Securities Litigation – Questions For Trustees

Introduction

Much has been written about securities litigation and, more specifically, securities class actions: the route by which shareholders seek to recoup losses incurred as a result of an act of fraud by a company, its directors, officers or advisers, or to change corporate governance practices. Worldcom and Enron have dominated the business pages frequently since they both went spectacularly bankrupt five years ago and, as a result of securities class actions against these companies or their advisers, substantial sums have been paid to shareholders by the banks and advisers involved. Securities class actions are primarily a US phenomenon but they do occur, albeit with much less frequency, in other jurisdictions (notably Canada, Australia and Netherlands). UK investors have become more active in joining class actions, occasionally as lead plaintiff; something which was virtually unheard of until only a few years ago. It has also become noticeable that more European companies are being sued by investors in the US, so, like it or not, class actions are becoming of greater interest to UK investors, including pension funds.

The principal potential benefits of joining a law suit are twofold: to gain compensation for real financial losses incurred; and to encourage reform of corporate governance practices at a company, thus protecting or enhancing shareholder value in the longer term.

That said, there are concerns that the flood of litigation ($18.3bn of settlements in 2006, according to ISS) has imposed a disproportionate cost on companies in terms of executives' time spent preparing for and defending suits instead of managing the business. In addition, the fear of litigation may act as a deterrent to individuals serving as directors thus weakening the quality of those overseeing management. It has also been argued that litigation risk might make management less entrepreneurial, of which there is little or no evidence in the US so far, and that it would result in a lowering in the quality of information provided to shareholders by management.

However we should recognise that given the limited shareholder rights and protections currently available (most notably the ability to vote a director off the board), litigation will continue to be a feature of the US system. UK pension funds have a growing investment in the US and therefore should not, without careful consideration of their reasons, ignore the potential to recoup losses or encourage better governance there.

Securities litigation is a complex area and the purpose of this note is not to restate all of the issues which trustees need to look at but to provide a checklist of questions which should be asked of managers and advisers by any trustees who aim to monitor securities litigation activity. For those who want more detail, publications from lawyers and advisers are readily available.

1. **Do trustees have a fiduciary duty to join a securities class action?**

   As far as we can ascertain, no UK trustee has been sued for not joining a securities class action. Even in the US a recent case against a group of mutual funds, alleging that leaving money on the table was a breach of their fiduciary duties, did not come to court. That said, it seems self-evident that trustees have a duty to protect the assets in their scheme and that they should therefore at the very least not neglect opportunities to recoup losses, where the cost and effort are commensurate with the expected return.

   It is normally possible for a shareholder to join a SCA after it has been settled but before payments are made to the plaintiffs. Thus it is important that an investor is able to track outstanding lawsuits and several service providers, as well as specialist US law firms, exist to help with this process. A more complicated question is whether they should act as lead plaintiff (on which see below) and trustees should decide as a policy matter whether they are prepared to act as lead plaintiff and in what circumstances.

   Derivative suits, alleging breach of fiduciary duty, can also be brought by an existing shareholder on behalf of the company against its officers and directors. Damages, if any, are paid to the company, rather than to investors, and are met by the defendants or, possibly, Directors' & Officers' insurance. The plaintiff lawyers, as with all shareholder litigation, receive their fees as a proportion of the recoveries and on a contingency basis. Although investor plaintiffs are unlikely to receive a direct financial gain from the successful pursuit of a derivative action, this route has been seen as a way of encouraging governance reform and better behaviour on the part of directors.

2. **Who can claim and how?**

   In the US, investors are automatically part of a suit unless they have been specifically excluded or choose to opt out. Thus claiming is a matter of completing a prescribed form, providing evidence (e.g. transaction statements) of holdings and dealings during the qualifying period (the class period) and any other required information and sending it to the claims administrator. However, completing forms and lodging claims are not straightforward and using expert assistance is often worthwhile. A fund's custodian would be the usual starting point.

3. **Who should take responsibility for notifying a pension fund of the existence of a class action?**

   The manager who invested in the stock may have some responsibility, but in practice the custodian banks are much better placed to act on behalf of the trustees as they should have a complete record of holdings and transactions. A good custodian should, as part of a corporate actions service, advise his clients to claim on settled cases by the appropriate deadline. Some will, in addition, assist their clients in making the claim.

Those funds who wish to consider the possibility of becoming a lead plaintiff, challenging the appointment of the lead plaintiff, or of launching a suit independently in the limited time frame available will need early warning of a class suit. Again, US law firms provide such a service.

Litigation is handled on a no-win-no-fee, contingency basis, meaning that all up-front costs are borne by the law firm. Where institutional investors become lead plaintiff the lawyers' fees are reduced and rarely rise above 25% of recoveries.

4. **Who are the service providers?**

In addition to lawyers and custodian banks, there are specialist firms who provide notification and/or advice on class actions. Monitoring is complicated where fund managers or custodians have changed.

5. **Should UK pension funds act as lead plaintiffs or as active participants?**

UK funds have acted as lead plaintiffs, but rarely. There are times when it may be necessary as US courts have in the past occasionally excluded foreign shareholders. The commitment of time required should not be underestimated nor should the likelihood of intrusive disclosure requests from the defendants' lawyers which will be far greater than the requirements generally needed to claim in a settled case. This may involve attending a court in the US.

Trustees will need to assess the costs and risks as against the scale of the losses incurred. Even where lawyers are remunerated on a contingency basis, the indirect financial costs should not be underestimated. There is also some reputational risk, although the reality is that this has been small to date. Against that, it should be noted that recoveries are on average one-third higher where an institutional investor is the lead plaintiff.

In the US, many pension funds request a loss calculation from their adviser once a suit is filed which can be used to determine if the fund should become a lead plaintiff.

6. **Why are class actions rare in the UK/Europe?**

There are complex legal and practical reasons for this, which include how lawyers are paid and the existence, in the UK at least, of procedural impediments to acting as a class. However they are not unknown and are evolving in some jurisdictions. In the UK, the Group Litigation Order is available although so far its main use by pension fund trustees has been against HMRC on tax issues. Also, in the UK, the loser bears the winner's costs, which adds risk and acts as a deterrent to filing a suit.

7. **What are the risks?**

   The main direct risk to the plaintiff is reputational and only where the fund has acted as lead plaintiff. Even should an action fail, the likely damage would appear small, but it important that trustees have assessed the reputational risk before embarking on a suit.

8. **What are the costs?**

   Service providers charge a fee for supplying data and advice. However there are very material differences between the costs of entering into a suit and those of claiming in a settled case. The former involves instructing lawyers and will normally be on a contingency fee basis although it is possible to go for a time-expended approach. The latter may be provided by the client's custodian as part of the overall service, but some charge fees. The claims processing services generally charge fixed fees on a transaction basis but one or two providers offer a contingency fee on the basis of a share of the proceeds recovered. There are additional costs in terms of management time and training which trustees need to take into account.

9. **What about pooled funds?**

   It is reasonable to expect pooled fund managers to pursue class actions on behalf of their investors. Trustees should ask their managers about their policy.

10. **Reporting to trustees.**

    Trustees should request periodic reports from their advisers on class actions including the number of claims outstanding, claims filed and the monies received over the period. A manager who is involved in several class actions may warrant additional questions from the trustees.