Original Article

A brief overview of securities class actions and risk management for pension fund trustees

Received (in revised form): 15th March 2012

David Seidel
is the Chief Executive and Chief General Counsel of iiTRA Limited, which manages the Institutional Investors Tort Recovery Association, a membership organisation that manages the securities class action rights of pension funds, asset managers, insurers and family offices.

ABSTRACT The history of securities class actions and their importance for pension funds is reviewed along with the risk factors that need to be managed by pension trustees including the nature of claims, factors for determining court jurisdiction, legal cost awards, litigation funding and insurance, fiduciary obligations and the need for community of interest.

Pensions (2012) **17,** 121–125. doi:10.1057/pm.2012.12

Keywords: class action; history; risk management

After a long period of suspicion, securities class actions, with their prospect of recovering substantial sums to benefit fund beneficiaries, are now being considered seriously as something to be undertaken by pension trustees. Trustees, with some justification, were reluctant to be legal pawns in some foreign lawyer's hands and were sceptical that litigation was an acceptable form of corporate governance. The only people who gained on a macro-economic scale out of class action litigation, they thought, were the lawyers. However, those days seem to be passing, and increasing numbers of trustees are exploring their options in relation to their litigation rights. However, just how potential recoveries may be realised is dependent upon balancing a number of issues.

Collective redress or class actions or group litigation is not new. Until recently, the best known cases have sought compensation for common causes of damages because of negligence, whether from product liability or personal injury. Past examples past include faulty automobile design such as in the Ford Pinto case or drugs with unadvised side effects such as in the thalidomide case. One might consider this kind of litigation as something endemic to the United States; however, it is in fact spreading worldwide. For example, for more than 3 years, the European Commission has been consulting on collective redress for consumers, which should lead to an EU-wide procedure for group remedies. With that in mind, one does not need a crystal ball to anticipate future class actions being initiated on behalf of people who over the last several years acquired surgical silicone implants from Poly Implant Prothèse or were passengers on the grounding and partial sinking of the Italian cruise ship Costa Concordia on 13 January 2012.

Securities class actions remain a highly specialised form of collective redress because of evidentiary complexity – not litigation procedure. There are rarely tangible products to inspect and rarely materials to analyse. Instead, potential plaintiffs simply need to refer to the free market

Correspondence: David Seidel
iiTRA Limited, 55 Old Broad Street, London EC2M 1RX, UK
E-mail: david.seidel@iitra.org

with its rules, regulations and factors affecting market price. One must undertake extensive and extensive detective work to determine why and how corporate decisions were made (in the case of pension funds, in the decision to make or retain an investment) and then assessing how those facts lead to a legal claim for a loss of value and a right to recover damages. It is, of course, insufficient for the value in any particular share to simply decrease, as market fluctuations are common and expected. What is required is a direct, causal link between the misconduct and a decrease in share value. In a similar vein, where the conduct complained of is improper disclosure, a decision – whether by directors or shareholders, and based on incomplete or inaccurate information – will not result in a claim for damages where full disclosure would not have altered that decision.

High-profile securities class actions, such as those involving Enron and Worldcom, seem a somewhat recent phenomenon. In fact, the jurisprudence on securities class actions has been developing (primarily in the United States) for approximately 40 years. At the same time, other jurisdictions around the world – examples include Australia, Korea and various provinces in Canada – have enacted or are in the process of enacting laws allowing for securities class actions, and in those countries the case law is developing quickly.

A function of tort (that is, a civil wrong) law, most securities class actions are claims for damages based on the negligence of a company and/or its directors. More often than not the complaint alleges misrepresentations whether for (i) inaccuracies in a company's accounts, statutory filings and/or public statements, and/or (ii) non-disclosure of material facts relating to the company's activities. In undertaking such courses of action, it is alleged that a change in share prices occurred outside of the market, either causing people to invest when they would not otherwise have done so or causing existing shareholders to retain their shares when they might have otherwise disposed of them. When the truth emerges, the share value can decline materially. Higher-profile (and fortunately rare) cases may involve allegations of fraud or corruption, such as the offering of an investment with high returns but is eventually revealed as a Ponzi scheme.

At their heart, judgments in securities class actions follow the three primary and philosophical goals of punishment. The first goal is retribution – that is, compensating those who have suffered harm from corporate misconduct. Second, there is rehabilitation with the court determining what constitutes good corporate conduct and good corporate governance, and expecting the defendant to adhere to those rules in future. Finally, there is deterrence – that is, that the threat of future securities class actions will cause other companies and their directors to adopt the sound governance procedures that have been laid down by the courts. From the perspective of the fund manager holding securities affected by corporate misconduct, all are worthy objectives from which they should be entitled to benefit if the risks are properly managed. This includes recognising that there are times when a 'securities class action' is not in fact a class action at all.

In litigation, generally, there are three options on where to bring a securities class action claim: where the defendant is headquartered, where the shares were traded or where the alleged misconduct took place. Before initiating any action, it is imperative for any proposed plaintiff to understand the rules of procedure and evidence in the chosen jurisdiction. With most securities class actions being filed in the United States, the question of jurisdiction for the non-US plaintiff has become simpler in one respect but more complex in another.

It was more complex before mid-2010 when plaintiffs could choose between two different legal systems under which to sue – federal law or state law. The former was preferred for publicly traded American companies, as it was the same jurisdiction as that which governed the Securities Exchange Commission. It was not surprising that the federal court became the choice for securities class actions, so much so that plaintiffs from around the world at one time sought collective redress against foreign-traded companies with no connection to the United States whatsoever. More recently, in *Morrison* v. *National Australia Bank* [2010] US Supreme Court 561, the United States Supreme Court began to address that particular issue. That case, having been judicially considered more stringently since then, now stands for the proposition that non-US plaintiffs are barred from participating in any federal US class actions.

Nevertheless, the *Morrison* line of cases has not eliminated the possibility of non-US plaintiffs bringing actions in America. In order to do so, the proposed plaintiff is required opt out of the federal class action by initiating a separate individual action under state law. A non-US plaintiff is therefore now prohibited in many cases from becoming involved in the federal class action. This prohibition sounds worse than it is in fact; a foreign plaintiff can still initiate a claim under state law for the same damages it would have sought in federal law where the *Morrison* prohibition does not apply. Of course, state proceedings are not without jurisdictional risk. The same issue of finding a substantive nexus of the misconduct within the state is crucial and will weigh heavily on a judge's mind before the court will accept that it can decide the case.

Since *Morrison*, the jurisdictional issue has become simpler for the non-US plaintiff, in that there is no longer a choice between federal and state law and more complex in ensuring that there are sufficient facts to enable a state court to proceed and hear the case. If jurisdiction is accepted, the plaintiff's case is only in respect of its own holdings. In other words, for the foreign plaintiff the securities class action becomes an individual action even though it will likely benefit from the findings and decisions of the main federal securities class action. Because of a confluence of facts and defendants, if there are a number of foreign plaintiffs issue proceedings under the same state law then these will be consolidated or joined into one hearing. With multiple plaintiffs, it may seem like a securities class action; however, each foreign plaintiff will represent itself in respect of its own holdings.

Related to jurisdiction is the issue of legal costs, a factor of considerable importance in the United Kingdom, Australia and Canada, among others. Unlike the United States where each side in a law suit pays its own costs, with law firms being prepared to fund all of the costs of complex litigation, there are many common law jurisdictions that not only restrict contingency fee arrangements, but also have rules requiring the 'loser' of the case to pay a significant contribution towards the 'winner's' legal costs. With a likely contribution being upwards of 50 per cent, there are greater risks in becoming involved in securities class actions in other places around the world. Those risks can also be managed through third party funding arrangements and/or insurance. By availing oneself of these facilities, it is also likely that the case will be better prepared, as the third party will wish to oversee the preparation of the case and assess the risks of all aspects of the lawsuit before it is initiated. Regardless of whether it is a law firm or a funder or an insurer underwriting the risk of handling the case for the plaintiff, it will expect a suitable reward for doing so. This will be a percentage of any judgment proceeds. As a note of caution, there are many jurisdictions such as Australia or Ontario where the risk/reward agreement with the funder of a case must be approved by the court at the time the action is certified as a securities class action.

Although one criticism is that third party funders are unlikely to proceed with any case unless there is a reasonably good likelihood of return, they are also experts in litigation risk assessment and will act as good bellwethers on the potential success of any group action. Moreover, they help in avoiding frivolous litigation. Their presence may also have a psychological impact to the action, equalising the power balance in what may be a battle of almost biblical proportions. Publically traded companies have millions of shares issued. In a securities class action, every shareholder, from the smallest holding to the largest, will be a member of the plaintiff class against the company – that is, small shareholders with few resources (David) against big business with significant assets at its disposal (Goliath). With the intervention of third party funding, it is unlikely that any party will win simply by using procedural rules often so as to cause the other side to liquidate its assets while pursuing the litigation.

Beyond the legal system, there is another risk of concern to pension trustees of which to be aware. It is the impact of litigation on the fund's and the trustees' reputation. With an increasingly pervasive and invasive media, pension trustees do not wish to have their involvement in any securities class action characterised in any untoward or inaccurate way. As a result, upon learning of the slightest news interest in any securities class action, care must be taken to ensure the 'story' of any class action is presented, highlighting how the trustees are not acting for themselves but they are discharging their duties as trustees by protecting the financial futures of their beneficiaries where otherwise there would be none. Standing up for the rights of an unnumbered and unnamed collective may seem a trifle altruistic in tone, yet it coincides entirely with trustees' main fiduciary duties: acting in the best interest of the fund beneficiaries.

In the end, any decisions made by a pension fund about becoming involved in one or more securities class actions vests with the pension fund trustees. Their fiduciary duty does not require them to spend more money than the fund is likely to receive in the end. However, as outlined above, there are ways and means of controlling the risks in any such litigation. Conversely, those same duties do not permit trustees to simply turn away from the prospect of generating future recoveries if they think it appropriate to do so.

So what can pension trustees do in practice, given that their time, resources and expertise are limited? One solution is to sign up with one of the specialist law firms, which offer a 'free' service. These are often very helpful, although by necessity they will be limited in scope. An alternative is to retain a specialist firm to monitor securities class action settlements and judgments around the world. There are several such outsourcing agencies throughout Europe and the United States who can keep track of a fund's holdings to determine when there is a current recovery interest and proves the fund's claims by undertaking all filings with the court administrators. Some custodians suggest that they can offer this service, but it is not really their core competency. Although these services involve costs, most monitoring service fees are based on a percentage of successful recoveries. There may also be some upfront fees charged for the setting up the database of the funds' historical and current holdings. In the end, the cost of monitoring and filing for recoveries in settlements and judgments is minimal compared with the annual recoveries that can be generated.

However, for non-US funds, the retention of a specialist-monitoring firm may be a necessary but not sufficient solution, not sufficient as a result of the *Morrison* line of cases. This is because monitoring agencies look at securities class actions that have ended whether by settlement or judgment. They do not concern themselves with current or anticipated actions or assisting a client with becoming involved with any proposed action. They simply wait until an award is made or agreed.

As stated above, most securities class actions are and continue to be initiated in the United States federal court. According to annual statistics released by NERA Consulting, the average number of securities class actions initiated in the United States is approximately 190 cases per year. A recent motion decision in *In Re: BP plc Securities Litigation*, [US District Court, Southern District of Texas, 13 February 2012] has extended the *Morrison* principles to the extent that no matter what happens in any federal securities class actions – no matter how they are resolved, whether by settlement or judgment – non-US plaintiffs are excluded from it and are not entitled to take part in the litigation. Any potential foreign plaintiffs wishing to pursue recoveries from the same facts giving rise to the federal securities class action must take positive action and litigate individually under state law.

The risks (and there are risks) of litigating any securities-related lawsuit need to be properly managed. Although there can be costs and drawbacks, the benefits include being involved in a community of interest, which bring investors with diverse interests together in a common cause, namely recovering their losses arising out of fraud or misrepresentation in relation to their shareholdings. Working collectively offers no guarantee of success; however, it should reduce the costs and the expenses to a minimum and enable the acquisition of expertise and skills, which otherwise would be unaffordable. In addition, it should improve returns to investors.