Litigation

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International Trends in Securities Litigation: Issues and Recommendation for European Companies

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Two recent developments have heightened the risk of securities litigation against European companies in both U.S. and European courts. First, European institutional investors have increased their involvement in U.S. securities litigation. Many have turned to U.S. courts to sue European companies, and these investors' growing familiarity with U.S. litigation increases the chance that more will do so. This trend also places pressure on lawmakers to ease restrictions on collective litigation in Europe. Several countries have responded by adopting new procedures to facilitate collective litigation, and further change is under discussion. Second, in the years leading up to the current stock market decline, U.S. residents invested trillions of dollars in securities purchased abroad, with the United Kingdom attracting the greatest share. Now that stock prices have plummeted, these investors also may attempt to bring suit against European companies in U.S. courts. Notably, a company need not sell securities in the United States to find itself targeted in such suits.

This article examines the factors fuelling these increased risks and suggests concrete strategies to reduce exposure to them.

Increased Risk of Suit in U.S. Courts by European Institutional Investors

Since 1995, U.S. law has encouraged institutional investors to participate in securities class actions by establishing a presumption that the plaintiff with the largest purported loss should be appointed as "lead plaintiff." No institutional investor from outside the United States sought the lead plaintiff role until 1999, when three European institutions unsuccessfully applied for it in a California case.[1] By March 2007, institutions from 13 separate European countries had sought the lead on 119 occasions.[2] German institutional investors were the most active, seeking the lead 50 times.[3] An upsurge in activity by UK institutions was reported in 2007,[4] possibly prompted by a press release in which the UK's National Association of Pension Funds urged European institutions to increase their involvement in U.S. litigation.[5]

Greater participation in U.S. securities litigation by European institutional investors increases the risk that European companies will be sued in the United States. Already, this trend has resulted in several cases filed in the U.S. by European institutional investors against European companies, including lawsuits against Parmalat, GlaxoSmithKline, and Royal Bank of Scotland.

The participation of European investors in U.S. securities litigation significantly increases the potential damages exposure for European companies. Under U.S. securities law, the number of shares purchased by the plaintiff class during the relevant time period is a key factor in determining the amount of damages. Most European companies that are listed in both Europe and the United States sell the bulk of their shares on European exchanges. Thus, when shareholders who purchased securities in Europe participate in a U.S. securities class action against a European company, the resulting damages exposure will be much larger than if the suit were limited to claims arising from purchases in the United States.

This effect on damages has led to much litigation about whether U.S. courts should exercise jurisdiction over claims by so-called "f-cubed" plaintiffs – foreign residents who purchased shares in a foreign company on a foreign exchange. In general, U.S. courts will not exercise jurisdiction over such claims unless they find that the allegedly wrongful conduct occurred in the United States, an inquiry referred to as the "conduct test."[6] Although most cases have rejected jurisdiction, the results of the conduct test can be difficult to predict. This difficulty arises because the test depends on vague standards, such as whether the defendant's activities in the United States were "merely preparatory" to the purported fraud, and whether acts in the United States "directly" caused the alleged harm.[7]

Litigation over inclusion of claims by f-cubed plaintiffs also continues at a later stage of the case, when the court decides whether it is appropriate for the case to proceed as a class action. In recent cases against Alstom and Vivendi, U.S. courts excluded certain European investors from the plaintiff class at this stage.[8] The aftermath of the Vivendi decision demonstrates the persistence with which some institutions have pursued claims against European companies in U.S. courts. Following the decision, an Italian institutional investor, Capitalia Asset Management, filed a separate suit against Vivendi in the United States. By February 2008, over 70 institutional investors had done the same.[9]

Change within Europe

European investors' growing familiarity with U.S. litigation – and the sizable settlements produced there – has led some of them to call for greater access to collective litigation in Europe. Although recent proposals from the European Commission focus on claims by consumers rather than investors,[10] several European countries have implemented procedural changes that facilitate collective litigation of securities claims. This section examines recent developments in three key jurisdictions: the United Kingdom and Germany, where collective litigation is considered most likely to emerge according to a survey of executives and lawyers,[11] and the Netherlands, which has adopted an innovative procedure for the settlement of collective claims.

The United Kingdom

Since 2000, the Civil Procedure Rules of England and Wales have permitted Group Litigation Orders (GLOs), which allow courts to issue binding rulings on common issues. Despite this change, collective securities litigation has not taken hold in the UK. No GLO has been made in a shareholder action challenging a company's disclosures, for example.[12]

Efforts are underway to change this situation by removing perceived barriers to collective litigation. According to some observers, collective litigation is impeded by requiring individual claimants to "opt in" to lawsuits. In contrast, U.S. courts permit collective litigation on an "opt-out" basis, which means that all claimants are bound by the court's ruling unless they take action to exclude themselves from the case. In late 2008, the Civil Justice Council of England and Wales recommended allowing opt-out cases in the United Kingdom.[13]

In addition, the availability of private third-party funding for litigation has increased, another development that facilitates collective litigation. According to Lloyd's of London, greater availability of third-party funding "may encourage claims that would have otherwise been considered too expensive, or too risky, to pursue."[14] At least some of this financing is targeted for securities litigation, such as a recently announced £160 million fund intended to finance litigation concerning "investor losses."[15]

Germany

In 2005, Germany enacted the Capital Markets Model Case Act, which permits collective litigation by allowing courts to choose a "test case" to try common legal or factual issues once 10 or more cases involving similar issues have been filed. In the interim, all related cases are stayed. Resolution of common issues in the test case binds all other litigants, but individualised issues are decided separately. If the parties to the test case settle, the settlement does not bind other litigants unless they approve it.

In April 2008, a highly publicised trial of a test case against Deutsche Telekom (DT) began. When the litigation is resolved, the result likely will be compared to the outcome of a similar case against DT in the United States, which settled for $120 million. Investors who bought DT securities on the Frankfurt exchange were not eligible for the settlement. Instead, the entire amount was divided among shareholders who bought DT securities in the United States, even though they reportedly accounted for less than 25 percent of DT's equity.[16] If the German litigation results in lesser or no recovery for German shareholders, calls for further legal change in Germany may be heard.

The Netherlands

With the passage of the Act on the Collective Statement of Mass Claims in 2005, the Netherlands became the first European country to permit settlement of collective damages claims on an opt-out basis. Known as the "WCAM," the Act allows non-profit organisations to seek court approval of such settlements on behalf of all claimants. If approved by the court, the settlement binds all claimants unless they opt out within three months.

The WCAM has played a key role in litigation against Royal Dutch Shell and SCOR Holding, two European companies faced with U.S. securities class actions. In the Shell case, U.S. institutional investors sought to represent all shareholders who purchased the company's securities during the relevant time, regardless of where the purchase occurred. While the parties were litigating about the court's jurisdiction over claims by non-U.S. purchasers, Shell agreed to settle those claims in the Netherlands for $352 million. Over protest by the U.S. institutions, the U.S. court then dismissed the claims of non-U.S. purchasers from the U.S. suit. Shell later settled the U.S. suit for approximately $83 million.

Using the WCAM to settle claims by European purchasers provided substantial benefits to Shell. If Shell had tried to settle those claims in the U.S. lawsuit, it would have faced considerable uncertainty about whether European courts would recognise a U.S.-style opt-out settlement. Settling in the Netherlands reduced that uncertainty. Although no court has yet decided whether settlements under the WCAM are binding outside the Netherlands, an argument can be made under EU law that such settlements bind claimants within the European Union.[17]

Similarly, SCOR also settled claims by U.S. purchasers in the U.S. court and claims by non-U.S. purchases in a Dutch proceeding under the WCAM. In contrast to the Shell case, however, the U.S. court already had decided to exclude non-U.S. purchasers from the U.S. case against SCOR before the company announced the settlement. Despite their exclusion from the U.S. case, SCOR may have agreed to settle with them in the Dutch proceeding in an effort to block such purchasers from bringing a spate of individual actions in U.S. courts, as happened to Vivendi.

U.S. Suits by Investors Who Purchase On European Exchanges

The global stock market decline also threatens to expose companies that are not listed on U.S. exchanges to the risk of securities litigation in the United States. That risk arises from potential claims by U.S. residents who purchased securities outside the United States. The value of non-U.S. securities held by U.S. residents increased each year between 2003 and 2007, reaching a high of over $7 trillion.[18] In 2007 alone, U.S. residents purchased an estimated $224 billion in long-term securities issued outside the United States.[19] As stock prices fell across the globe in 2008, U.S. investors undoubtedly lost substantial sums on their holdings of non-U.S. securities. Britain's FTSE 100 fell 31 percent, the largest annual drop since its launch in 1984, while France's CAC-40 fell 43 percent and Germany's DAX declined by over 40 percent. Each of these countries attracted substantial investment by U.S. residents before the decline.[20]

Given such large losses in market capitalisation and the unique combination of factors that make the United States such an attractive forum for plaintiffs in securities class actions, U.S. investors can be expected to turn to U.S. courts to recoup their loss on securities purchased in Europe. Indeed, in June 2008 a prominent U.S. law firm filed suit against European Aeronautic Defence and Space (EADS) on behalf of U.S. investors who bought the company's securities on exchanges in Frankfurt, Madrid, and Paris.[21] In such cases, plaintiffs are likely to invoke the "effects test" for U.S. jurisdiction, as the EADS plaintiffs did, rather than the conduct test. Under the effects test, a plaintiff need not show that the defendants engaged in wrongful conduct in the United States; instead, the plaintiff must show that the allegedly wrongful conduct had a substantial effect on U.S. citizens or in the United States.[22]

Strategies for Reducing and Managing Risk

Although the globalisation of capital markets has not led to the global adoption of the U.S.-style class action, it has resulted in increased participation by European investors in U.S. securities class actions, along with significant legal changes within Europe. These trends have heightened litigation risk for European companies. In the near- to medium-term, the greatest risk for European companies arises from exposure to litigation in U.S. courts. The incidence of such suits has increased over the last few years, and exposure is not limited to companies that sell securities on U.S. exchanges. The massive market capitalisation losses experienced in 2008 may exacerbate this trend. Accordingly, European companies should take steps to reduce their risks now.

While each company's situation is unique, most can reduce their risks by taking some or all of the following measures:

Understand and Monitor Legal Developments in Key Jurisdictions

In-house counsel should assess the jurisdictions in which the company does business to identify those that are high risk. Companies that are listed on a U.S. exchange or attract substantial investment from U.S. residents who purchase shares on European exchanges should consider the United States as a high-risk jurisdiction. Depending on the other locations where the company operates or raises capital, additional jurisdictions may be added. After identifying high-risk jurisdictions, in-house counsel should maintain (or ask the company's outside counsel to provide) an understanding of the rules in those jurisdictions regarding collective litigation in general and collective litigation of securities claims in particular. From time to time, the company should review its risk assessment in light of changes in the company's activities and changes to laws in the relevant jurisdictions.

Obtain Appropriate Insurance for Directors and Officers

The practice of obtaining insurance for securities claims against directors and officers is nearly universal among publicly traded U.S. companies. European companies that operate in the United States face similar risks, yet are much less likely to obtain directors and officers (D&O) insurance. According to one source, only 20-30 percent of European companies had obtained D&O insurance by 2006.[23] Any company that has identified the United States as a high-risk jurisdiction should make certain that its insurance policy provides coverage for securities class actions filed in the United States.

Such companies also should consider obtaining policies that cover the cost of responding to an investigation by U.S. regulators. The legal fees associated with regulatory investigations can be substantial, yet some policies do not provide coverage until the investigation results in the filing of charges, which may not occur until months or years after the investigation begins, if ever. As jurisdictions outside the United States make it easier to bring collective securities claims, European companies also should examine whether they need coverage for collective claims brought outside the United States, as some non-U.S. policies may not provide coverage for collective claims. Moreover, in addition to shaping the type of coverage required, the risk of collective securities claims affects the amount of coverage needed. Collective claims cost more to defend, and expose the company to larger potential damages, increasing the amount of coverage needed. The company should consult an insurance broker experienced in international policies about these and related issues. Litigation counsel with experience in the relevant jurisdictions also can advise regarding these issues.

Implement Compliance and Related Programs Tailored to High-Risk Jurisdictions

Company policies and training programs should reflect the requirements of complying with the laws of high-risk jurisdictions. Companies that have identified the United States as a high-risk jurisdiction should pay particular attention to policies and practices relating to stock sales by officers, directors and employees. Executives of those companies should consider whether to adopt stock-selling plans that provide a defence to insider trading claims under U.S. law. Particular attention also should be paid to policies and practices relating to the reporting of financial results, public statements about projected financial results, and announcements regarding key corporate developments, such as the launch of a new product or the status of applications for regulatory approval of a product.

Know the Factors that Heighten Risk

In deciding whether to bring suit, U.S. plaintiffs' lawyers look to certain factors time after time. By being aware of those factors and consulting with litigation counsel when they occur or are anticipated, a company often can reduce the risk of a lawsuit, or position itself for a stronger defence. Key factors include:

- Restating financial results or discovering accounting improprieties;
- Reporting financial results below the company's previous public forecasts or analysts' expectations;
- Announcing a merger, acquisition, restructuring, or similar event; and
- Disclosing delays or problems with a key product or the loss of a key customer or contract.

A significant drop in the company's stock price over a short time also will draw scrutiny, even if not accompanied by any other news about the company. If large stock sales by executives occur in the months leading up to any of these events, risk is further heightened.

If Litigation Occurs, Take a Global Approach

Even companies that do business globally often approach litigation as a local matter. Increasingly, however, global companies need a global litigation strategy. For example, a European company faced with securities litigation in the United States must consider the composition of the claimant class and evaluate the defence strategy in light of that fact. Outside counsel defending the U.S. litigation must be familiar with these issues and capable of handling cross-border discovery and fact investigation.

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