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Securities Litigation, Bankruptcy and Business: The Supreme Court Speaks in a Decisive Tone

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SECURITIES LITIGATION, BANKRUPTCY AND BUSINESS: THE SUPREME COURT SPEAKS IN A DECISIVE TONE*

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I appreciate the opportunity to speak to you today. My task has been made easier by the overview of business-related decisions by Professor Bucholtz. The thoroughness of her comments frees me to be a bit of gadfly and address several decisions that deal with current issues, have practical importance, or are interesting and well written.

I. LEGISLATIVE REFORM OF SECURITIES LITIGATION

Let me begin with a decision that falls in my category of current issues. During the Supreme Court's term, Congress enacted a sweeping revision of the federal securities laws. The revision, enacted over President Clinton's veto, was the Private Securities Litigation Reform Act of 1995[1] ("Reform Act"). The Reform Act amended the federal securities laws in a number of respects; perhaps most notable were the provisions designed to curb abusive class action lawsuits.

Within this context, Congress addressed the plight of the so-called "world's unluckiest investor." This hypothetical investor is one who seems to repeatedly appear as a lead plaintiff in securities class action lawsuits.[2]

The legislative history of the Reform Act described a typical encounter with this investor. In 1993, Philip-Morris issued a news release announcing a reduction in the average price of its cigarettes.[3] The company announced that the price reduction would signal a reduction in earnings.[4] Within five hours of

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1. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.A. (West Supp. 1996)).

2. *See* H.R. CONF. REP. NO. 104-369, at 32-33 (1995), *reprinted in* 1995 U.S.C.C.A.N. 731-32.

3. *See* H.R. REP. NO. 104-50, at 33 (1995).

4. *See id.*

the announcement, the first lawsuit was filed by a plaintiff who owned sixty shares of Philip-Morris' common stock.[5] Four more class action lawsuits were filed the same day, and five additional actions were filed the next day.[6] Two of the complaints accused Philip-Morris of engaging in conduct to create and prolong the illusion of the company's success in the *toy* industry.[7]

As Professor Bucholtz suggested in her opening remarks, there have been a number of efforts to tinker with the class action device since the adoption of the Reform Act. As one manifestation of this effort, state substantive and procedural laws are being revisited to see if there are viable alternatives for class actions outside the federal courts. Legislative initiatives, such as Proposition 211 in California (which would have made California state courts much more receptive to securities fraud actions) have been proposed, although the Proposition was rejected by California voters in November.[8]

A. Matsushita Electric Industrial Co. v. Epstein

A decision by the Supreme Court in February may prove to be a useful tool for plaintiffs as the viability of state court actions, class actions included, are explored in response to the Reform Act. The decision, *Matsushita Electric Industrial Co. v. Epstein*,[9] dealt with the question of whether exclusively federal claims can be released in the settlement of a state court class action.[10] Stated more elegantly in the words of Justice Thomas, the author of the opinion, the court examined the question of "whether a federal court may withhold full faith and credit from a state-court judgment . . . simply because the settlement releases claims within the exclusive jurisdiction of the federal courts."[11] The Court concluded that such a release was entitled to full faith and credit.[12]

The decision arose from a 1990 tender offer by Matsushita for the common stock of MCA, Inc.[13] The tender offer spawned a class action in the Delaware Court of Chancery for breach of fiduciary duty against MCA and its directors.[14] Other state law claims were later added to the action.[15]

After the state court action was filed in Delaware, a class action was filed in federal court in California.[16] The plaintiffs alleged violations of the Securi-

5. *See id.*
6. *See id.*
7. *See id.* (citing Theodore J. Boutrous, Jr., *Out of Control Securities Suite*, WASH. TIMES, Feb. 9, 1995, at 1; Junda Woo, *Judges Show Growing Skepticism in Class-Action Securities Cases*, WALL ST. J., Jan. 11, 1995, at C1). *See also* In re Philip Morris Sec. Lit., 872 F. Supp. 97 (S.D.N.Y. 1995), *aff'd in part and rev'd in part*, 75 F.3d 801 (2d Cir. 1996).
8. *See* Rodney Ho, *Mr. Entrepreneur Goes to Washington: Elections Give Smaller Firms New Power*, WALL ST. J., Nov. 7, 1996, at B2.
9. 116 S. Ct. 873 (1996).
10. *See id.* at 875-76.
11. *Id.*
12. *See id.*
13. *See id.* at 876.
14. *See id.*
15. *See id.*
16. *See id.*

ties Exchange Act of 1934[17] ("Exchange Act") and the rules thereunder.[18] Section 27 of the Exchange Act confers exclusive jurisdiction on the federal courts for suits to enforce the Exchange Act and rules thereunder.[19]

Skipping the procedural aspects of the case, the Delaware court action was settled while the federal class action was pending. The settlement purported to encompass all claims arising under the federal securities laws including, specifically, the claims asserted in the federal court action in California.[20] The respondents in the case were members of the Delaware and California classes who did not opt out of the settlement class or appear to contest the settlement.[21] When Matsushita invoked the settlement as a bar to prosecution of the California federal class action, the issue was framed.

The majority opinion[22] focused on the Full Faith and Credit Act,[23] which mandates that "judicial proceedings . . . shall have the same full faith and credit in every court within the United States . . . as they have by law or usage in the courts of such State . . . from which they are taken."[24] The opinion explained that section 1738 may be applicable to state court judgments incorporating class action settlement of claims subject to the exclusive jurisdiction of the federal courts.[25] In making this determination, a court should be guided by the framework established in *Marrese v. American Academy of Orthopedic Surgeons*.[26]

B. The Test in Marrese

Marrese established a two-part test. First, the law of the state rendering the judgment must be analyzed to determine the effect of the judgment. If state law would bar the claim from litigation in a state court, the first element of a two-part test is satisfied.[27] This was the result under Delaware law in this case. The second part of the test requires the court to determine if the claim is an exception to the rule in section 1738.[28] In this case, the Court reviewed the purpose of the exclusivity provision in section 27 of the Exchange Act (e.g., the expertise of the federal courts in the resolution of such claims and the benefits from the uniform application of the Exchange Act[29]), and concluded that there were no irreconcilable conflicts between section 1738 and section 27 that would

17. 15 U.S.C. §§ 78a-78*ll* (1994).
18. *See Matsushita Elec. Indus. Co.*, 116 S. Ct. at 876.
19. *See* 15 U.S.C. § 78bb (1994).
20. *See Matsushita Elec. Indus. Co.*, 116 S. Ct. at 876-77.
21. *See id.* at 877.
22. The Chief Justice and Justices O'Connor, Scalia, Kennedy, Souter and Breyer joined Justice Thomas. Justices Stevens and Ginsburg joined in part. Justice Stevens concurred in part and dissented in part. Justice Ginsburg also dissented in part.
23. 28 U.S.C § 1738 (1994).
24. *Id.*
25. *See id.*
26. 470 U.S. 373 (1985).
27. *See id.* at 381.
28. *See id.*
29. *See Matsushita Elec. Indus. Co.*, 116 S. Ct. at 882 (citing Murphy v. Gallagher, 761 F.2d 878, 885 (2d Cir. 1985)).

prevent state courts from exercising jurisdiction over the settlement of such claims.[30]

Before leaving the case, I want to note Justice Ginsburg's opinion concurring in part and dissenting in part. Time has not permitted me to delve into all of the details of the two class actions, but Justice Ginsburg wrote a very persuasive discussion of the adequacy of representation question, an element in any class action, its constitutional implications, and its bearing on the outcome of the case.[31] She also mentioned a settlement proposed in the Delaware class action but rejected by the Chancery Court.[32] The rejected settlement will guide us back to our point of origin — abusive class actions and the Reform Act. The settlement provided for no monetary benefit for the class members and a $1 million fee for the class action plaintiffs' lawyers.[33]

The ramifications of the *Matsushita* decision remain to be developed by class action lawyers and the courts, but it appears to encourage litigants to explore the state courts for the next chapter of the class action struggle. Business lawyers who represent public clients or those seeking financing in the capital markets inevitably will witness many more developments in this area.

II. THE BANKRUPTCY CODE

A. Citizens Bank of Maryland v. Strumpf

Let me shift the focus of my comments to the Bankruptcy Code ("Code") and a decision of practical importance to many of you. In *Citizens Bank of Maryland v. Strumpf*,[34] the Court examined the conflict between a bank's setoff rights and the automatic stay in section 326(a) of the Bankruptcy Code.[35]

The respondent filed for relief under Chapter 13 of the Bankruptcy Code[36] at a time when he had an account with the bank. At the time of filing the respondent was in default on a loan to the bank in the amount of approximately $5,000 and he had over $5,000 deposited in his account.[37]

The bankruptcy filing triggered the automatic stay[38] thereby preventing various types of activities by creditors to collect on their debts, including the setoff of debts.[39] You can easily imagine the frustration of a bank holding a bankrupt customer's deposits in excess of the outstanding balance of a loan in default.

30. *See Matsushita Elec. Indus. Co.*, 116 S. Ct. at 883.
31. *See id.* at 884-89.
32. *See id.* at 886.
33. *See id.*
34. 116 S. Ct. 286 (1995).
35. 11 U.S.C. § 326(a) (1994).
36. 11 U.S.C. §§ 1301-1330 (1994).
37. *See Citizens Bank of Maryland*, 116 S. Ct. at 288.
38. *See* 11 U.S.C § 362 (1994). Section 362(a)(7) expressly prohibits the setoff of prepetition debts.
39. *See Citizens Bank of Maryland*, 116 S. Ct. at 288.

In this case, however, the bank placed what it termed an "administrative hold" on so much of the debtor's account as the bank claimed was subject to setoff.[40] Shortly thereafter, the bank filed a motion with the bankruptcy court for relief from the stay, and to setoff the defaulted loan balance against the deposits subject to the administrative hold.[41]

The bankruptcy court found the administrative hold constituted a setoff in violation of the stay and sanctioned the bank for its actions.[42] Several weeks later, the bankruptcy court lifted the stay and authorized the setoff.[43] The authorization, however, was to no avail because the account balance by that time was zero.[44]

In a unanimous opinion written by Justice Scalia, the Supreme Court considered the question of whether the administrative hold imposed by the bank was the equivalent of a setoff thereby violating the automatic stay. The Court concluded that it was not.[45]

The Court explained that section 362(a)(7) of the Code[46] expressly prohibits "the setoff of any debt owing to the debtor that arose before the commencement of the [bankruptcy case] against any claim against the debtor."[47] While creditors' pre-bankruptcy setoff rights are recognized by section 553(a) of the Code,[48] the exercise of such rights is subject to the automatic stay.

The Supreme Court held that the creditor's refusal to pay its debt while it sought relief from the stay was not a setoff as contemplated by the Code.[49] The action by the bank was not a permanent reduction of the respondent's account balance, an essential element of a setoff. The opinion discussed the elements of a setoff under state law[50] but concluded that the determination of whether the setoff occurred under section 362(a)(7) of the Bankruptcy Code is a matter of federal law.[51] Under either federal or state law, however, for there to be a setoff there must be a permanent adjustment of the indebtedness.[52]

This decision provides an important tool for financial institutions. Because of the practical similarity between an administrative hold and a setoff, the bank's motion for relief from the stay and to authorize the setoff filed in conjunction with the administrative hold was critical in the outcome because it evidenced an intent not to setoff in violation of the automatic stay.

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40. *See id.*
41. *See Id.*
42. *See id.*
43. *See id.*
44. *See id.*
45. *See id.*
46. 11 U.S.C. § 362(a)(7) (1994).
47. *Citizens Bank of Maryland*, 116 S. Ct. at 288.
48. *See* 11 U.S.C. § 553(a) (1994).
49. *See Citizens Bank of Maryland*, 116 S. Ct. at 289.
50. The opinion explained that a majority of states find a setoff to occur when there is a decision to effect a setoff, some action is taken to do so and the setoff is recorded. *See id.*
51. *See Citizens bank of Maryland*, 116 S. Ct. at 289.
52. *See id.*

B. United States v. Noland

Let me mention a second decision arising from the bankruptcy courts. *United States v. Noland*[53] dealt with the doctrine of equitable subordination and the administrative priorities established by the Bankruptcy Code. The question was whether a post-petition, noncompensatory tax penalty, normally an administrative expense entitled to priority under the Bankruptcy Code, could be subordinated under section 510(c) of the Code.[54]

To understand the issue, consider the impact on creditors. In a Chapter 7[55] proceeding, such as the one here, the assets available for distribution to creditors upon the liquidation of the debtor are reduced by administrative expenses allowed by the Code.[56] The administrative expense involved in this case was a penalty for unpaid taxes accruing after the commencement of the bankruptcy proceeding.[57] Because the tax itself and the interest thereon were not disputed as administrative expenses, the I.R.S. would sustain no pecuniary loss. Creditors, on the other hand, would have their distributions reduced by the amount of the penalties paid by the debtor.

Thus, the application of the doctrine of equitable subordination entered the picture. The doctrine, a judicial creation recognized by section 510(c) of the Code,[58] allows a bankruptcy judge to subordinate certain claims, notwithstanding Congress' legislative scheme in the Bankruptcy Code, when the conduct of a creditor is inequitable.[59] For conduct to be inequitable, it must have conferred some unfair advantage on the creditor or disadvantage to other creditors. In addition, the subordination must not be inconsistent with other provisions of the Code.[60]

In writing for a unanimous Court, Justice Souter recognized limits on the power of courts to equitably subordinate claims.[61] The Court determined that the power to subordinate is limited by the statutory framework established by Congress in the Bankruptcy Code.[62] That framework is the source of priority for administrative expenses such as nonpecuniary tax penalties. Equitable subordination, to fit within this framework, should be justified by the particular facts of the case.[63] A bankruptcy judge, in exercising equitable powers, cannot make categorical distinctions which have the effect of rewriting the Code.[64]

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53. 116 S. Ct. 1524 (1996).
54. 11 U.S.C. § 510(c) (1994).
55. 11 U.S.C. §§ 701-766 (1994).
56. *See* 11 U.S.C. §§ 507(a), 503(b)(1), 726(a)(1).
57. The case was originally filed as a reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101-1174 (1994), but was converted to a liquidation under Chapter 7. The penalties were related to taxes due after the Chapter 11 filing but before the case was converted to a Chapter 7 liquidation. *See Noland*, 116 S. Ct. at 1525.
58. *See Noland*, 116 S. Ct. at 1526 (citing 11 U.S.C. § 510 (1994)).
59. *See id.*
60. *Id.*
61. *Id.* at 1527.
62. *See id.*
63. *See id.*
64. *See id.* The opinion in particular rejected the Sixth Circuit Court of Appeals conclusion that such

The Court concluded that a categorical distinction is exactly what had happened in the bankruptcy court and that there were no "particular" facts to justify equitable subordination.[65] While the unsecured creditors lost this one to the I.R.S., the opinion's deference to Congress' legislative scheme was justified.

III. SAVINGS AND LOANS

If I could persuade you to read one decision from last term to give you an idea of the Court's expertise in analyzing complex business issues, I would refer you to *United States v. Winstar Corporation*.[66] This is an extraordinary opinion involving arcane accounting issues in the savings and loan industry. The case involved the rather mundane subject area of government contracting, but I found it to be strong evidence of the ability of the Court to navigate its way through extremely complex business issues. Today, my point is to bring the case to your attention, especially the facts, without an exhaustive discussion of the government contracting issues resolved by the Court.

For many, the savings and loan crisis of the last decade is nothing more than a historical footnote. With the perspective we gain from the passage of time, however, this crisis may occupy a significant role in the study of law and public policy. Let me start my discussion of the case with some background about the savings and loan crisis as explained by Justice Souter[67] in the opinion.

Savings and loan associations were creatures of the New Deal created to provide home mortgages.[68] Savings and loan associations, also known as S&Ls and thrifts, accepted deposits that were insured by the Federal Savings and Loan Insurance Corporation ("FSLIC").[69]

Because of soaring interest rates in the late 1970s and the early 1980s, many S&Ls suffered financial problems brought about by high interest rates required to secure deposits and portfolios of fixed rate mortgages at low interest rates.[70] The response of the federal government to alleviate the possibility of widespread insolvencies was to deregulate the thrift industry.[71] Through legislation passed in the early days of the Reagan Administration, thrifts were allowed to invest in new ways and to compete more aggressively for deposits.[72] Along with deregulation came the reduction in the capital reserve require-

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penalties are susceptible by their very nature to subordination. *See id.*

65. *See id.* at 1528.

66. 116 S. Ct. 2432 (1996).

67. Justice Souter delivered the opinion of the Court. He was joined by Justices Stevens and Breyer. Justice O'Connor joined in part. Justices Scalia, Kennedy and Thomas concurred in the judgment. Chief Justice Rehnquist dissented and was joined in part by Justice Ginsburg.

68. *See Winstar Corp.*, 116 S. Ct. at 2440.

69. *See id.*

70. *See id.*

71. *See id.*

72. *See id.* at 2441.

ments.[73] The reduction in the capital reserve requirements allowed the institutions to grow explosively without increasing capital; deregulation allowed thrifts to expand into new (and often riskier) investments.[74]

As I mentioned, insurance on deposits was provided by the FSLIC. The reserves of FSLIC declined by approximately $2 billion between 1980 and 1985.[75] Reserves in 1985 were $4.55 billion.[76] In 1985, the FSLIC estimated that it would take approximately $15.8 billion to close all of the institutions deemed insolvent under generally accepted accounting principles (GAAP). By 1988, however, FSLIC was insolvent by $50 billion. The cost of the crisis through the end of 1995 amounted to $140 billion.[77]

Realizing that the FSLIC lacked the funds to bail out all of the insolvent S&Ls, the Federal Home Loan Bank Board ("FHLBB"), the industry's regulatory authority, encouraged a number of so-called "supervisory mergers" between healthy thrifts and insolvent ones.[78] Such transactions were not intrinsically advantageous to healthy institutions so, as an inducement, the FHLBB promised that the acquisitions would be subject to special accounting treatment to help the healthy institutions meet their capital requirements.[79]

The *Winstar* decision involved three supervisory mergers in which three healthy institutions negotiated for, and were granted, special accounting treatment as part of the transactions. Each of the supervisory mergers occurred before 1989,[80] the year Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989,[81] also known as FIRREA.

FIRREA completely rewrote the regulatory scheme in the savings and loan industry and as part of the process eliminated all of the special accounting gimmicks in supervisory mergers consummated before FIRREA.[82] With the elimination of the accounting gimmicks, two of the three S&Ls involved in this case were declared insolvent and seized by the government. The third was able to survive after a massive private recapitalization.[83]

The three institutions involved in this case filed actions in the Court of Federal Claims for breach of contract.[84] They won.

The starting point in the court's decision was the special accounting treatment given to the supervisory mergers. Absent FIRREA, there was no question that the institutions were entitled to employ the accounting treatment authorized and approved by the FSLIC and FHLBB in the supervisory mergers. Under FIRREA they could not. Thus, could the federal government, through the adop-

73. *See id.*
74. *See id.*
75. *See id.*
76. *See id.*
77. *See id.*
78. *See id.* at 2442.
79. *See id.*
80. *See id.* at 2447.
81. Pub. L. No. 101-73, 103 Stat. 183 (codified at 12 U.S.C. §§ 1811-1835a (1994)).
82. *See Winstar Corp.*, 116 S. Ct. at 2446.
83. *See id.* at 2447.
84. *See id.*

tion of FIRREA, deny the accounting treatment it had previously authorized? Did the contracts limit the authority of the government to regulate the thrift industry?

The opinion written by Justice Souter reviewed a number of special rules applicable to contracts with the government. The first, and perhaps the most interesting, is the canon of construction that the surrender of sovereign authority must appear in "unmistakable" terms.[85] As applied here, the Court had to resolve the question of whether the government's sovereign prerogative was limited by the contracts in question. The government argued that it was.[86] The institutions, however, argued that the government's authority to regulate was unimpeded by the contracts. The contracts merely allocated the risk of loss to the government if the government changed the regulatory scheme[87] (i.e., if the government ended the accounting gimmicks).

The Court carefully traced the development of the unmistakability doctrine, and explained that modern impetus for its development was the application of the Contracts Clause[88] to public contracts.[89] The doctrine evolved from certain public contracts by state legislatures which had the effect of binding successor legislatures. The decisions generally involved an effort to abrogate subsequent government action on the basis of a contract granting a concession to a party.[90]

Justice Souter's opinion distinguished these cases. Here, the institutions did not seek to abrogate FIRREA.[91] The government and the institutions, as the institutions had argued, had agreed to allocate the risk of losses caused by future sovereign acts.[92] This, the Court found, would not implicate the government's sovereign powers at all and, accordingly, would not be subject to the unmistakability doctrine.[93]

Time has limited my treatment of this case. I recommend that you read it for the analysis of legal issues unique to government contracts, especially in anticipation of regulatory and political change. But more importantly in the context of today's topic, the level of analysis of the business issues throughout the opinion, including the concurring and dissenting opinion, is excellent.

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85. *See id.* at 2453.
86. *See id.*
87. *See id.*
88. U.S. CONST. art. I, § 10, cl. 1.
89. *See Winstar Corp.*, 116 S. Ct. at 2454.
90. *See id.*
91. *See id.* at 2458.
92. *See id.*
93. *See id.* at 2459.