlement strategy, both because of the standard policy provision requiring cooperation of the insured with the insurer for settlement and the increased likelihood that an insurer that is included in this process will contribute to a settlement.

- The amount of damages claimed by the plaintiffs (which a damages expert can estimate).
- The damages cap under the PSLRA.
- The PSLRA provisions limiting the defendant's liability for damages.

The amount which would likely settle the case is some percentage of the total amount of damages claimed by the plaintiffs with adjustments based on the damages cap and the defendant's proportionate liability. Parties should also adjust the settlement amount based on the strength of the plaintiffs' case. If two cases have the same drop in market capitalization, the stronger case on the merits would be expected to settle for a higher amount than the weaker case. This rather obvious conclusion reflects the risk the various parties assess, as they weigh the possibility of an adverse verdict against the cost of getting to verdict, which includes attorneys' fees. Defendants and insurers will generally differ in their cost assessment due to varying facts causing their potential liability exposure to vary. Extraneous factors, such as avoidance of reputational harm that might come from discovery, can also affect the settlement amount.

Notably, despite these limitations, large market capitalization losses may result in settlements of hundreds of millions or even billions of dollars. In 2019, 74 securities class action settlements were approved, totaling over $2 billion, including four mega settlements (that is, settlements equal to or greater than $100 million). These mega settlements ranged from $110 million to $389.6 million, and two are among the 100 costliest class action settlements of all time. (See Cornerstone Research, Securities Class Action Settlements: 2019 Review and Analysis, at 1, 4, available at *cornerstone.com*; Institutional Shareholder Services Inc. (ISS) Securities Class Action Services (SCAS), The Top 100 U.S. Class Action Settlements of All Time, at 2 (Dec. 31, 2019), available at *issgovernance.com*.) Four mega settlements in 2018 also joined the list of the largest class action settlements (see ISS SCAS, The Top 100 U.S. Class Action Settlements of All Time, at 2 (Dec. 31, 2018), available at *issgovernance.com*).

Damages Models

Securities class action settlement negotiations generally require an estimation of the damages claimed by the plaintiffs. The parties typically begin by retaining an expert to estimate the reduction in market capitalization that an alleged misrepresentation or omission may have caused, usually through a form of statistical analysis known as an event study. An event study is a regression analysis which attempts to identify whether and how much of a stock price movement (or, in some cases, a lack of movement) is caused by the alleged false or omitted material information.

Financial economists often supplement their event studies with opinions based on other economic tools, which may include an analysis of:

- Public news reports, to isolate new information disclosed on a particular date (because only new information affects stock price in an efficient market).
- Investment analyst reports, to gain insight into what importance, if any, financial professionals assigned to the relevant misrepresentation or correction when it was made.
- Intraday stock price movement, to disaggregate the effect of multiple but not simultaneous disclosures.
- Trading models, to identify the number of shares affected by the misrepresentation.
- Valuation models, to inform the court's assessment of stock price inflation and damages.

Consulting firms such as Cornerstone Research and NERA Economic Consulting publish annual reports that can help counsel identify correlational trends in percentages of market capitalization and settlement amounts. These statistics may inform the decision about how much to ask for or offer in settlement negotiations. For example, Cornerstone Research relies on a simplified tiered damages analysis, which uses simplifying assumptions to estimate per share damages and trading behavior, to compare shareholder losses across many cases with the goal of identifying and analyzing potential trends. Tiered damages measure potential shareholder losses based on the dollar value of a defendant's stock price movements on specific dates and an estimate of the number of shares traded during the class period. Cornerstone Research recently found that this measure is the most important factor in predicting settlement amounts.

Specifically, as measured by simplified tiered damages:

- In cases asserting claims under Section 10(b) of the Exchange Act:
  - larger cases typically settle for a smaller percentage of the tiered damages; and
  - smaller cases (those with less than $25 million in simplified tiered damages), on average, settle within two years and are less likely to include factors such as institutional lead plaintiffs or related regulatory actions or criminal charges.
- Cases asserting only Securities Act claims tend to settle for smaller median amounts and involve smaller issuer defendants (measured by the total assets or market capitalization of the issuer) than cases that include Rule 10b-5 claims.

(Cornerstone Research, Securities Class Action Settlements: 2019 Review and Analysis, at 5-8, available at *cornerstone.com*.)

However, determining actual economic losses in a given case always requires in-depth economic analysis.

Search Exchange Act: Section 10(b) Litigation Experts for more on event studies and the role of experts in securities actions.

Search Exchange Act: Section 10(b) Defense Toolkit for a collection of resources to help counsel defend lawsuits brought by private plaintiffs asserting claims of material misstatements or omissions in violation of Section 10(b) of the Exchange Act and its implementing regulation, Rule 10b-5.

Damages Cap

The PSLRA caps damages to prevent recovery for only nominal losses. The cap limits damages to the difference between the purchase price paid by the plaintiff and the stock's average trading price during the 90-day period after the last corrective disclosure (15 U.S.C. § 78u-4(e)(1)). This 90-day period, typically referred to as the "bounce-back" provision, aims to limit a plaintiff's damages to losses actually caused by the fraud or violation, as opposed to other unrelated market conditions, by allowing the market to incorporate all of the relevant information and the stock price to adjust accordingly (H.R. Conf. Rep. No. 104-369, at 42; S. Rep. No. 104-98, at 20). This cap can limit damages substantially, if not entirely, where the stock rallies following a stock price drop purportedly caused by a fraud or violation.

Proportionate Liability

Before the PSLRA was enacted, a defendant found to have violated the federal securities laws was jointly and severally liable for the entire damages award, regardless of the defendant's knowledge of, or level of participation in, the violation. Recognizing that this approach incentivized fringe participants to settle for amounts disproportionate to their level of fault, Congress included a proportionate liability provision in the PSLRA that limits damages to the proportion of the judgment that corresponds to the percentage of responsibility of each defendant. However, proportionate liability applies only on a finding that the defendant did not knowingly commit the violation. (15 U.S.C. § 78u-4(f)(2).)

The proportionate liability provision applies to:

- Defendants in private actions under the Exchange Act, when a plaintiff does not demonstrate as required that the defendant acted with intent (for more information, search Exchange Act: Section 10(b) Elements and Defenses on Practical Law).
- Outside directors in private actions under Section 11 of the Securities Act, which imposes strict liability for misstatements absent a successful affirmative defense (for more information, search Securities Act: Section 11 Elements and Defenses on Practical Law).

(15 U.S.C. § 78u-4(f)(10)(C).)

If a court finds that the defendant knowingly violated the securities laws, the defendant remains subject to joint and several liability for the entire damages award, less the proportional amounts paid by other defendants, including those that have settled before the final verdict (15 U.S.C. § 78u-4(f)(2)).

Additionally, the PSLRA contains provisions addressing the effect of a settlement on a defendant's liability for damages. In particular, the PSLRA provides:

- A "bar order" that protects a settling defendant from future claims for contribution, indemnification, and other similar claims by non-settling defendants (15 U.S.C. § 78u-4(f)(7)(A)).
- A damages offset for non-settling defendants, which ensures that they pay no more than their proportionate share of liability (15 U.S.C. § 78u-4(f)(7)(B)).

OTHER KEY TERMS

In addition to the settlement amount, securities class action settlement agreements usually include terms governing:

- The scope of releases. A typical class or settlement class releases the defendants from future class and other actions on the same claims being brought by those who are included in the definition of the class in a case which is settled and where the settlement is approved by the court.
- The form and means of notice and who pays for it.
- Any compensation the class representative is to receive beyond what she would receive as a member of the class.

In 2019, 74 securities class action settlements were approved, totaling over $2 billion, including four mega settlements (that is, settlements equal to or greater than $100 million).

- Who will pay for other settlement expenses.
- *Cy pres* plans, if agreed to (see below *Cy Pres Distributions*).
- The procedures for objecting to the settlement or opting out of the class, including deadlines for doing so (see below *Objections to Settlement* and *Opt-Outs*).
- Settlement termination. Settlement agreements commonly include a provision that the settlement may be terminated if opt-outs exceed a certain percentage of the class. This is often referred to as a "blow provision," and the parties usually choose to include it in a side agreement.

Counsel considering settlement negotiations should prepare to discuss these issues.

Search Securities Class Settlement Negotiation Checklist for more on settlement negotiations in securities class actions.

SETTLEMENT APPROVAL PROCESS

The settlement approval process is typically made up of:

- The motion and hearing for preliminary approval of a proposed settlement.
- The notice period.
- The final approval hearing.

PRELIMINARY APPROVAL MOTION AND HEARING

FRCP 23(e) requires the parties to seek from the court preliminary approval of a proposed settlement before notifying the class about the proposed settlement. In considering whether to grant preliminary approval, a judge must make a preliminary finding that the proposed settlement appears fair and reasonable on its terms. The court may evaluate various factors when making this determination, including whether the proposed settlement:

- Appears to be the product of serious, informed, and non-collusive negotiations.
- Has no obvious deficiencies or signs of collusion.
- Does not improperly grant preferential treatment to class representatives or segments of the class.
- Falls within the range of settlement compensation that is reasonable given the facts of the matter.

(FRCP 23(e); see *Noye v. Yale Assocs., Inc.*, 2019 WL 3837507, at *3 (M.D. Pa. Aug. 15, 2019); *In re NASDAQ Mkt.-Makers Antitrust Litig.*, 176 F.R.D. 99, 102 (S.D.N.Y. 1997).)

The motion for preliminary approval attempts to outline for the court how the settlement terms fulfill the FRCP 23(e) factors, as well as any other factors normally considered by the court in question. The court should also make findings of fact and conclusions of law if a dispute exists about the propriety of the settlement (*In re Initial Pub. Offering Sec. Litig.*, 226 F.R.D. 186, 189-90 (S.D.N.Y. 2005)).

The parties typically attach as exhibits to the preliminary approval motion all documents the court needs to approve the settlement on a preliminary basis. Depending on the rules of the court, the parties may attach the exhibits to the motion, the memorandum of law, or an attorney declaration. Exhibits generally include the draft proposed:

- Settlement agreement.
- Notice to the class.
- Preliminary order approving the settlement.
- Final order approving the settlement.
- Judgment.

At the preliminary approval stage, the court's inquiry is typically much less detailed than in the final approval process (see below *Final Approval Hearing*).

In many cases, the court will combine the preliminary approval hearing with the hearing to certify a settlement class. In these cases, counsel must file a preliminary approval motion that demonstrates that the class should be provisionally certified for purposes of settlement.

NOTICE TO THE CLASS

Class actions require the provision of notice to class members at certain stages. Unlike traditional lawsuits where the parties generally are aware of and understand the case, class actions involve absent members that may not learn of the action without the class notice mechanism.

Class notice is particularly important in the settlement context because it provides absent class members with knowledge of a proposed settlement and their right to object (FRCP 23(e)(5)). Under FRCP 23(e)(1), the court must "direct notice in a reasonable manner to all class members who would be bound" by a proposed settlement (FRCP 23(e)(1)(B)). In addition to FRCP 23(e), the PSLRA and CAFA contain provisions addressing class notice (see above *Legal Framework for Securities Class Action Settlements*).

To comply with the notice requirement, counsel generally must:

- Seek court authorization to give notice.
- Seek a finding that the proposed method of notifying class members is reasonable.
- Include certain details in the notice to allow class members to make informed decisions.
- Determine how to allocate the costs of providing notice.

Search Class Actions: Notice Requirements for more on class notice requirements in the context of a proposed settlement.

Court Authorization to Give Notice

Plaintiffs typically file a motion to request permission to give notice to the class and usually request the court to hear the motion at the time for preliminary approval, although this is not required. The court will direct notice to class members only if it determines that the time and expense of giving notice is justified by the parties' showing that the court will likely be able to:

- Approve the proposed settlement under FRCP 23(e)(2).
- Certify the class for purposes of judgment on the proposed settlement.

(FRCP 23(e)(1)(B).)

The specific information the parties provide to the court to help it determine whether to direct notice may vary based on the specific class action and proposed settlement (FRCP 23(e)(1)(A)). However, the motion should generally address:

- Whether a class has been certified.
- The extent and type of benefits that the settlement will confer on the class members, such as information regarding:
  - the claims process;
  - the anticipated rate of claims by class members; and
  - the distribution of unclaimed funds.

- The likely range of litigation outcomes and risks, including the existence of any pending or anticipated litigation on behalf of class members involving the same claims.
- The proposed handling of an attorneys' fee award.
- The proposed settlement agreement (FRCP 23(e)(3)).
- Any other information pertinent to determining whether the proposal is fair, reasonable, and adequate.

(2018 Advisory Committee's Note to FRCP 23(e)(1).)

Additionally, as discussed below, the court may consider the proposed method of notifying class members, contents of the notice, and allocation of costs.

Reasonableness Standard for the Notice

The court must direct notice in a reasonable manner (FRCP 23(e)(1)(B)). Generally, reasonable notice must:

- Be calculated to reach all class members.
- Convey all required information.
- Permit a reasonable amount of time to respond.

(See *In re Ikon Office Sols., Inc., Sec. Litig.*, 194 F.R.D. 166, 174-75 (citing *Mullane v. Cent. Hanover Bank & Tr. Co.*, 339 U.S. 306, 314 (1950)).)

Courts usually require individualized, direct notice to class members where practicable. If this is not feasible, acceptable substitutes may include posting notices on the internet or publishing attention-grabbing notices in newspapers and other media.

In securities lawsuits, most plaintiffs argue that the case qualifies for class treatment based on predominance under FRCP 23(b)(3). Counsel proposing a settlement of an FRCP 23(b)(3) class may use US mail, electronic means, or other appropriate means to provide the best notice that is practicable to class members, including combining the means of notice (FRCP 23(c)(2)(B)).

If the court deems notice insufficient, it can order the appointment of a class action notification expert to advise the court on the sufficiency of the proposed method of notice and recommend improvements (see, for example, *Kaufman v. Am. Express Travel Related Servs., Inc.*, 283 F.R.D. 404, 408 (N.D. Ill. 2012)).

Search Class Actions: Certification for more on predominance and the required notice for FRCP 23(b)(3) class actions.

Contents of the Notice

The notice to the class should aid class members in making informed decisions on whether to object to or opt out of the settlement. If the court simultaneously certifies a settlement class and grants preliminary approval of a settlement agreement, parties can provide a single meaningful notice that informs absent class members of:

- The existence of the class action.
- The definition of the class.
- The settlement agreement.
- The opportunity to opt out.

(See 2003 Advisory Committee's Note to FRCP 23(e)(3).)

The notice to the class must include the following:

- The amount of the proposed settlement.
- A statement:
  - of the average amount of recoverable damages per share if the plaintiff prevailed, where the settling parties agree on the amount; or
  - from each settling party concerning the issues on which the parties disagree, where the parties disagree on the average amount of recoverable damages per share.
- A statement of the attorneys' fees and costs sought.
- The name and contact information of the plaintiffs' counsel that will be available to answer questions from class members.
- A statement explaining the reasons the settlement is fair and reasonable.
- Any other information required by the court. Relevant information may include:
  - a statement that the proposed settlement will bind all class members if approved;
  - the definition of the class;
  - a reasonable estimate of the number of class members in each state and an estimate of the proportionate share of the claims;
  - a disclosure stating if the class is to be certified for settlement purposes only;
  - the proposed or final notification to class members of their rights to opt out of the class action or, if opt-out rights are not available, a statement to that effect; and
  - an outline of the original claims, relief sought, and defenses, or a copy of the complaint and materials filed with the complaint.

(15 U.S.C. § 78u-4(a)(7); see Manual for Complex Litig. (Fourth) § 21.313 (2004).)

Costs of Providing Notice

Depending on the size of the class and the information available about potential class members, providing notice can be quite complex and expensive. The parties usually specify in the settlement agreement how they will allocate the costs of providing notice of settlement. These costs are typically paid either:

- From the common settlement fund.
- Separately by the defendant or from a fund the defendant created.

The parties may also negotiate to share costs. The court usually directs class counsel or their agents (claims administrators, notice agents, or both) to oversee distribution of the notice to the class members and to help ensure informed election of, or exclusion from, class membership.

Search Settling Class Actions: Process and Procedure and Class Actions: Notice Requirements for information on reach calculations to determine the number of non-identical class members who would be reached by a class action settlement notice.

FINAL APPROVAL HEARING

As discussed above, a court may approve a class action settlement only after a hearing and on finding that the settlement is fair, reasonable, and adequate (FRCP 23(e)(2)). The December 1, 2018 amendments to FRCP 23(e)(2) add factors that the court must consider in reviewing a proposed settlement, specifically, whether:

- The class representatives and class counsel have adequately represented the class.
- The proposal was negotiated at arm's length.
- The relief to the class is adequate, considering:
  - the costs, risks, and delay of trial and appeal;
  - the effectiveness of the proposed method to distribute relief to the class and process class member claims;
  - the terms, including the timing and payment of the proposed attorneys' fee award; and
  - any agreement identified under FRCP 23(e)(3) in connection with the proposed settlement.

(FRCP 23(e)(2).)

Some courts have developed their own similar factors. In some circuits, however, the factors have remained the same for decades. The factors set out in FRCP 23(e)(2) do not necessarily eliminate the factors that the circuits have developed. Instead, they focus the court and counsel on the core procedural and substantive requirements that are minimum requirements for settlement approval by all federal courts. (2018 Advisory Committee's Note to FRCP 23(e)(2).)

FILING THE PROPOSED SETTLEMENT AGREEMENT

Any class action settlement agreement that is reached between the parties must be filed with the court, and any related side agreements or undertakings must be identified to the court (FRCP 23(e)(3)). The parties may petition the court to keep certain terms of the settlement agreement confidential. Courts typically balance confidentiality concerns against the rights of, and fairness to, the proposed settlement classes.

A securities class action settlement may involve side agreements related to the settlement that merit protection against general disclosures. The court may direct the parties to provide a copy or summary of any side agreements to resolve any confidentiality concerns. (See, for example, *In re HealthSouth Corp. Sec. Litig.*, 334 F. App'x. 248, 250 & n.4 (11th Cir. 2009) (noting that the number of opt-outs required to trigger a blow provision is typically kept confidential); *In re Initial Pub. Offering Sec. Litig.*, 226 F.R.D. at 204-05 (after conducting an *in camera* review of certain insurance-related side agreements, denying the underwriters' request for discovery concerning those agreements because they did not influence the terms of the settlement); *Columbus Drywall & Insulation, Inc. v. Masco Corp.*, 258 F.R.D. 545, 560 (N.D. Ga. 2007) (after conducting an *in camera* review, preserving the confidentiality of certain side agreements that allowed the defendant to terminate its settlement if opt-outs by class members reached certain levels); see also 2003 Advisory Committee's Note to FRCP 23(e)(2).)

OBJECTIONS TO SETTLEMENT

Any class member may object to a proposed settlement if the settlement requires court approval under FRCP 23(e)(5) (see *Eubank v. Pella Corp.*, 753 F.3d 718, 720 (7th Cir. 2014)). An objection to a proposed settlement must state:

- Whether the objection applies only to the objector, to a specific subset of the class, or to the entire class.
- The grounds for the objection, with specificity.

(FRCP 23(e)(5)(A).)

Grounds for an objection include claims that the proposed settlement contains:

- An unreasonable or unfair plan of allocation (see, for example, *In re Cendant Corp. Litig.*, 264 F.3d 201, 219 (3d Cir. 2001)).
- Defective notice (see, for example, *In re AOL Time Warner, Inc.*, 2006 WL 903236, at *14-15 (S.D.N.Y. Apr. 6, 2006)).
- An unreasonable *cy pres* provision (see, for example, *In re MetLife Demutualization Litig.*, 689 F. Supp. 2d 297, 351-52 (E.D.N.Y. 2010); see below *Cy Pres Distributions*).
- Unreasonable or excessive counsel fees and expenses (see, for example, *In re General Elec. Co. Sec. Litig.*, 998 F. Supp. 2d 145, 153-54 (S.D.N.Y. 2014); *In re Thornburg Morg., Inc. Sec. Litig.*, 912 F. Supp. 2d 1178, 1211-12 (D.N.M. 2012)).
- Conflicts of interest (see, for example, *In re Initial Pub. Offering Sec. Litig.*, 671 F. Supp. 2d 467, 490-91 (S.D.N.Y. 2009); *In re WorldCom, Inc. Sec. Litig.*, 2004 WL 2591402, at *16 & n.41 (S.D.N.Y. Nov. 12, 2004)).
- Unreasonable service awards to class representatives (see, for example, *In re Am. Bus. Fin. Servs. Inc. Noteholders Litig.*, 2008 WL 4974782, at *18-19 (E.D. Pa. Nov. 21, 2008)).
- Unreasonable requirements for the claims process (see, for example, *Lee v. Ocwen Loan Servicing, LLC*, 2015 WL 5449813, at *12 (S.D. Fla. Sept. 14, 2015)).
- An inadequate benefit to the class (see, for example, *Farber v. Crestwood Midstream Partners L.P.*, 863 F.3d 410, 416 (5th Cir. 2017)).

Search Class Actions: Appeals for information on appealing a court's ruling on objections to a settlement agreement.

OPT-OUTS

In a class action settlement, class members have the opportunity to either accept the settlement or opt out and pursue individual claims on their own behalf. Courts must strictly enforce the time period set out in the notice for opting out (FRCP 23(b)(3), (c)(2)(B)).

Opt-outs have become increasingly common in securities class actions. A recent study found that the opt-out rate for securities class actions has more than doubled in the most recent four-year period for which data is available. Prior to 2014, the rate of opt-outs in class action settlements was 3.4 percent compared to 8.9 percent between 2014 and 2018. For large cases with a settlement amount of over $20 million, the rate of opt-outs is 28 percent. (Cornerstone Research, Opt-Out Cases in Securities Class Action Settlements: 2014-2018 Update, at 2, 4 (Sept. 2019), available at *cornerstone.com*.) In large settlements, the possibility of a large individual settlement, particularly with large investors including institutional investors, can be an incentive to opt out.

Also among the likely drivers of the recent increase in opt-out rates is a US Supreme Court ruling concerning the statute of repose in the Securities Act. In *California Public Employees' Retirement System v. ANZ Securities, Inc.* (CalPERS), the Supreme Court held that the three-year statute of repose in the Securities Act is not subject to tolling under the Court's ruling in *American Pipe & Construction Co. v. Utah* (*CalPERS*, 137 S. Ct. 2042, 2049-52 (2017)). *American Pipe* held that commencing a putative class action tolls the applicable statutes of limitations for individual class members' claims until class certification is denied (*Crown, Cork & Seal Co. v. Parker*, 462 U.S. 345, 354 (1983); *Am. Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 554 (1974)). In *CalPERS*, the Court concluded that an action brought by an individual investor, who was a member of the putative class but later opted out to proceed in a separate suit, was untimely because it was filed after expiration of the three-year repose period (137 S. Ct. at 2055).

The *CalPERS* decision may cause investors to opt out of a securities class action to maintain their ability to pursue individual claims and recoveries within the statute of repose period. In the year following *CalPERS*, four large investment funds entered into opt-out settlements before the settlement of the main class action (see Alison Frankel, *Securities Fraud Defendant Agrees to Pay $217.5 Million to Opt-Outs. A Portent?* (Oct. 29, 2018), available at *reuters.com*).

Search Expert Q&A on Tolling of Securities Claims After CalPERS for more on *CalPERS* and its impact on securities litigation.

Federal Securities Class Action Settlement Toolkit

The Federal Securities Class Action Settlement Toolkit available on Practical Law offers a collection of resources to assist counsel with settling class actions under the federal securities laws. It features a range of continuously maintained resources, including:

- Class Actions: Overview
- Securities Act and Securities Exchange Act Liability Provisions: Overview
- Securities Litigation Involving the Private Securities Litigation Reform Act
- Class Action Settlement Agreement (Federal)
- Attorneys' Fees in Class Action Settlements
- Calculation Method for Attorneys' Fees in Class Action Settlements by Circuit
- FRCP 68 Offers of Judgment
- Motion for Final Approval of Class Action Settlement: Notice of Motion or Motion (Federal)
- Securities Class Settlement Negotiation Checklist
- US Securities Class Action Flowchart
- What's Market: Objections in Class Action Settlements
- What's Market: Process of Settling Class Actions

CY PRES DISTRIBUTIONS

Securities class action settlements typically involve some level of funds left over after settlement funds are distributed to class members. This is due in part to difficulties in identifying and notifying class members, which involve an investigation into who were the beneficial owners of the stock at the pertinent time. The often lengthy time between the securities violation and the initial and residual settlement distributions further complicates the process. In many cases, the *cy pres* doctrine provides for the distribution of leftover funds to charities.

In deciding whether to approve a *cy pres* distribution pursuant to FRCP 23(e), the court considers whether a settlement is fair, reasonable, and adequate based on many factors, including:

- The adequacy of the nexus between the alleged class injury and the *cy pres* recipient.
- Whether the award to the class is non-distributable.
- The compensation to class members as compared to the *cy pres* award.
- Whether counsel or the court faces criticism or a conflict of interest.

(See, for example, *In re Citigroup Inc. Sec. Litig.*, 199 F. Supp. 3d 845, 851 (S.D.N.Y. 2016); *Better v. YRC Worldwide, Inc.*, 2015 WL 566962, at *2 (D. Kan. Feb. 11, 2015).) PL