Legal Backgrounder

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BONDHOLDERS' STATE SECURITIES SUITS POSE NEW THREAT TO WALL STREET

by

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Prior to Congress's enactment of the Securities Litigation Uniform Standards Act of 1998 ["Uniform Standards Act"] it was virtually unheard of for a large institutional *bondholder* to commence an individual securities-based action against a corporation or its underwriters in state court. Recently, however, we have seen a substantial growth of such actions. Over the past two years, bondholders have commenced individual actions against issuers and their underwriters, accountants, lawyers, officers, and directors in state courts around the country alleging violations of the Securities Act of 1933 ["Securities Act"], and asserting additional state law claims for violations of the blue-sky laws, breach of contract, and/or common law fraud. Bondholders have brought lawsuits like these in connection with offerings by Enron,[1] WorldCom,[2] Qwest,[3] Tyco,[4] Global Crossing, and Alliance Capital, to name a few.

This new trend of state bondholder litigation, often seeking damages in tens or hundreds of millions, is especially disturbing when one considers the fact that the Private Securities Litigation Reform Act ["PSLRA"] and the Uniform Standards Act have finally provided issuers and underwriters (through use of the Judicial Panel on Multi-District Litigation) with effective reforms that coordinate shareholder class action in a single forum where these disputes can be resolved in a fair and efficient manner for all parties involved. Now, however, innovative plaintiffs' firms have found a new way to circumvent the foregoing legislative reforms. By enlisting large institutional investors who have purchased corporate bonds, such as state employee pension funds, plaintiffs' lawyers have been able to continue bringing big dollar securities actions in state courts around the country. These actions are unconnected with and intentionally avoid the reach of securities class action litigations in which these bondholders might otherwise be included as class members.

By virtue of the differences between corporate debt and common stock, bondholders have

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distinct rights and remedies that enable an attorney to plead these actions around federal jurisdiction. For example, bondholders are far more often in a position to sue under the Securities Act than are shareholders. The Securities Act provides private rights of action for false statements made in a registration statement or prospectus as part of an issuance of stock or debt. In light of the fact that corporations issue debt securities far more frequently than they issue additional stock, it is more likely that a bondholder will have a recent registration statement upon which to base a Securities Act claim than would a shareholder. The large size of bondholders' investments can also justify plaintiffs' lawyers taking these individual cases from a potential recovery perspective. Moreover, initial purchasers tend to invest in much larger dollar amounts than after-market purchasers. Shareholders, by comparison, must rely more often on the causes of action created by the Exchange Act of 1934 ["Exchange Act"], the primary purpose of which is to regulate trading of securities after the original distribution has been effected.

The distinction between a plaintiff being able to assert claims under the Securities Act, as opposed to the Exchange Act, is crucial. The Securities Act expressly provides for concurrent jurisdiction in state and federal court, and claims asserted thereunder do not provide an independent basis for federal jurisdiction.[5] Exchange Act claims, such as one for making a false or misleading statement under Section 10(b) and Rule 10b-5, on the other hand, are subject to exclusive federal jurisdiction.[6] Consequently, they provide an independent basis for removal under federal question jurisdiction. The end result is that defendants seeking to remove a state Securities Act action to federal court must find some independent basis for the exercise of federal jurisdiction.

The cases that are most problematic for defendants are those that either cannot be removed, or that federal courts have remanded to state court after removal. By bringing a Securities Act claim based upon allegedly false or misleading statements in a debt offering prospectus, or registration statement, bondholders may be able to establish specific personal jurisdiction over the issuers and underwriters in those states in which the issuers or underwriters solicited investors or mailed registration statements or prospectuses. Once a plaintiff-bondholder obtains personal jurisdiction over an issuer or underwriter in a given state court, that plaintiff can then assert a litany of related state claims including: claims under that state's Blue Sky laws, claims for common law fraud, claims for breach of contract and/or fraud in the inducement. Where the bondholder has also purchased stock in the same company, the bondholder could also assert claims under the state's Blue Sky law equivalent of a Section 10 claim under the Exchange Act. The end result would be a broad sweeping state court proceeding that encompasses most, if not all, of the same claims previously asserted in a federal shareholder class action.

Moreover, these state bondholder actions, unlike federal shareholder class actions, are not subject to the various procedural safeguards imposed by the PSLRA. Most notably, the PSLRA imposes: (1) heightened pleading standards on plaintiffs requiring them to plead with specificity each allegedly false statement as well as facts sufficient to give rise to a strong inference of scienter (for claims that require fraudulent intent); (2) procedures for selecting lead plaintiff to represent the shareholder class; (3) procedures for lead plaintiff to then select counsel of its choice to serve as counsel for the class; and (4) a stay of all discovery until a motion to dismiss testing the sufficiency of the complaint has been decided. By contrast, state securities cases provide no procedural safeguards protecting issuers and underwriters from professional plaintiffs or lawyer-driven securities actions. Issuers or underwriters who are defendants in these actions can be subjected to the enormous costs associated with discovery before any motions to dismiss are decided.

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The absence of the PSLRA's procedural safeguards enables these state court proceedings to move more quickly than federal court counterparts. This, in turn, provides the state court plaintiffs with disproportionate leverage vis-`a-vis federal shareholder class actions. As federal district court Judge Cote recently observed in denying the New York City Employees' Retirement System's motion to remand a bondholder action it brought in New York state court arising out of Worldcom's bankruptcy:

> It is beyond cavil that judicial economy and efficiency are best served by exercising the jurisdiction that so clearly exists. The MDL panel has consolidated scores of cases … to promote the expeditious and efficient resolution of the claims…. With the consolidation of the litigation in one court, the motion practice and discovery process can be managed to protect the rights of all parties and to preserve, to the extent possible, the maximum amount of assets for recovery by plaintiffs with meritorious claims … ***A remand would encourage a race for assets, a race that may deprive many victims of the alleged fraud of their fair share of the recovery***.

See In re Worldcom, Inc. Sec. Litig., 02 Civ. 3288, 2003 U.S. Dist. LEXIS 2790 *70-72 (Emphasis added). In like fashion, several other federal district courts have denied similar motions to remand bondholder actions in connection with the Enron and Worldcom MDL proceedings.[7] Although the Enron and Worldcom scenarios are slightly atypical in that both companies had filed for bankruptcy, giving rise to independent grounds for removal to federal court, the notions of judicial efficiency and fundamental fairness articulated in these recent opinions should have broader application.

Defendants' inability to remove bondholder actions from state court means that there is no practical way to coordinate cases pending in different states, even if they are based on virtually identical facts. Instead, a corporation is put in the untenable position of having to defend dozens of duplicative actions all over the country simultaneously. This creates the potential for publicly traded corporations — as well as their officers, directors and underwriters — to be sued in every state in the country as well as be subjected to "51 [sets of rules] — one for the federal system and 50 different ones in the states." 144 Cong. Rec. S12445, S12447-48 (daily ed. Oct. 13, 1998) (statement of Sen. Domenici). The Uniform Standards Act was enacted expressly to spare corporations and underwriters this burden. As the Conference Report makes clear, Congress enacted the Uniform Standards Act to prevent plaintiffs' lawyers from "exploiting differences between Federal and State [securities] laws," and "to make Federal court the exclusive venue for most securities fraud class action litigation involving nationally traded securities." H.R. Rept. No. 105-803, at 15 (1998). Now, these same entrepreneurial trial lawyers are using large institutional bondholders as their latest way of circumventing the PSLRA and Uniform Standards Act.

The potential preclusive effect of any early rulings on state bondholder actions presents a final, and significant, concern for defendants. In light of the fact that many of these bondholder actions allege facts and legal claims that are virtually identical to those pending in shareholder class actions, any substantive decisions rendered in these bondholder actions could be entitled to preclusive effect in the federal class action. *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 331 (1979); *Deweese v. Town of Palm Beach,* 688 F.2d 731, 733 (11th Cir. 1982). This result is particularly disturbing when one considers that many of the states in which these actions have been filed lack well developed case law on these issues. For instance, Alabama and Mississippi state courts each have issued only a handful of reported securities opinions. Consequently, should state bondholder actions prevail in a race to

judgment, the result could be judges with little or no experience handling complex securities actions rendering opinions that might be entitled to a preclusive effect in federal shareholder class actions.

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1. *See The Retirement Systems of Alabama v. Merrill Lynch & Co., et al.*, CV-2002-738-H (Cir. Ct. Mont. Cty, Ala.), *California Public Employees Retirement System v. Banc of America Securities LLC*, CGC 02-414500 (Super Ct. Calif., Cty of San Fran.), *Connecticut Resources Recovery Authority v. Lay, et al.*, CV-02-0821551-S (Super. Ct. Jud. Dist. Hartford, Conn.), *PERS of Mississippi v. Lay*, *et al.*, Civil Action No. 251-02-1376 (Cir. Ct. Hinds Cty, Miss.), and *Public Employees Retirement System of Ohio, et al. v. Fastow, et al.*, Case No. 02-CVH-09-9770 (Ct. of Common Pleas, Franklin Cty, Ohio).

2. *See The Retirement Systems of Alabama v. J.P. Morgan Chase & Co.*, (Cir. Ct. Mont. Cty, Ala.); *Board of Trustees of the Teachers' Retirement Systems of the State of Illinois v. Worldcom, Inc., et al.*, Case No. 02 CH 12384 (Cir. Ct. Cook Cty, Illinois); *West Virginia Investment Management Board v. Worldcom, Inc.*, C.A. No. 02-C-1877 (Cir. Ct. Kanawha Cty. W. Va.); *California Public Employees, et al v. Worldcom Inc, et al.*, Case No. BC 277711 (Super. Ct. L.A. Cty., Cal.).

3. *See California State Teachers' Retirement System v. Qwest Communications Int'l, Inc.*, Case No. 415546 (Super Ct. Calif., Cty of San Fran.).

4. *See Ron Premuroso v. Tyco Int'l Ltd.*, Case No. 02-13836 (Cir. Ct., 15th Jud. Dist., Palm Beach Cty, Fla); *Irving Goldfarb v. Tyco Int'l Ltd.*, Case No. 02-15007 (Cir. Ct., 15th Jud. Dist., Palm Beach Cty, Fla); *Ray Rappold v. Tyco Int'l Ltd.*, Case No. 02-15008 (Cir. Ct., 15th Jud. Dist., Palm Beach Cty, Fla); *Jim Myers v. Tyco Int'l Ltd.*, Case No. 02-15009 (Cir. Ct., 15th Jud. Dist., Palm Beach Cty, Fla); *John Hromyak v. Tyco Int'l Ltd.*, Case No. 02-15007 (Cir. Ct., 15th Jud. Dist., Palm Beach Cty, Fla).

5. Securities Act § 22, 15 U.S.C. § 77v(a) ("The district courts of the United States … shall have jurisdiction of offenses and violations under this title, and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this title.").

6. Exchange Act § 27, 15 U.S.C. § 78aa ("The district courts of the United States … shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and law brought to enforce any liability or duty created by this title or the rules and regulations thereunder.").

7. *See*, *e.g.*, *Conn. Resources Recovery Auth. v. Kenneth L. Lay*, Mar. 17, 2003 Order, 3:02CV2095, *slip op.* (D. Conn.); *Board of Trustees of the Teachers' Retirement Sys. of Ill. v. Worldcom, Inc.*, No. 02 C 5542, 2002 WL 31546158 (N.D. Ill. Oct. 18, 2002); *American National Insurance Company, et al v. J.P. Morgan Chase & Co*, August 12, 2002 Order, C.A. No. G-02-0299, *slip op.* at 16 (S.D. Tex).

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