

# Why Institutional Investors Opt-Out of Securities Fraud Class Actions and Pursue Direct Individual Actions



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The rising tide of institutional investors opting-out of “mega-fraud” securities class actions and securing multiples on the recoveries they would have received in the respective securities class action settlements has garnered the attention and active participation of large and respected mutual funds, hedge funds, public pension plans, Taft-Hartley funds and other institutional investors around the world. As a recent example, in the *Qwest* securities litigation, the total of publicly disclosed opt-out settlements exceeded the settlement of the entire securities class action. The Teacher Retirement System of Texas, California State Teachers’ Retirement System, Colorado Public Employees’ Retirement System, and State of Alaska announced opt-out recoveries in excess of 30 — and as high as 45 — times what they would have recovered in the securities class action settlement against Qwest. Notably, a substantial majority of the opt-out settlements in *Qwest* involved institutional investors that reached resolution of their opt-out claims before filing a complaint or engaging in any litigation or discovery.

The opt-out recoveries in *Qwest* are not isolated incidents or anomalies. In the past ten years, institutional investors have opted-out of other large securities fraud actions, such as *AOL/Time Warner*, *Enron*, *Tyco International*, *Adelphia* and others, and have reported settlements that represent significant multiples of what they would have received as participants in the securities class action settlement. Indeed, over ninety (90) prominent domestic and foreign institutional investors have recently pursued opt-out securities litigation, including, among others, The Vanguard Group, BlackRock, Janus, Franklin Mutual Advisors, Russell Investments, Federated Investors, Fred Alger & Company, Nuveen Investments, California Public Employees’ Retirement System,

Capstone Asset Management, Munder Capital, New York State Common Retirement Fund, Stichting Pensionenfonds ABP, AUSA Life Insurance Company, and the London Pensions Fund Authority.

So why are sophisticated and respected institutional investors selectively opting-out of certain securities class actions and pursuing direct litigation?

- **Opportunity for Increased Recovery**

Institutional investors, with losses in the tens or hundreds of millions of dollars caused by a particular securities fraud, are incentivized to maximize their recoveries and have achieved significant premiums on their recovery of losses caused by securities fraud by selectively and strategically opting-out of certain securities class actions.

- **Broader Claims for Recovery**

In a direct state court action, an investor may potentially assert broader and more expansive liability and damages claims against corporate wrongdoers (including aiders and abettors), while avoiding the litigation hurdles, limitations and delays imposed by the federal securities laws, including heightened pleading standards and a discovery stay under the Private Securities Litigation Reform Act of 1995 (“PSLRA”).

- **Complete Control Over Litigation Strategy and Settlement**

By opting-out, an institutional investor has complete control over the prosecution of its own unique claims, including the selection and direction of legal counsel, negotiation of attorneys’ fees, absolute settlement authority, and utilization of its size and stature as leverage in settlement negotiations or at trial.

- **Availability of Claims Abandoned in the Class Action**

A direct action allows an investor to bring additional claims for losses on securities that were abandoned or otherwise not included in the securities class action, or against defendants not named in the class action.

- **Overcome Jurisdictional Challenges**

Recently, in certain cases alleging securities fraud against non-U.S. companies, U.S. federal courts have declined to assert subject matter jurisdiction over class claims of investors who purchased stock on a non-U.S. exchange. In other cases against non-U.S. companies, non-U.S. investors who purchased stock on a non-U.S. exchange have been excluded from the certified class because of inadequate assurances that any disposition by the U.S. court would be honored abroad. In both circumstances, investors could overcome these jurisdictional challenges by filing a direct action in the U.S., or by pursuing more favorable individual or class claims in a non-U.S. court.

- **Absence of Potential Insolvency**

The aggregate losses of the entire class in certain mega-fraud securities cases can equal tens of billions of dollars, such that a full or even significant partial recovery of the total damages would likely bankrupt the defendant company. By opting-out, an institutional investor can typically seek to recover a larger percentage of its losses without any such recovery limitation based on potential insolvency of the defendant company.

- **Corporate Governance Opportunities**

Defendant companies understand that institutional investors typically maintain a long-term position in their company, with a resolute interest in strong corporate governance. As a result, institutional investors can potentially leverage their size and position to incorporate important governance reforms in a direct action settlement.

- **Immediate Distribution of Settlement Funds**

Direct action settlement funds are typically distributed to the investor within thirty days from the date of settlement. In contrast, class action settlements

are subject to a settlement approval process and claims administration period that could last one to two years before settlement funds are distributed to class members.

- **Opportunity for Negotiated Resolution Before Formally Opting-Out**

By employing a “wait-and-see” approach, an institutional investor can attempt through counsel to negotiate a settlement of its direct claims with defendants before formally filing a complaint or otherwise opting-out of the class; and, if negotiations are not fruitful, the institutional investor may either do nothing and remain a member of the class or opt-out at a later time and proceed with a direct action.

While there exist strong motivations for institutional investors to selectively opt-out of certain securities class actions, as discussed in greater detail below, the decision to opt-out should not be taken lightly and involves important factors to consider that may potentially impact the success of a direct action. By seeking the advice of counsel at the onset of litigation, institutional investors can ensure that they are making appropriate and timely decisions to successfully chart the proper course to maximize recovery of their losses caused by securities fraud.

## **Opportunity for Increased Recovery**

Given the individual damages suffered by large institutional investors in a mega-fraud securities class action, which can total in the tens of millions of dollars, there is an opportunity to achieve a premium on the recovery of investment losses by selectively opting-out of certain securities class actions. For example, the recoveries by several opt-out plaintiffs in the *AOL/Time Warner*, *Qwest* and *Tyco International* securities litigations highlight the significant financial benefits that individual litigation may provide in certain circumstances.

In 2006, the *AOL/Time Warner* securities class action settled for \$2.4 billion — a considerable settlement regarded as the fifth-largest in the history of securities class actions.<sup>1</sup> Yet, plaintiffs that opted-out and pursued individual actions have claimed to achieve settlements far in excess of what they would have received in the class action recovery. For instance,

the State of Alaska, which asserted a \$60 million individual claim, settled its direct action for \$50 million — a recovery representing over 80% of its asserted losses, and that representatives of the State of Alaska have described as “50 times what we would have received in the class [settlement].” Similarly, the California Public Employees’ Retirement System settled its direct action against AOL/Time Warner for \$117.7 million, or 90% of its claimed losses of \$129 million. In addition, both the University of California and the Ohio State Pension Funds, which settled their direct action claims for \$246 million and \$175 million, respectively, claim to have received more than 16 times what they would have received in the class settlement.

Investors who opted-out of the *Qwest* securities class action were also able to command a significantly higher premium to what they would have recovered in the class settlement to resolve their individual actions. In fact, the total amount of recoveries achieved in *Qwest* opt-out actions actually exceeds the securities class action settlement. In 2005, the *Qwest* securities class action settled for \$400 million. To date, *Qwest* has disclosed at least \$411 million in payments to settle opt-out actions. For example, the Teacher Retirement System of Texas settled its direct action against *Qwest* for \$61.6 million, or 44 times the \$1.4 million it would have recovered in the class settlement. In addition, the Alaska Permanent Fund settled its direct action for \$19 million, or 45 times the approximately \$422,000 it would have received, and the Colorado Public Employees’ Retirement System settled for \$15.5 million, or 38.75 times the amount it would have received in the class settlement. Indeed, the California State Teachers’ Retirement System, which settled its direct action for \$46.5 million, was able to recover from *Qwest*’s Chief Executive Officer alone what it would have recovered in total from the class action settlement.

In 2007, the *Tyco International* securities class action settled for \$3.2 billion, representing what is regarded as the third-largest securities class action settlement in history.<sup>2</sup> Despite the significant class recovery, several sophisticated institutional investors opted-

out of the class action to pursue individual actions. While few individual action settlements have been publicly announced thus far, those investors who have disclosed settlement terms have reported a significant premium to what they otherwise would have recovered.

## Broader Claims for Recovery

The federal securities laws place constraints on securities class actions that are not implicated in individual actions. These obstacles include a stay on discovery and pleading standards that are among the highest in any area of civil litigation. In addition to avoiding these litigation hurdles, investors who pursue individual actions are free to bring state claims that offer broader liability against defendants and are unavailable to the class, such as common law fraud claims, certain claims of negligence and negligent misrepresentation, and claims against secondary actors for aiding and abetting. Indeed, state law claims against secondary actors may be particularly favorable when there is concern of an ability to pay damages. The extraordinary circumstances of the *Enron* securities litigation are illustrative.

*Enron* was bankrupt from the outset of the securities class action and had no ability to compensate investors who were harmed by its massive fraud. Yet, by pursuing claims against the investment banks and auditors that facilitated or participated in *Enron*’s fraud, the class was able to recover approximately \$7.2 billion in negotiated settlements. However, several financial institution defendants who did not settle with the class continued to litigate the case. Those defendants successfully challenged class certification, with the Fifth Circuit Court of Appeals ruling that as secondary actors, the financial institution defendants could not be held liable to the victims, even if they knowingly participated in the scheme to defraud *Enron*’s shareholders.<sup>3</sup>

The Supreme Court of the United States denied *certiorari* to review the Fifth Circuit ruling. However, the Supreme Court issued its opinion in the *Stoneridge* securities litigation, addressing related issues. Although the Supreme Court declined to

<sup>1</sup> See Securities Class Action Services, “Top 100 Settlements Report” (Sept. 30, 2008).

<sup>2</sup> *Id.*

adopt the narrow view of the Fifth Circuit, the *Stoneridge* opinion makes it extremely difficult to bring federal securities claims against secondary actors.<sup>4</sup> Indeed, based on the Supreme Court's decision in *Stoneridge*, the remaining financial institution defendants in *Enron* were granted summary judgment from liability and the claims against them were dismissed.

Under *Stoneridge*, if another "Enron" situation were to arise today, defrauded investors would effectively have no class recourse under the federal securities laws. Rather, defrauded investors would need to file a direct action asserting broader state law claims to hold accountable any secondary actors who participated in the wrongful conduct. In fact, when the remaining class claims were dismissed in the *Enron* action after *Stoneridge*, the lead plaintiff in the class action moved the court to add "private, non-class, state-law claims" against certain secondary actors in order to "preserve an avenue of recovery" for its individual losses.<sup>5</sup>

## Complete Control Over Litigation Strategy and Settlement

By remaining passive in a securities class action, investors' claims are subject to the quality and dedication of the lead plaintiff and its chosen counsel, who owe duties to represent the interests of the entire class. While this frequently yields favorable results, a direct action offers investors the ability to forge its own litigation strategy, to be carried out by its choice of counsel. In addition, an investor who pursues an individual action can maintain control over which claims to pursue and in which forum, and also determine the timing of the lawsuit and potential settlement. Furthermore, as discussed below, a sophisticated institutional investor with considerable holdings may be able to negotiate a favorable settlement through its own counsel, and based on its own legal strategy, prior to formally opting-out of the class action and without filing a lawsuit.

## Availability of Claims Abandoned in the Class Action

Massive frauds typically involve large corporations that issue numerous securities through public stock and debt offerings during the period of wrongdoing. Often, sophisticated institutional investors will hold, and suffer losses on various types of those securities, such as bonds or preferred stock, that plummet in value when the fraud is revealed. While the lead plaintiff in a securities class action has the responsibility of identifying and pursuing all sources of recovery on behalf of the class, a class representative that purchased the specific security must assert the claims in order for the class to recover. Although the lead plaintiff in the class action may designate other investors who purchased these securities to serve as class representatives, the lead plaintiff's failure to do so could prevent recovery by any class member.

Similarly, massive frauds often involve the participation of ancillary actors, such as company auditors, investment banks that served as underwriters on issued securities, or other advisors. While the lead plaintiff in a securities class action may or may not name all culpable parties as defendants, an institutional investor pursuing direct action can ensure that it will pursue all possible claims against all possible defendants on all securities it purchased, thereby maximizing its potential recovery.

## Overcome Jurisdictional Challenges

In recent cases alleging securities fraud against non-U.S. companies, some U.S. federal courts have declined to assert subject matter jurisdiction over the claims of investors who purchased stock on a non-U.S. exchange. In these cases, the courts' decisions turned on whether enough of the events and actions of the alleged fraud actually occurred in the United States. Challenges to subject matter jurisdiction can occur at any time during the litigation, but are typically raised in the defendant's initial motion to dismiss. When a federal court dismisses class action claims for lack of subject matter jurisdiction, institutional investors can, under certain circumstances, avoid the consequences of such a ruling by

<sup>3</sup> See *Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 394 (5th Cir. 2007), cert. denied, 128 S. Ct. 1120 (2008).

<sup>4</sup> See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

<sup>5</sup> University of California Press Release, "UC seeks to amend its complaint in Enron securities fraud case" (Jan. 23, 2009).

filing a direct action in an appropriate U.S. state court, or by individually filing both state and federal law claims in a federal court. The jurisdictional reach of state courts, or federal courts applying state law, is less limited than under federal jurisdiction constructs, and is typically dependant only on whether the defendant's presence or conduct in the state is sufficient to assert personal jurisdiction.

In other cases alleging securities fraud against non-U.S. companies, non-U.S. investors who purchased stock on a non-U.S. exchange have been excluded from the certified class because of inadequate assurances that any ruling or adjudication by the U.S. court would be honored abroad. For example, in the *Vivendi* securities class action, claims were brought in U.S. federal court on behalf of U.S. investors and investors in several European countries who bought Vivendi stock on a non-U.S. exchange. Ultimately, the court excluded from the class investors from Germany and Austria after concluding that courts in those countries would be unlikely to recognize and enforce the outcome of the U.S. class action since those investors were not active participants in the litigation.<sup>6</sup> Essentially, the U.S. court feared that investors from those countries would get a proverbial "second bite at the apple" after disposition of the U.S. class action. To overcome the court's concerns and to avail themselves of the favorable claims and venue offered by the U.S. courts, several excluded investors filed a direct action against Vivendi in U.S. federal court.

Alternatively, regardless of any rulings on subject matter jurisdiction or exclusion from the certified class, institutional investors with claims against non-U.S. companies may be able to negotiate a settlement of individual claims in courts of jurisdiction outside of the United States. For example, European investors might be able to reach a group settlement enforced by a special court in the Netherlands pursuant to the Dutch Act. Indeed, this option was recently pursued on behalf of numerous institutional investors in connection with a pan-European settlement of claims related to the *Royal Dutch/Shell* securities litigation. Significantly, European investors can pursue a settlement under the Dutch

Act at any stage of the U.S. securities class action, and even before opting-out and filing an individual action, as was the case with the institutional investors who reached a direct action settlement in *Royal Dutch/Shell*.

## Absence of Potential Insolvency

In certain cases of mega-fraud, the aggregated damages of the entire investor class are so large that a full or even significant partial recovery would likely bankrupt the defendant company. Accordingly, plaintiffs in securities class actions often confront this argument in settlement negotiations and are sometimes pressured by the court or court-appointed mediators to moderate their settlement expectations to take into consideration the defendant company's ability to pay a settlement or satisfy a judgment at trial. While an institutional investor may have damages in the tens of millions of dollars, a company will often have the ability to compensate an institutional investor for the entirety of its damages or satisfy a judgment at trial.

## Corporate Governance Opportunities

Notwithstanding the occurrence of fraud, institutional investors often retain long-term positions in the defendant company, with a resolute interest in corporate governance. By opting-out and pursuing a direct action, larger institutions are able to voice their corporate governance concerns and can require meaningful reform be included in the terms of any settlement. Specifically, an institution could seek policies that generally promote more transparency and accountability within the company. For example, an investor could seek to add independent directors, or hold all directors more accountable and responsive to shareholders by implementing director and committee-person term limits or by eliminating a staggered board and holding annual elections of all directors. Over time, such reforms can prove to be quite valuable, as companies with strong corporate governance have proven to be more profitable and less volatile, and are less likely to commit fraud in the future.

<sup>6</sup> See *In re Vivendi Universal, S.A. Sec. Litig.*, 242 F.R.D. 76 (S.D.N.Y. May 21, 2007).

## Immediate Distribution of Settlement Funds

When a negotiated settlement is reached in a direct action, the plaintiff may be paid immediately upon execution of the settlement. In contrast, a securities class action settlement must first receive preliminary approval and then final approval from the court, which occurs after notice and a hearing on the proposed plan of allocation before any funds are distributed to class members. After final approval, claims forms must be filed with the claims administrator and then processed to ensure that only actual class members receive the settlement funds, and that the amount is what they are entitled to receive. The entire process from the date that a securities class action settlement is announced until the class members receive any portion of the recovery typically can take between one to two years, but could be longer in the case of a complex settlement.

## Opportunity for Negotiated Resolution Before Formally Opting-Out

Regardless of the ultimate decision whether or not to opt-out of a securities class action, institutional investors may benefit by retaining counsel early in the litigation to assess their individual claims, potential damages, and opportunity for resolution of direct claims before formally opting-out. As accomplished by many institutional investors in *Qwest*, institutional investors, through counsel, may be able to negotiate a favorable resolution of their claims prior to formally opting-out of the class action and prior to filing their own complaint. If negotiations are unsuccessful, the investor has the option of remaining a member of the class and participating in any class settlement, or choosing to opt-out at a later point in the litigation to proceed with a direct action. This no-risk, “wait-and-see” approach is particularly conducive to institutions that would not ordinarily be inclined to participate in class actions or publicly disclose litigation results, such as Janus Capital, who recently resolved its claims against AOL/Time Warner prior to initiating formal litigation and without disclosing the terms of settlement.

## Factors to Consider Before Opting-Out

While there are strong motivations for institutional investors to opt-out of certain securities class actions, there are important factors to consider that may potentially impact the success of a direct action in any particular case. The important factors that should be weighed by institutions who are considering opting-out of a securities class action include: (i) the magnitude of the institution’s actual losses and estimated damages; (ii) the strength of the direct legal claims for recovery against defendants; (iii) the procedural status of the class action, including any prior rulings or observations by the presiding court and the potential impact on discovery and trial; (iv) the most favorable venue option to file the direct action; (v) the solvency of the defendants to satisfy a reasonable settlement or judgment; (vi) the opportunity to join together with other institutional investors to prosecute the direct claims and share litigation expenses; (vii) the statutes of limitation and jurisdictional issues with respect to any potential state and federal court claims; (viii) the potential scope of discovery to be required of the institutional investor; (ix) the most advantageous time to opt-out of the securities class action to potentially maximize recovery; (x) the resources, reputation, and prior results of legal counsel retained to prosecute the direct claims and negotiate any resolution; and (xi) the impact of any settlement or settlement negotiations in the class action or in other opt-out cases pending against defendants.

Because any one of these factors could impact the ultimate success of a direct action, the decision to opt-out of a securities class action should not be taken lightly, and should be made only with the advice of counsel after weighing the potential upside and downside associated with each factor.

## Conclusion

Clearly, there is an increasing trend of institutional investors selectively opting-out of certain large securities class actions and securing recoveries equal to multiples of what they otherwise would have recovered in the class action. In recent high-profile securities cases, public institutions have announced direct action settlements of up to 90% of

their claimed losses and up to 50 times what they would have received in the corresponding class settlement. The success of institutional investors in direct action settlements is facilitated mostly by their ability to bring broader claims for recovery in an individual action, and to maintain complete control over the litigation and settlement of their claims. Specifically, institutional investors are able to select their own counsel and forge their own legal strategy in an individual action, making sure they seek recovery against all viable defendants for losses on all securities they purchased, or increasing their chances of forcing meaningful corporate governance reform. In addition, a direct action might allow institutional investors to overcome jurisdictional challenges in cases against non-U.S. companies.

Another significant factor contributing to the success of individual action settlements is the ability of institutional investors to decide if, and when, they will opt-out of a class action. By taking a “wait-and-see” approach, institutional investors, through counsel, can attempt to negotiate a favorable resolution to their direct claims prior to formally opting-out or filing a lawsuit. If negotiations are successful, they can potentially recover a premium to what they would have recovered in any class settlement. Otherwise, they can remain a member of the class without harm and reserve making their decision on whether or not to opt-out until later in the litigation.

Ultimately, however, the decision to opt-out involves the weighing of important factors that may potentially impact the success of a direct action in any particular case. These factors not only include a thorough factual and legal analysis of the merits of the potential opt-out claims for recovery, but also important strategy decisions to ensure maximum recovery. In certain cases, during certain stages of the litigation, the benefits of opting-out of the class action may be substantially outweighed by the risks of pursuing individual claims. Therefore, institutional investors should remain selective in the cases they decide to opt-out from and carefully consider the upside and downside of the factors impacting the success of a particular opt-out action with the advice of counsel, to ensure that opting-out is the proper course of action to maximize the recovery of their losses caused by a particular securities fraud.



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