

Protecting the rights of international clients in US securities class action litigation

Brian P Murray¹

Murray Frank & Sailer LLP, New York

bmurray@murrayfrank.com

Brian Murray provides an overview of the role of international institutional investors in US securities class action litigation and cautions that a failure to monitor such litigation could leave international institutional investors vulnerable to claims by their own investors.

Introduction

The globalisation of the securities markets has resulted in an increasingly worldwide reach of the US securities laws. The two major US securities statutes, passed in the 1930s, are silent as to their extraterritorial reach. However, US courts have shown a willingness to apply these laws to transactions or frauds conducted abroad, provided there is either sufficient conduct concerning the fraud in the United States or the fraud has a sufficient effect in the United States. As a result, the remedies afforded to defrauded investors in the United States are increasingly available to non-US entities. This article will explore the rights and remedies available to non-US investors under the US federal securities laws.

The global reach of US securities laws

Although the US securities laws are silent as to their extraterritorial reach, over the past 30 years US federal courts have established various tests and benchmarks for applying the US securities laws to transactions on foreign exchanges or by foreign entities.² The various scenarios to consider are:

- (1) purchases of securities in the United States by a non-US entity;
- (2) purchases on a non-US exchange by a non-US entity of the securities of a US company committing fraud;
- (3) purchases on a non-US exchange by a non-US entity of the securities of a non-US company committing fraud, where that company's securities are also listed in the United States; and
- (4) purchases on a non-US exchange by a non-US entity of the securities of a non-US company committing fraud, where that company's securities are not also listed in the United States.

In the first two scenarios, the defrauded institutional investor can definitely avail itself of the protection of US securities laws. In the third and fourth scenarios, US jurisdiction over the case will depend on the

amount of fraudulent conduct that occurred in the United States and the effect the conduct had in the United States.

Any purchase of stock on a US stock exchange, regardless of the nationality of the purchaser, is subject to the US securities laws. However, 80 per cent of companies listed on US exchanges are now dual-listed on non-US exchanges. Investors who purchase securities on a non-US exchange may also be entitled to the protections of the US securities laws. Non-US investors who do not examine at least the possibility of getting involved in US litigation are potentially leaving money on the table. In one of the more famous examples of non-US investors missing out on a lucrative opportunity, investors in DaimlerChrysler instituted a securities class action in the United States on behalf of purchasers on both US and European exchanges. However, the only plaintiffs named in the case had purchased their securities on the US exchange. The court allowed the case to proceed on behalf of purchasers in the United States, but refused to include those investors who had purchased on the European exchange in the certified class, because, among other things, there was no proposed class representative who had purchased on a foreign exchange.³ The case eventually settled for US\$300 million. Purchasers on the US exchange shared this money, while purchasers on the European exchange received nothing from the class settlement.⁴

Getting involved may be more than just a good idea – it could be the law

Although the law will vary in accordance with the home country of the institution, in the United States at least, an institutional investor is under a duty to maximise its financial interest in claims it holds for the benefit of its investors.⁵ A violation of this duty may lead to lawsuits brought by angry beneficiaries of or investors in the institution. If the institution is defrauded in the purchase of a stock, it may hold valuable causes of action including claims under the US securities laws. 'Some state officials view the lawsuits as their duty to be publicly accountable to fundholders and to try to recover losses in cases where they believe fraud occurred, and this thinking should be applicable to public as well as private institutions managing other people's money.'⁶

In the United States, a trustee has a duty to investigate relevant facts, to explore alternative courses of action and, if in the best interests of the trust beneficiary, to pursue claims.⁷ As fiduciaries, trustees have a fiduciary responsibility to consider the merits of participating in any litigation on behalf of their beneficiaries. Failure to investigate a valid claim may breach an institution's fiduciary responsibilities to its members and expose the institution to liability. As stated by one US court, 'it may not only be prudent to initiate litigation, but also a breach of fiduciary duty to not pursue a valid claim'.⁸ Therefore, in determining whether to participate in a particular litigation, the main question is whether the benefits that accrue to the class, and thus to the institutional investor, outweigh the costs to the institution. The relevant factors to consider are the magnitude of the loss on the investment; the extent to which the institution has a continuing investment in the company; and the time commitment required to be involved in the case together with the resources available to commit to the case.

By considering these factors, even if your institutional client decides not to pursue litigation on behalf of its beneficiaries, your client will have a defence to a breach of fiduciary duty claim. By not considering these factors, your client may be exposed to a breach of fiduciary duty claim to the extent such a duty exists under the applicable law.

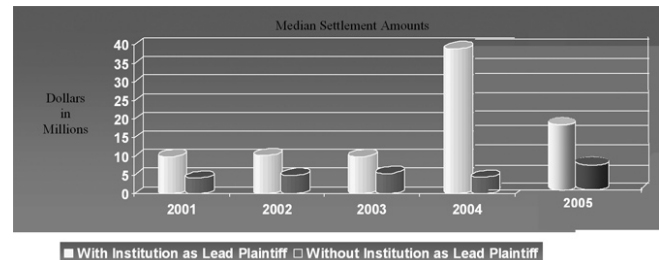
Why should international institutions get involved in US securities litigations?

Private shareholder class action lawsuits have long been the most cost-effective way for defrauded shareholders to obtain financial recoveries in the United States. With the growing involvement of institutional investors, these lawsuits have become even more effective, resulting in increasingly valuable recoveries, requirements of additional corporate governance provisions as a condition of settlement and lower attorneys fees. In general, institutions generate better results for the class because: (1) institutions have greater resources and expertise and can formulate better settlements; (2) institutions have a long-term outlook and the resources to reject a quick settlement; and (3) an institution can require corporate governance reform as part of a settlement. In addition, since representation of an institution can lead to the coveted and lucrative 'Lead Counsel' appointment for a law firm, many law firms are willing to represent institutions on a reduced fee schedule.

An institutional investor as lead plaintiff can increase recovery

Statistically, a securities class action in the United States will settle for a higher value if an institution is involved as lead plaintiff. One writer has stated that 'securities

class actions directed by institutional investors can significantly increase the recoveries to defrauded investors'.⁹ One study has found that having an institutional investor as lead plaintiff can result in a 100 per cent increase in settlement size, as the following chart indicates.¹⁰

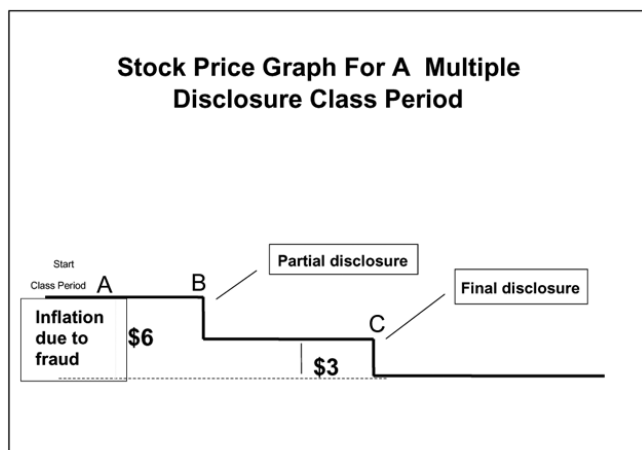


Thus, it is not surprising that the study's authors concluded in a prior study that 'The presence of an institutional investor as lead plaintiff is associated with an increase in settlement size,' even when controlling for such factors as estimated damages and the quality of the claims.¹¹ However, in 2005, which represented the high-water mark of institutional involvement in these cases, only 35 per cent of securities class action cases included an institutional lead plaintiff. Thus, by failing to consider serving as lead plaintiffs, your institutional client may be missing an opportunity to increase its recovery if it has been defrauded.

Ensuring your institutional client receives its fair share of a settlement

A lead plaintiff is barred by statute from receiving more than its proportionate share of a settlement. However, there are a great many decisions which have to be made when determining how to calculate a proportionate share. For example, if a security is subject to multiple partial disclosures during a class period, decisions will have to be made as to how to calculate recognised losses. One way to calculate those losses is to use the same formula regardless of when purchases are made during the class period. In a case with multiple partial disclosures of the fraud, such a formula works to the disadvantage of members who purchased at the beginning of the class period and who purchased shares inflated by the full effect of the fraud (line A-B on the illustration below), before the partial disclosures began to minimise the inflation caused by the fraud. As a lead plaintiff, an institutional investor can make its voice heard in order to apportion recognised losses so that those who purchased early in the class period have greater recognised losses than those who purchased after a partial disclosure (during period B-C in the illustration below). Likewise, if the institution purchased during the class period but after a partial disclosure (during B-C), it will want to ensure that the earlier purchasers (A-B) don't take too great a share of a recovery. As these examples suggest, absent active

participation in a case, your client will lose the ability to have a say in the plan of allocation of any recovery.



If your client doesn't take steps to be involved, it could be excluded

It is black-letter law that a plaintiff must have standing to pursue a case on behalf of the class it seeks to represent. At the lead plaintiff stage,¹² the lead plaintiff does not need to have standing to sue on behalf of each type of security offered by a company.¹³ However, eventually there must be a class representative¹⁴ for each type of security, or those claims will be dismissed.¹⁵ For example, if a lead plaintiff has purchased only the defendant's common stock, but the defendant has also issued preferred stock or bonds, there must be a class representative who purchased preferred stock or bonds during the class period in order to proceed with the claims related to the preferred stock or bond. Furthermore, there must be a class representative for each type of bond. If a class representative has purchased Series A bonds but not Series B bonds, only Series A bonds will be included in the class. This problem is especially acute for institutions because some bonds are offered only to institutional investors and absent an institutional class representative, there will be no class representative. An institution should ensure that the type of securities it purchased are included in the class definition and that there is a class representative for that type of security, or it runs the risk that the security it purchased will not be included in a recovery. Also, in a case with public offerings, including a purchaser from each underwriter of each offering will increase the number of defendants in a case and increase the pool of assets to fund a recovery.¹⁶

Recently, a class action against Van der Moolen Holding NV settled for US\$8 million for the benefit of purchasers of Van der Moolen ADRs on the New York Stock Exchange only.¹⁷ Despite the fact that 80 per cent of the trading in Van der Moolen securities occurred on European exchanges, purchasers on those exchanges were omitted from the class definition and will not share in the settlement.

An institution should protect a continuing investment

If your client is an institution, it is more likely to continue to hold the company's stock as opposed to 'flipping' the stock for short-term gains. Thus, it will consider the long-term effect of the lawsuit on the company, since it will continue to be a part owner of the company. Beyond the initial tangible benefit of obtaining a higher settlement (or getting the benefit of a settlement at all, given the risk of exclusion), institutions who act as lead plaintiff or class representative have the additional benefit of a decreased risk of being the victim of future fraud.

SETTLEMENTS MAY INCLUDE CORPORATE GOVERNANCE REFORMS

In the settlement context, a party may be successful in getting a company to agree to corporate governance changes that would be rejected out of hand if attempted through the usual channels of a proxy fight. Thus, a securities class action can be an instrument for positive and lasting change. Corporate reforms have been achieved by institutional investors in many securities class action settlements.¹⁸

CORPORATE REFORMS WILL PROTECT A CONTINUING INVESTMENT

Deficient corporate control environments, lack of audit oversight independence, inadequate management supervision by independent directors and a lack of vigorous insider trading policies and controls together create a corporate culture that encourages the occurrence of abuse and fraud. If an institution continues to hold stock in such a company, it will continue to be the victim of such abuse and fraud. Good corporate governance rules can create an environment where fraud is less likely to occur and institutional involvement in a securities class action can facilitate positive change. Corporate reforms that can be requested as part of a settlement include:

- requiring officers to hold 33 per cent of stock acquired upon option exercise for a year;
- requiring corporate directors to own a substantial equity stake in the corporation;
- indexing option exercise prices to market performance;
- forbidding stock option re-pricing without a shareholder vote;
- forbidding insider stock sales during stock repurchase programmes;
- forbidding accelerated vesting of stock options under change-of-control definitions that include merely a vote for a merger, rather than actual consummation of the merger itself;
- requiring a Corporate Ethics Officer with real authority and independent reporting responsibility to the board to promote ethical behaviour by executives;
- mandating the annual election of all directors;

- requiring two-thirds of the Board to be independent;
- appointing a lead director with specified powers and duties; and
- requiring that the Audit, Compensation, Nominating and Corporate Governance Committees be composed only of independent directors.

Immediate steps your institutional clients should be taking

An institution faces a wide variety of fiduciary duties, such as the duty to file claims and investigate cases, but there is an equally wide spectrum of services available to help an institution fulfil its fiduciary duties.

Filing proofs of claim in settled cases

The most obvious step an institution should take in any case is to ensure it receives its share of a settlement when another person or entity has instituted the litigation and carried it through to completion.¹⁹ While this may seem obvious,²⁰ fewer than 30 per cent of institutional investors file proofs of a claim,²¹ and it is estimated that European shareholders failed to claim US\$2.4 billion in settlement proceeds in 2003-04.²² When money is there for the taking, your client faces exposure to a lawsuit by its shareholders or clients if it fails to claim the money to which it is entitled.

There are services available that will monitor an institution's portfolio and administer the claims form process.²³ Alternatively, an institution can attempt to monitor pending class actions itself by, for instance, periodically checking the websites of claims administrators or leading plaintiffs' securities law firms.²⁴ It is also possible to simply rely on receiving a notice in the mail, but this strategy is not foolproof, as not every purchaser's name appears on transfer sheets (depending on whether the institution is a record or beneficial owner) and if the name does not appear, the notice must be forwarded through the claim of record owners. This can be time-consuming and the proof of claim form may not be received until after the claims filing deadline. In addition, it is possible for the notice to be discarded in the mailroom if the person opening it does not recognise it as a proof of claim form.

Acting as lead plaintiff and/or investigating claims

As shown above, it may not be enough for some institutions to merely participate in security class actions as silent class members and wait for a recovery. For one thing, a case might not be filed at all, and for want of a class representative the fraud could go unpunished and the institution could never recover its money. Secondly, absent a watchful eye, it is possible the security owned by the institution will be left out of a class definition. This problem is especially acute for foreign institutions, because without a representative

of purchasers on foreign exchanges the defendants will argue that such foreign exchange purchases shouldn't be included in the class.²⁵ Even worse, foreign institutions may not be included in the class definition in the first instance, leaving them no chance for recovery. Some institutions, perhaps motivated by privacy concerns, do all class action monitoring in-house. While this is a viable and perfectly acceptable option, it is no doubt an expensive and time-consuming task when performed in-house, and many institutions choose to outsource the task of monitoring their portfolios for possible fraud/negligence causes of action to a law firm or outside service. The more experienced US class action securities firms offer such a service (usually for free) and there are fee-based service providers who perform such services as well.

Conclusion

In many instances, international investors are entitled to the protection of the US securities laws. However, absent a diligent effort to claim money to which they are entitled and to ensure they are included in the class of investors entitled to the recovery, your clients may not be receiving the full benefits and protection of the US securities laws. The prudent outside (and in-house) counsel will work with international investors to ensure they are maximising the benefits they should be receiving from US securities class action cases.

Notes

- 1 Mr Murray is a member of Murray Frank & Sailer LLP, a law firm in New York. Mr Murray concentrates on securities and antitrust cases, representing individuals and institutions in individual and class action cases.
- 2 The courts principally look at the amount of fraudulent conduct in the US and the effect of the fraud in the US. See *Itoba v Lep Group PLC*, 54 F.3d 118, 121-22 (2d Cir 1995).
- 3 *In re DaimlerChrysler AG Sec Litig*, 216 FRD 291, 300-01 (D Del 2003).
- 4 Years later, holders of 1.8 per cent of Daimler-Benz shares were awarded €230 million in a German court proceeding, but this was a private action, not a class action. 'Daimler ordered to pay €230 million to investors', *Financial Times*, 22 Aug 2006, p 14.
- 5 See 'Restatement (Second) of Trusts', 177 ('The trustee is under a duty to the beneficiary to take reasonable steps to realise on claims which he holds in trust').
- 6 Kathy Hennessy, 'NJ plans to sue over pension fund losses', *AP*, 8 August 2002.
- 7 *McMahon v McDowell*, 794 F.2d 100, 112 (3d Cir 1986).
- 8 *In re Telxon Corp Sec Litig*, 98-CV-2876 (ND Ohio 2000). In 1998, the United States Secretary of Labour stated: '[a] fiduciary may have a duty to serve as lead plaintiff where no single individual has sufficient interest or resources to serve in such capacity or where, as a large stakeholder, the fiduciary has an interest in assuring that an alternate class representative with a less substantial stake in the outcome does not unduly compromise the interests of the class in settlement, fail to vigorously prosecute the actions, or fail to protect the interests of the class *vis-a-vis* its attorneys.'
- 9 John P Coffey and John C Browne, 'The Results Are In . . . Class Action Settlements Are Significantly Higher When Institutional Investors Act As Lead Plaintiffs', *Institutional Investor Advocate*, Volume 6, 2nd Quarter 2004.
- 10 Laura E Simmons and Ellen M Ryan, *Post-Reform Act Securities Lawsuits Settlements, 2005 Review and Analysis*, available at www.cornerstone.com.

- 11 Laura E Simmons and Ellen M Ryan, *Post-Reform Act Securities Lawsuits Settlement Reported through December 2003*, available at www.cornerstone.com.
- 12 A 'lead plaintiff' is chosen by the court at the outset of the case based on whether it has the 'largest financial interest' in the case relative to other movants (if any) for lead plaintiff status. The lead plaintiff chooses lead counsel to direct the action. See 15 USC § 78u-4(a)(3)(B)(III).
- 13 *In re Initial Public Offering Sec Litig*, 214 FRD 117, 122-23 (SDNY 2002).
- 14 A 'class representative' is designated under Fed R Civ P 23 to represent the interests of similarly situated persons and must have standing for each claim it seeks to assert.
- 15 *In re Enron Corp Sec, Deriv & ERISA Sec Litig*, 2004 WL 405886, at *24 (SD Tex Feb 25, 2004) (claims of certain bondholders dismissed because no class representatives had purchased those types of bonds).
- 16 See *In re Royal Ahold NV Sec Litig*, 03-MD-1539 (D Md) (underwriter dismissed from case since no plaintiff purchased from them on public offering was added back as a defendant later when additional institutions who purchased from underwriters stepped forward to act as class representative).
- 17 *In re Van der Moolen Holding NV Sec Litig*, 03-CV-8284 (SDNY).
- 18 See, eg, *In re Cendant Corp Litig*, No 98-cv-1664(WHW) (DNJ) (settlement included requiring Audit, Nominating, and Compensation Committees to be comprised only of independent directors; majority of Board of Directors to be independent; annual election of all directors; and prohibition against repricing options without shareholder approval); *Pirelli Armstrong Tire Corp Retiree Med Benefits Trust v Hanover Compressor Co*, H-02-0410 (SD Tex) (settlement required appointment of two new directors and enhanced independence requirements for Board members); *In re 3Com Sec Litig*, No C-97-21083-EAI (ND Cal) (settlement required 3Com to establish new position of Trading Compliance officer and for Audit Committee to be comprised of at least three directors, all of whom are independent); see also: Jay Eisenhofer, 'An Invaluable Tool In Corporate Reform; Pension Fund Leadership Improves Securities Litigation Process', *Pensions and Investments*, 29 Nov 2004, p12 (listing corporate therapeutics achieved in *Healthsouth*, *Siebel* and *Broadcom* cases).
- 19 'Institutional investors have a fiduciary responsibility to monitor securities class action suits and file claims on behalf of their clients.' Institutional Shareholder Services, Securities Class Action Services, at www.issproxy.com/institutional/analytics/scas.jsp.
- 20 *Stegall v Ladner*, 05-CV-10062 (D Mass).
- 21 See James D Cox and Randall S Thomas, 'Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of The Failure of Financial Institutions To Participate In Securities Class Action Settlements', 58 *Stan L Rev* 411, 413 (2005).
- 22 'Investors miss out on US pay-outs', *Financial Times*, 19 May 2005, at p 27.
- 23 See, eg, www.magenta-one.com; www.issproxy.com.
- 24 See, eg, www.berdonllp.com/claims; www.gilardi.com/php/current.php; www.gardencitygroup.com/cases/index.html; www.murrayfrank.com/cm/settledcases/settledcase.asp.
- 25 See *DaimlerChrysler*, discussed *supra* at note 3 and accompanying text.