The fundamentals of asset recovery

US and European institutional investors are establishing new 'best practices': portfolio monitoring systems to identify US securities fraud claims and claim filing procedures to ensure the collection of class action settlement funds

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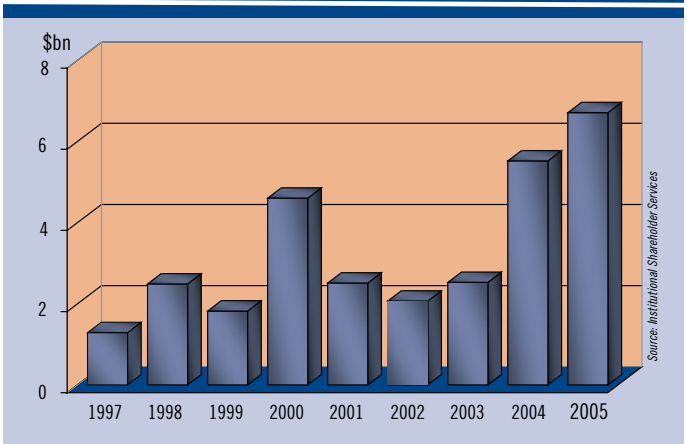
Over the past decade, the US securities markets have been repeatedly shaken by a series of extraordinary corporate accounting scandals. While the largest of these cases – such as Enron, WorldCom and Cendant – have been well documented and publicised, many other lesser-known but equally egregious corporate frauds have also harmed the overwhelming majority of investors in the US securities markets.

Regardless of sound investment policies, institutional investors are simply not immune from the sizeable damages that corporate misdeeds can inflict on their bottom line and, as a result many are now participating in combating and preventing frauds. The past five years have witnessed a drastic increase in the amounts recovered in these cases, and much of it is due to the active involvement of institutional investors in securities class action filings.

In 1995, in order to curb abusive litigation practices, the US Congress passed the Private Securities Litigation Reform Act (PSLRA). Prior to the PSLRA, recoveries from securities class actions were relatively modest in comparison to the magnitude of the damages caused by the underlying frauds. Accordingly, institutional investors were not especially concerned with either serving as a lead plaintiff or even filing the claim forms necessary to collect their rightful share. The PSLRA changed this by inviting institutional investors to use their size, sophistication, and power to achieve significantly greater shareholder recoveries and bring about positive changes in corporate governance by taking a leadership role in justified and sensible litigation. The results have been remarkable.

Securities class action settlement amounts



As noted in the chart below left, yearly recoveries in securities fraud cases are on the rise and now consistently measure several billion US dollars annually. As of February 2006, the last 14 months have seen over $14bn both recovered and in the pipeline of pending and tentative settlements. US public pension plans, and now major European institutions, are consistently serving as lead plaintiff in US securities class actions. These sophisticated investors systematically review potential claims, identify cases of merit to prosecute, and insist on meaningful settlements – which often include far-reaching corporate governance reforms. Legal fees as a percentage of recovery have also shrunk greatly as a result of the supervision of these lead plaintiffs.

Indeed, Professor Elliott Weiss[1], a longtime critic of class action abuses prior to the PSLRA, says "Recoveries are in a whole different league than was the case before the PSLRA was adopted and are much more reflective of the merits of the claims being litigated."

Portfolio monitoring and claims administration – two important services

As class action settlements have grown, so has the need for investors to have in place professional solutions identifying which potential fraud claims are of sufficient value and factual merit to be pursued through litigation, and which are not. It has become equally important to establish a reliable and systematic process for collecting and filing claims from the pool of class action settlement funds that are available to the non-litigating investors in the represented class.

Today, many institutional investors decide to act as lead plaintiffs in securities class actions after identifying their claims through a process known as 'portfolio monitoring'. Portfolio monitoring is a service offered by experienced law firms that screens investment portfolios for losses that may have been caused by corporate misconduct. If a genuine fraud is assessed as the cause of damages, lead plaintiffs can begin the process of recovering a portion of the total loss by filing a class action suit prosecuting the bad actors responsible and then working toward

[1] Professor Weiss authored the 1995 article, 'Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions', 104 Yale L.J. 2053 (1995), which proposed reforms for the organisation of securities class actions, and was the basis of the lead plaintiff provisions of the PSLRA. He serves as counsel to Bernstein Litowitz Berger & Grossmann LLP.

a settlement with the opposing parties. Once a settlement has been reached, litigants and other non-litigating investors seek to recover their portion of it through a process commonly referred to as 'claims administration'.

Claims administration is the process of identifying and filing claims on behalf of investors entitled to a portion of the proceeds of securities class action settlements. Many institutional investors rely on custodial banks to file proof of claim forms in class action settlements. Another group of institutional investors have hired firms that specialise in filing proof of claims. There is now a growing pool of investors who have begun turning to law firms to file proof of their claims, concluding that since the claims stem out of legal actions, the filing process best requires the specific experience and expertise offered by law firms who are the dominant practitioners in this area.

Portfolio monitoring and claims administration both typically require some form of electronic access to a client's investment portfolio and both involve strict time deadlines for, respectively, filing lead plaintiff motions and filing proof of claim forms. To investors unfamiliar with the concepts, this may create some measure of confusion. These processes are indeed completely separate and distinct. The monitoring of securities fraud claims occurs on the 'front end', when fraud allegations are just coming to light, whereas claims administration procedures are done on the 'back end', after a securities class action case has been settled and funds are available to be claimed.

Why portfolio monitoring is essential to the active fund manager

Under the PSLRA's notice provision, the first plaintiff to file a complaint must publish a notice within 20 days of such a filing to identify the claims and the class of harmed investors, as well as to advise members of the class of their right to move to serve as lead plaintiff in the action within 60 days from the date of publication of the notice. Consequently, the key factor giving rise to institutional investors seeking portfolio monitoring services by US securities law firms is the fact that this 60-day period is a relatively short period of time to analyse the trading in a vast institutional portfolio, and then determine the merits of a claim and the potential for a recovery. Thus portfolio monitoring greatly facilitates the review process and eliminates wasteful and burdensome administrative work for institutional investors.

The mechanics of portfolio monitoring

At the outset, portfolio monitoring by law firms requires some form of electronic access to investment portfolios under the terms of a completely confidential, 'attorney-client' agreement.

This process includes three key components: tracking, analysis and counsel:

Tracking involves a detailed review of a client's holdings to determine whether the client has a significant position in a company that has been sued for securities fraud.

The *analytical* part of portfolio monitoring is often divided into two general sub-categories: a decision on the relative merit of the case based on the facts and the law, and an informed estimate of the potential for meaningful recovery. A number of investigative techniques are employed to assemble as much factual information as can be done within the 60-day lead plaintiff deadline.

Counselling a client on whether or not to pursue a lead plaintiff position in a securities class action, or whether to opt out of a class action and pursue an individual securities class action, involves considering myriad factors including:

- the amount of the loss sustained by the institutional investor;
- whether the fact pattern is more likely evidence of fraud or simply mismanagement;
- whether the losses occurred after a restatement of earnings by the company suspected of fraud;
- whether there is evidence of unusual or ill-timed insider trading; and
- whether the defendants are solvent.

In some circumstances a client may have a loss large enough to pursue a recovery on its own, outside of the class action. However, to pursue this approach requires another level of detailed analysis, and an institutional investor should definitely consult an experienced US securities law firm to assess the options.

Sound asset management requires attention to fraud losses and their recovery

Every year, billions of dollars are left on the table by institutional and individual investors who fail to submit timely proof of claim forms in US securities fraud cases. As settlements continue to increase in size, the unclaimed portions are only getting larger as well. In 2005 alone, $6.7bn was recovered for aggrieved investors in securities class actions and yet, according to a study by James D Cox of Duke Law School and Randall S Thomas of Vanderbilt Law School[2], less than 30% of institutional investors with provable losses submit projected claims in class action settlements. As the funds are distributed *pro rata* depending on the number of claims filed, the money left on the table by a large institutional investor can easily reach into the millions of dollars annually.

Not surprisingly, using experienced US securities law firms to monitor their investment portfolios has become commonplace among larger US public pension plans. Today the practice is beginning to take hold in Europe. And why not? The top law firms in the field charge no fees or expenses to provide the service, and the information gained is vital to fiduciaries. Similarly, many US funds are now applying increased scrutiny to the claim filing practices of their custodial banks, or hiring outside agencies such as law firms to ensure that the money lost due to securities fraud finds its way back into the fund's investment portfolio.

As US pension funds have concluded, no one is obligated to lead a securities class action or to file an individual securities fraud action. However, every pension plan is obligated to know what rights it has, and what potential monetary recoveries are available. Indeed, every pension plan and institutional investor has a clear obligation to file timely proofs of claim and maximise the fund's value. A lesser effort may be construed as a failure to protect the interests of the fund. ■

Dominic Auld, Esquire, special counsel to Bernstein Litowitz Berger & Grossmann LLP, also assisted in the preparation of this article.

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[2] The study is entitled 'Letting Billions Slip through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements' and can be found in the *Stanford Law Review*, Vol. 58. P 411 November 2005.