US Shareholder Litigation: A Primer for European Institutional Investors[1]

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Foreword

Shareholder litigation, while commonplace among US investors for some time now, has only recently crossed the Atlantic to European investors. The last few years have seen not only a rapidly increasing awareness of securities class actions, derivative actions, and direct actions by institutional investors based in Europe, but also a deluge of US law firms seeking to be retained by these investors to represent them in such cases. The authors of this paper saw a need to raise awareness with respect to US shareholder litigation to assist investors in getting through the sales pitches and understanding what this type of engagement is about, and what the benefits can be under the right circumstances. We hope that this primer will prove useful and provide the first step for many investors in developing a system to consider, monitor, and evaluate what is becoming an important tool for investors worldwide. We would like to thank all of those who assisted in compiling the information for this piece and helped with the seemingly endless editing process. This includes David Russell of Universities Superannuation Scheme; David Kessler, Stuart L. Berman, and Sean M. Handler, attorneys at Schiffrin & Barroway, LLP; and those who wish to remain anonymous.

Executive Summary

Active share ownership is on the rise globally and one form of this activism, US based shareholder litigation, has begun to be adopted by European institutional investors. It is not widely recognised that one of the main goals of active shareowners in shareholder litigation today is to increase the long-term value of the defendant companies through changes in corporate governance and corporate behaviour. Indeed, it can be seen as an additional tool that active shareowners have in their engagement armoury. Thus, as shareholders in US companies are afforded few rights, the courts have become an arena for addressing corporate malfeasance, implementing corporate governance changes and, of course recovering losses.

Shareholder litigation, in the form of securities class actions (a standard class action where investors sue on behalf of themselves and all other similar investors), derivative actions (where an investor sues certain officers and directors or third parties on behalf of the company itself), and direct actions (where one or a small group of investors bring their own claims against a company seeking either financial remuneration, a specific reform in corporate behaviour or some other redress) involving companies like News Corporation, Tenet Healthcare, Fairchild Corp., AOL/TimeWarner, Royal Ahold, and others, have set important legal precedents, significantly improved corporate governance, and returned money to investors and corporate coffers. The unfolding 'derivative' action against Viacom, Inc. may well extend those precedents into the process of how executive compensation levels are set.

The perception that shareholder litigation simply serves the purpose of draining corporate resources and lining the pockets of attorneys is no longer true. The reality is that under the proper circumstances shareholder litigation can leave the target company in better shape than it was found, thereby creating more value.

Some of the important changes and reforms that have been achieved in shareholder litigation include:

- separating the roles of CEO and Chairman,
- appointment of shareholder-nominated Directors,
- declassifying the board so that all Directors must stand for election annually,
- reforms in executive compensation,
- limiting outside auditors strictly to the auditing function,
- requiring a 3 to 5 year rotation of outside auditors,
- mandating use of stock options for executive officers or restricted stock that vests over time.

Whilst there has been some involvement of European investors in such actions, the majority of European institutions are still unaware of how effectively non-US investors can become engaged in US based shareholder litigation — particularly when working in collaboration with other investors, both US and non-US. Two excellent examples of such cross-border cooperation are the News Corp case (which saw institutional investors from Europe, Australia, and the United States join forces to reverse a broken promise to investors from the company's management), and the Delphi Corp. securities class action (where institutional investors from Europe and the US are serving together as lead plaintiffs).

At a minimum it would appear that institutional investors have a fiduciary obligation to participate in the monetary settlements that result from shareholder litigation. With many billions of dollars available to investors each year, for which collecting only requires the completion of the proper paperwork, there is a risk to not pursuing these settlements. Investors with any significant investment in US securities should establish a mechanism for reviewing shareholder litigation and settlements that may affect them.

Background to the primer

The involvement of European institutional investors in US-based shareholder litigation is still in its infancy.[4] Only a few such investors have taken the lead or co-lead plaintiff role or collected their share of the myriad of settlements coming down the pipeline each year. The majority are losing out on millions of Euros simply because they fail to file a proof of claim form in cases which have reached settlement. However, one of a few bright spots is the recent corporate governance settlement reached in a direct action against News Corp (explored in more detail on pages 5 and 6) with a group of Australian, Dutch, UK and US institutional investors. In addition, European institutional investors have recently sought lead plaintiff positions in high-profile securities class actions against companies such as Delphi Corp., UnitedHealth Group, Pfizer, Inc., Parmalat, and Merck & Co. Inc. Further, in many instances these European institutions teamed up with US based institutional investors. We hope that this is a harbinger of things to come.

European investors put forward a variety of reasons to explain their historic lack of participation: a fear of the US system of litigation, a lack of familiarity with the leading US firms in this field, a lack of trust as to the motives of some of these firms, and misunderstandings about the contingency fee system, pursuant to which class action law firms get paid in the US. Also, there is scepticism about the size and scope of the losses and potential recoveries, both monetary and through corporate governance reforms. That scepticism extends to questioning the wisdom of suing a company in which you still own shares. Lastly, many institutional investors cling to the traditional cultural response that 'we just don't do that sort of thing in Europe.'

We believe the time is now ripe for a more structured debate about the opportunities and challenges facing European institutional investors related to US-based shareholder litigation. Capital market changes are driving ever higher cross-border investments, most notably in US equities, given the country's standing as having the most liquid of all capital markets. Europe is now living through a period of falling or low investment returns relative to the 1990s, while many pension funds face huge unfunded liabilities. And, because of the shifting boundaries of fiduciary duties, non-engagement could bring its own costs to institutional investors and trustees who simply continue to ignore the trends.[5]

Against that background, our intention here is to present a more objective analysis of the history and trends within US securities class actions. We aim to enable other institutional investors to consider their merits or faults based on facts, as opposed to the previous rhetoric and misconceptions that have customarily surrounded public discourse on this issue. From that, we hope to spark a larger debate.

With that aim in mind, this paper is structured as follows.

SECTION 1: Discusses passive and active activities that could be used by active shareowners when considering shareholder litigation as an engagement tool. It then answers the question 'why sue a company (especially in the US) that we own?'; and tackles the point: 'we just don't do that sort of thing in Europe.'

SECTION 2: Raises to the forefront the issue that we believe is a key consideration for European active shareowners: corporate governance. It examines in detail how investors can achieve corporate governance reform through shareholder litigation, and gives examples of the type of reforms that already have been achieved. It also draws attention to the case for active engagers to move beyond remedial actions, and to become proactive on a wider range of issues, in addition to leading-edge corporate governance reforms.

SECTION 3: A primer to shareholder litigation discusses the origins and legislative changes, along with capital market developments that have changed the landscape.

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[4] Commentators generally use the expressions, 'securities class actions,' or 'shareholder litigation' interchangeably to describe the same thing. This paper continues that tradition.

[5] Indeed, a high-level group recently took the view that governance, environmental and social issues are material to the value of a company, thereby falling within the definition of a fiduciary duty for investors. *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*. A report produced for the Asset Management Working Group of the UNEP Finance Initiative. Freshfields Bruckhaus Derringer, October 2005.

SECTION 4: Highlights some of the most important topics within securities class actions currently: the mechanics of bringing a case forward; recent trends in the number of cases, investor losses and recoveries; the emergence of creative settlements; and the administrative and financial costs of participation by investors.

SECTION 5: Offers concluding remarks.

1. Shareholder litigation and engagement

a. Passive and active approaches

In the context of considering the use of shareholder litigation as an engagement tool, litigation can be seen as a spectrum ranging from passive to active approaches. Investors who only pursue a passive approach to shareholder litigation would expect their custodial banks to file settlement claims or file them in-house on an ad-hoc basis, or even retain an external consultant to file all settlement claims.[6] By contrast, investors who have adopted an active approach towards litigation could have a lawsuit filing notification agreement with a specialist agency, either independent, tied to a law firm, or with a specialist class action law firm. These law firms/agencies monitor the fund's US portfolio, alerting the fund when new cases are filed in which it has a potential claim or advising the fund about when to seek a leadership role, file a separate case or play some other active role in those securities class action cases where the size of its losses warrant such action. Furthermore, these firms can often assist the fund in recovering its share of all settlements to which it is entitled.[7]

b. Investors' rights, and why sue a company (especially in the US) that we own

Our answer to the European question of 'why sue a company (especially in the US) that we own?' is a simple one. For those European investors who see themselves as active engagers, it is a tactical instrument to help achieve their goal of changing corporate behaviour and increasing value. In that sense, dialogue is also a tactical tool. It works in most countries and with a minority of US companies. But when it comes to the majority of US companies, active engagers may have little choice but to consider litigation in the US.[8]

As will be seen in section 2 below, shareholders in the US have few rights to effect real change in the companies in which they invest. Their votes on shareholder resolutions are non-binding, and except in rare instances they can neither nominate directors independently of management, nor vote against the management's slate of proposed directors; they can only withhold their support. Recent attempts by the SEC to change the director nomination and election process were roundly defeated by organised business. Moreover, the State of Delaware and its judiciary, where the overwhelming majority of US publicly traded companies are incorporated, has historically been very favourable to companies and their boards. Seen in that light, attempts by European investors to initiate a dialogue to effect change would, at many companies, risk being soundly rejected.

The News Corp case referenced in the introduction is illustrative of the impact that US and non-US investors can have when acting together. To briefly recap, in August 2005, News Corp's Board unilaterally extended the term of the company's 'poison pill,' despite having reached an agreement the previous year with a group of

[6] External consultants typically charge a fee for filing claims.

[7] In this instance some US firms monitor an institutional investor's US portfolio, and handle the claims administration system at no cost. Some allege that conflicts of interest have arisen in regard to those arrangements, where the same firm could earn a substantial fee from ensuing litigation. However, some investors view choosing a reputable firm as sufficient to overcome this potential problem. For others, use of an independent law firm to evaluate and advise on what to do when a monitoring firm recommends that the fund take a leadership role in a lawsuit may be appropriate. It should be noted however that the quality of these portfolio monitoring programs may vary considerably from firm to firm. Funds should conduct their due diligence to ensure they are getting the most complete and high quality service. Funds may also want to consider adoption of policies to guide them in making decisions on when it is appropriate to take an active role in securities litigation.

[8] As regards shareholder/director communications, the following illustrates the state of play: 'There is virtually no effective mechanism for communication between shareholders of large public companies and boards of directors. Most executives actively discourage or even forbid independent directors from communicating with shareholders.' Scott C. Newquist, with Max B. Russell, *Putting Investors First: Real Solutions for Better Corporate Governance* (New York: Bloomberg Press, 2003), p 116.

international institutional investors to submit any such extensions to a shareholder vote.[9] The prior agreement had facilitated the investors' acceptance of Rupert Murdoch's proposal to relocate the company from Australia to the more corporate-friendly US state of Delaware.[10]

Unhappy with News Corp's failure to meet the terms of the agreement, the shareholders sought to dialogue with Murdoch, and News Corp's Board, but to no avail. Left with no other viable recourse, the institutional investors from Australia, the Netherlands, the UK and the US filed a suit on October 2005 in the Chancery Court of Delaware. The main aim of the suit was to get the 'poison pill' Murdoch had initiated put to a shareholder vote, in line with the original agreement between the two sides.

Murdoch and other board members tried to dismiss the suit on the grounds that notwithstanding any formal agreement with shareholders, the board has ultimate decision-making power. The Judge rejected that argument in an interim ruling in December 2005, allowing the case to go forward to trial. In a state renowned for its pro-business legal framework, this alone was a major victory for shareholder rights. Murdoch and the board members asked the Delaware Supreme Court to hear an immediate appeal of that decision, but the Court declined to do so. Murdoch could still have filed an appeal after trial, but in a dramatic turnaround ahead of the scheduled 24 April 2006 trial date, the News Corp Board suddenly backed down and agreed to a settlement whereby it will refer the extension of the 'poison pill' to shareholders at the October 2006 Annual General Meeting. The settlement means that the Judge's decision will stand and cannot be appealed. The Judge's recognition that management and directors are accountable to shareholders under Delaware law has ramifications for corporate behaviour across the whole of the USA.[11]

The News Corp case exemplifies how some CEOs view shareholders and their referenced pursuit of high standards of corporate governance in investees; and on the other hand, how determined shareholders, both US and non-US, can use American law to protect their rights and interests. That certainly seems to be the view of Michael O'Sullivan, President of the Australian Council of Superannuation Investors, who took a lead role in co-ordinating the shareholder campaign, when he commented: 'Our decision to pursue the action in the Delaware court, is a message to News Corp and to other companies, that long term investors expect agreements between companies and shareholders to be honoured. . . . Perhaps the major achievement for shareholders is the demonstration that international co-operation between institutional investors gets results.'[12]

Notwithstanding the above, there are some who argue that the correct market response is for investors to sell their shares, and to walk away from their responsibilities — 'vote with their feet,' as the saying goes. However, the 'exit strategy' approach undermines the strategic principle of active and responsible engagement (to invest for the long term and to engage, when necessary, to voice concerns and/or to bring about change). Moreover, such an approach could increase equity volatility, and in a world of indexing is not always feasible.

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[9] Poison pills or shareholder rights plans are devices used by incumbent management to block potential take-overs.

[10] Key to understanding the investors' decision to litigate against News Corp and individual directors, including Rupert Murdoch, is the intense negotiations that took place between the two sides over the board's proposal to move the company's corporate domicile from Australia to the more 'business friendly' US State of Delaware in 2004. Shareholders sought and gained changes to the new Delaware certificate of incorporation. One of the contentious issues, namely that the extension of a poison pill provision would require the approval of the shareholders, was seemingly solved when the board adopted a policy to that effect. On 11 August 2005, News Corp unilaterally announced its intentions to extend the provisions for a further two years, thereby contravening the Board Policy and the agreement with the shareholders.

[11] Two issues from this case are particularly intriguing as regards the historic allegiance of the State of Delaware and corporate executives, and the tensions it creates with key aspects of globalization. The first issue is the changing nature of capital markets, where multi-billion dollar institutional shareholders, increasingly wishing to exercise their ownership rights, are now the norm. As noted by the Judge, 'It would threaten widely held investor expectations if a Delaware court were to decide that shareholders are outsiders . . . and not in some sense the "owners" of the corporation with authority to exert themselves collectively via "voice" and not only via "exit".' The second issue is the problems that could arise where non-US investors seeking to take seriously their ownership responsibilities could negatively impact Delaware's corporate future. The Judge reflected that dismissing the case would, '. . . decrease the likelihood that a foreign company would gain shareholder approval to reincorporate into Delaware (as) shareholders in the foreign company would have no confidence that promises or representations regarding the foreign company's corporate governance made to induce their favourable vote would be enforceable under Delaware law.'

[12] Australian Council of Superannuation Investors press release, 'News Corp Surrenders on Poison Pill, Shareholders Will Decide,' 7 April 2006. See http://www.acsi.org.au

c. Investors' responsibilities as well as rights

Lest it be forgotten, when a securities class action is pursued, those who bear the brunt of the losses that gave rise to the case are the ultimate beneficiaries. Ergo, the ultimate responsibility of these institutional investors is their fiduciary duty to pensioners, savers and unit holders. From that, the response of European institutional investors that 'we just don't do that sort of thing in Europe' raises questions as to whether they are being derelict in their duties of loyalty and care, particularly in the area of filing to collect on settlement claims.[13]

The concept of active engagement and responsible investment extends as well to the investee company. Corporate fraud and malfeasance are not just about corporate insiders enriching themselves at the expense of shareholders and other stakeholders. It has a corrosive and toxic effect on the company itself. Pursued correctly, investors can leave the investee company in much better shape than was the case when the fraud and malfeasance occurred. As will be seen, that applies especially if forward-looking corporate governance changes are implemented through a derivative action, where any recovery stays with the company rather than being distributed to shareholders.

In today's world, leaving shareholder litigation to other agents is not a realistic option. For a variety of reasons, external investment managers and others who could fulfil that role are often either legally unable or unwilling to unilaterally effect change on investors' behalf. That applies to recovering financial settlements, effecting corporate governance reforms, and getting involved in shareholder litigation. The contractual arrangements between fund owners and their clients often do not include any reference to the various forms of active engagement. While all yield differing outcomes, the root causes of the problems are the same: ignorance, skewed incentive systems, and rampant conflicts of interest, some of which may be solved through market mechanisms, and some through public policy. As a result, many have concluded that European pension funds and other institutional investors should seriously consider incorporating shareholder litigation as a tactical weapon, into their active engagement arsenal. They should consider taking action in the right situations, whether it is recovering settlement money, initiating corporate governance reforms, taking an active role in shareholder litigation when appropriate, or some combination thereof. The question then, is why and how to take action.

2. Shareholder litigation and corporate governance reforms

The serial nature of corporate scandals has catapulted corporate governance to the forefront of public policy debate and action. Recent national-level reforms in many countries are welcome. However, some point to gaps in some key countries, especially around implementation and enforcement.[14] Shareholder litigation is, in our view, a complementary mechanism to regulation for institutional investors looking to effect meaningful corporate governance reforms. Indeed, its use to secure such reforms has dramatically increased in the last few years, with some investors now demanding significant governance changes alongside financial recoveries. The Wall Street Journal, quoting a recent NERA study, noted that some investors are willing to see reduced payouts in return for governance reforms.[15] There need not, however, be an inherent trade-off between maximising financial recoveries and achieving governance reforms. A hands-on lead plaintiff and skilled counsel can achieve both. Furthermore, this gives institutional investors the opportunity to seek forward-looking reforms, and not just remedial ones. One proposal that may warrant further discussion among institutional investors and other willing actors — but is not a subject of this paper — is the possibility of setting aside a small percentage of recoveries (say ten or twenty percent) to fund proactive programme efforts to improve corporate governance and attack corporate fraud and mismanagement at their source.

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[13] This point is taken up by Professors James D. Cox and Randall S. Thomas (reference below) in their work, and is a strong conclusion of the UNEP Finance initiative report cited in 5.

[14] Some have questioned whether the Sarbanes-Oxley legislation (enacted in 2002) which requires, among other things, corporate executives to certify the accuracy of their financial results, has fundamentally changed the attitude of corporate officers to fraud and malfeasance.

[15] 'Governance at Gunpoint,' Phyliss Plitch, The Wall Street Journal, 17 October 2005.

Three avenues exist to effect corporate governance changes. The first arises through a standard securities class action, where the lead plaintiff can demand governance reforms as part of any settlement. The second avenue is through an independent 'derivative action.' Derivative actions are utilized where breaches of fiduciary duty occur, regardless of whether fraud or malfeasance may have occurred. In this case, the shareholder(s) move on behalf of and for the benefit of the company itself, which has failed to pursue recovery from the harmful activities of its corporate officers or executives due to conflict of interest. The third avenue, which is a recent trend, is a direct action by one or a small group of investors regarding a particular issue. The previously detailed News Corp case is the most prominent example of this type of action. The goal is to secure corporate governance reforms (pay for performance plans resulting in deep cuts in executive compensation, for example, are now increasing) to change the future behaviour of the board, its committees, executives, and management, such that the governance failure that gave rise to the action is less likely to occur in the future. One further advantage is that because the litigation is done through the judicial system, the settlement and its attendant governance reforms are legally binding on the corporation.

The reasoning behind this approach is readily understandable once the following is clear: contrary to the prevailing mythology, there is little 'shareholder democracy' when it comes to US corporations. Shareholders cannot nominate their own director candidates independently of management, short of engaging in an expensive proxy fight, nor can they vote against those put forward by management. Their only option is to withhold voting support, with the result that the management slate still wins. That, along with poison pills and staggered elections, can entrench a board, whose loyalties may primarily be to the CEO and other insider directors. Further compounding the problem is the fact that shareholder resolutions, even when passed by an overwhelming majority, typically have only an 'advisory' status. Management may, if it wishes, simply ignore the vote. The only effective redress offered by the regulatory system governing ownership and control is for shareholders to wage what is in effect a full blown take-over battle, with the associated huge financial and political costs.

When confronted by that situation, it should come as no surprise that institutional investors are pursuing corporate governance reforms as part and parcel of securities class actions and derivative actions. They, along with their representative counsel, are winning some major changes. Many changes have focused on the composition of the board, as well as the structure of other groups such as committees.

Corporate governance reforms have included enabling institutional investors to nominate and elect their own board members; splitting of the CEO and Chair roles; the creation of specialist board committees composed entirely of independent directors (with strict definitions of independence); and term limits for directors accompanied by non-staggered elections. The limiting or halting of multiple directorships and the removal of shareholder rights plans (poison pill provisions) also feature prominently. Moves to link executive pay to performance have been realised, along with moves restricting stock option awards. Similarly, strict controls against insider trading and related-party transactions are being introduced. As regards accounting issues, the banning for audit firms of all non-audit work to the company, precluding the provision of personal tax or financial planning advice to any officer or director, and the regular rotation of audit firms have all have been part of corporate governance reform settlements.

Interesting as those general examples are, readers will gain a better flavour of the dynamics of achieving corporate governance reforms by looking at particular cases, shown on the following page.

The case against Abercrombie & Fitch was based on the CEO's compensation package, agreed to by the Compensation Committee, but which bore no relation to any accepted performance measures. The approval of such an unrealistic pay package by the Committee was seen as a clear breach of fiduciary duty, just as the total lack of transparency in communicating it to investors was viewed as a breach of their duty to disclose. It initially consisted of huge increases in base pay, a $12 million 'stay bonus,' transportation perks, a potentially crippling retirement plan, and massive stock options. Following litigation, the 'stay bonus' was cut by half, stringent performance targets were required, no payout was introduced should the company fail to meet the targets, and stock options were eliminated. Moreover, extensive governance changes were made to the composition of the Compensation Committee to help prevent such abuses occurring in future: the Committee was reconstituted with a majority of non-executive directors (one executive director was barred from the Committee), strict limits were set on the number of executive directors, and independent counsel and compensation consultants were retained. Significant changes were also implemented to the company's disclosure regime, including the expensing of all stock options, prior to corresponding changes in the accounting rules.

The charges against Charter Communications were that key executives had falsely inflated subscriber numbers and subscriber growth figures (with dysfunctional corporate practices that systematised the problem) to falsely inflate the stock price, alongside problems with several accounting practices. In the event, the settlement ensured, among other things, that the company's bylaws were amended to include a totally new set of corporate governance principles. These were designed to prohibit the inflation of subscriber numbers through the creation of a new corporate compliance programme (including an externally managed and anonymous 'whistle-blower' scheme, overseen by an accountable Corporate Compliance Committee). At the same time a new Disclosure Committee was created to better ensure that the Company's SEC filings are materially correct and SEC compliant. The Audit Committee was thoroughly revamped, and its membership, organisation, remit and reporting practices are now in line with the current best practices of corporate governance.

The HealthSouth settlement delivered important board-level reforms for institutional investors that the regulatory system is still unable to deliver. A central theme that the lead plaintiff (the Teachers Retirement System of Louisiana — TRSL) had to address was how to reconstitute the board that had been in place at the time that a massive fraud was executed (HealthSouth's reported earnings had been overstated by more than $2.4 billion, among other things). The solution reached in the settlement was the resignation of five directors, with the creation of a nomination committee, comprised of an appointee of the TRSL, up to three individuals serving on behalf of other large institutional investors, and a representative of HealthSouth. That settlement serves as a reminder that shareholder litigation can bring shareholder democracy where none exists in the US.

The action on behalf of Sprint Corporation against its top executives and board arose after their particularly audacious attempt to loot the company. At the time, Sprint and WorldCom, then the world's No. 2 and No. 3 long distance carriers, were in discussions about a possible merger. Prior to that, Sprint's shareholders had approved a 'change of control' provision, which came into effect upon the sale of the company, or the finalisation of a merger. However, during the merger/takeover discussions, the executives agreed in secret to make the change of control provision contingent solely upon a shareholder vote in favour of a merger/takeover, irrespective of the actual outcome. They also knew that in the event of shareholders agreeing to any merger/takeover then either the US or European competition authorities would likely block the deal. The shareholders, unaware of what was going on, approved the deal. Sprint's top officers then awarded themselves over one billion dollars in stock options, which they promptly cashed in. For their part the regulators then blocked the deal, but by then the damage was done. The subsequent derivative action did cement in place a cast-iron provision that no change of control provision could occur outside of a merger/takeover actually occurring.

We believe that derivative actions have proved to be a powerful tool for institutional investors in achieving real corporate governance reforms in the US, and that their use will spread. Alert readers will have noticed, however, that the examples we cite above are all remedial in nature. On that note, we further believe that leading-edge active engagers will soon initiate proactive derivative actions on a range of front-burner corporate governance issues. These actions will aim, for example, to strip out poison pill provisions, or to put in place new executive compensation systems and packages that firmly anchor them to realistic performance targets, as well as to block imprudent acquisitions. Similarly, those investors with a focus on environmental and other extra-financial issues could work with experienced counsel to initiate forward-looking changes to corporate behaviour in these areas.

3. A primer to shareholder litigation

What follows is a summary guide to the history of US securities class actions. It will focus especially on their post-1995 evolution, when US legislators brought institutional investors, particularly pension funds, into play with the passage of the Private Securities Litigation Reform Act ('PSLRA'). The origins of the PSLRA lie in the legislative and regulatory reforms passed in the 1930s to respond to waves of corporate scandals. The intention of those reforms was to protect investors, and wider financial market integrity, beginning with the 1934 Securities Act (the '34 Act').

In essence, when individual investors have suffered damages from a common wrong, they may move forward to initiate legal proceedings against the executive officers and directors of an investee company whose action has negatively impacted their investments. Usually, though not exclusively, this occurs in a Federal court. In general, the shares of the investee must be traded on a US securities exchange, such as the New York Stock Exchange or NASDAQ. Crucially, the company need not be domiciled in the US, nor need the investor seeking redress.

At the time of the 34 Act, and for many years thereafter, equity ownership was the domain of individuals. Therefore, it was they who first sought the position of lead plaintiff in securities class actions, which were authorized in the US with the enactment of Rule 23 of the federal rules of civil procedure in 1966. It remained that way until major changes occurred in capital markets, whereby institutional funds, especially pension funds became the dominant financial market actors. Their role as preferred lead plaintiffs was then institutionalised by the PSLRA.[16]

Critics of the PSLRA have said that some provisions did weaken safeguards against fraud, by tightening the burden of proof requirements for investors, making it extremely difficult for corporate victims to prove wrongdoing. From this viewpoint, it strengthened immunity for those companies producing false statements — known in the jargon as 'Safe Harbours.' On the other hand, a new aspect of the PSLRA encouraged institutional investors to take the lead and serve as the controlling party in shareholder litigation.[17]

The new 'lead plaintiff' provision of the PSLRA intended that the investor or group of investors with the largest financial interest in the litigation that has come forward to the court would lead the litigation, and not the lawyer who first filed the case. This eliminated what was referred to as the 'race to the courthouse.' No longer could an investor with very few shares of a company's stock become a lead plaintiff simply because their lawyer was able to file a complaint quickly. Rather, large investors now have time to evaluate their losses and the merits of a particular case. They bring to the table their attendant power, skills, expertise and resources to better control the process and outcome. They have the ability to best represent the interests of the class, determine corporate governance measures, negotiate a settlement, or go to trial (though that is very rare). In addition, they have been very successful in significantly reducing attorneys' fees, leaving more money to the class.

[16] In 1950, for example, households held around 90 percent of issued US stocks, but by 1994, that figure had shrunk to 48 percent. By contrast, the percentage of shares held today by institutional investors has reached 60 percent in the US, and 70 percent in the UK.

[17] The Act was narrowly passed when the Republican Party took control of the House and Senate in the 1994 mid-term elections. President Clinton had vetoed it, but Congress overrode the veto.

4. Key hot topics within shareholder litigation

a. The securities class action litigation process

The actions of executive officers of public companies listed on the US stock markets (whether domestic or foreign) are bound by a series of civil and criminal laws and regulations. Securities class actions may be brought under common law in the US judicial system, and are typically brought against the officers of the companies for a range of offences (parallel derivative actions are dealt with below).

Direct financial fraud against the interests of investors is the obvious infringement, but so too are accounting and non-accounting matters. Of the former, providing misleading statements to the market about future earnings and profits, with the expectation of inflating the share price above its warranted value is common in such suits. This is sometimes followed by a re-statement of the company's financial results at some future point, where the stock drops in value as the market adjusts to the true situation, incurring investor losses. As regards the latter, the dramatic over-statement of future earning estimates is also common in these suits, when in fact the corporate officers and executives are either reckless, or know full well that the numbers would not be met. Common, too, is talking-up a new product, a future merger or an 'exciting' acquisition with the expectation of boosting share price by virtue of the news alone when in reality, nothing of the sort is likely.

Once the judge appoints an investor (or group of investors) as lead or co-lead plaintiff, and its law firm as lead counsel, a formalised process begins. The amended complaint laying out grounds for the case is drafted by the law firm. After research and investigation by counsel (at their own expense) the draft complaint is reviewed by the client, and then filed with the court if it meets with the lead plaintiff's approval. The typical response by defendants is to file a motion to dismiss the case, especially since the PSLRA does not allow the plaintiff to demand evidentiary discovery (production of documents and taking of oral depositions) until after the judge has ruled on the motion to dismiss. The judge's ruling on the motion to dismiss is pivotal, but it may be that the court's decision is not rendered for some long period of time following the filing of the initial complaint. If the complaint is sustained, the process continues with document discovery,[18] the certification of the class and its members, and depositions.

Once all fact discovery is complete, the parties engage experts to render opinions regarding, among other issues, the amount of damages suffered by the class. This is a key issue, as a portion of the losses incurred by investors in most cases may be the result of normal market factors rather than the fraud. Thereafter, the parties prepare for trial. However, due to the enormity of the amount at stake for defendants and the risk that shareholders might not prevail, most securities class actions do not proceed through the pre-trial process described here, and settle either before or during the discovery process. The settlement process is ordinarily the juncture in the litigation at which the lead plaintiff plays its greatest and most important role, establishing, with the assistance of its counsel and possibly experts, the range of recovery it wants for the class.

It is well established that courts in the US encourage the early resolution of complex litigation, and through a variety of different avenues, the parties often find themselves in settlement discussions or mediation while the motion to dismiss is pending, or soon after the court's decision is known. The conclusion of the motion to dismiss briefing process, which discloses for each side the other side's strengths and weaknesses, often brings parties in the strongest and weakest cases to the table.

Cases that settle after the court decides the motion to dismiss most often are resolved through private or court-assisted mediation. Once the court has rendered a decision for the motion to dismiss, many courts either actively direct, or at least, encourage parties to engage in 'alternative dispute resolution.' In some jurisdictions, the parties must complete forms choosing their preferred type of private dispute resolution, and the very act of completing the forms often motivates the parties to talk. In other cases, courts refer parties for settlement conferences with a court-appointed magistrate whether the parties believe themselves to be amenable to talking, or not. Courts sometimes compel plaintiffs to send 'demand' letters to defendants. This juncture — after the decision, but before formal discovery — is a juncture at

[18] Document discovery is where the parties seek production of documents relevant to the issues of the lawsuit.

which all but the most entrenched defendants are interested in negotiations because their one shot at ending the litigation early (motion to dismiss) is over, and they are generally not eager to produce documents or witnesses in discovery.

In the cases where the parties decide to use private dispute resolution, the negotiation tends to require many months and counsel should wholly involve the lead plaintiff in the decision-making process. Obviously, the most important decision to be made is what will be the parameters of the settlement: will it be all cash, and how much, and from whom? Will it include shares of the company's securities and/or corporate governance changes? The parties must also choose a mediator, schedule mediation dates, consult with damage experts, and prepare mediation statements, either for submission to the mediator only or to be exchanged among the parties. Although lead counsel will handle these responsibilities, ample opportunity exists for the lead plaintiff to assess the case and to guide the decision-making process. The lead plaintiff is also expected to be present for the negotiations, either in person or by telephone. Although some cases settle at the mediation, many negotiations are consummated only after additional informal negotiations or formal mediation sessions.

Once the negotiations are completed, and the universe of the recovery is established, the parties must negotiate the contractual terms of the settlement. Following the conclusion of the contractual negotiations, the paperwork evidencing the agreement is submitted to the court, which must preliminarily approve the settlement before notice can be sent to all potential class members. During a period generally ranging between 60–90 days, class members are permitted time to consider the settlement and to decide whether they wish to 'opt-out' (to possibly pursue their own claims) or to object to a term of the settlement or the request for attorneys' fees, before the settlement is again submitted to the court for 'final approval.' Settlement objections are rare, though institutional investors sometimes object to requests for attorneys' fees where they appear to be excessive. These objections, if taken into consideration by the court, may motivate the court to award a lower fee than it otherwise would have, thereby increasing the recovery to the class.[19]

Ultimately, the court will hold a final hearing to consider and approve the settlement. At that time, the judge will issue a final order setting out the terms of the settlement that likely includes payment of the counsel's fees and expenses out of the settlement proceeds. Following that, the claims administrator (hired by the plaintiff's counsel and approved by the Court) with approval of the lead plaintiff will determine the per person recovery of the class members, and ultimately distribute the settlement fund to the class members after approval by the Court of the distribution process.

b. Litigation cases — on the rise

Since the passage of the PSLRA several trends have emerged.[20] The number of cases filed per year has risen, from 110 in 1996 to 268 in 1998, with an annual average of 212 in the post-PSLRA period. In line with this, 217 cases were filed in 2004[21]. Curiously, 2005 saw a drop to 176 in the number of cases filed, and filings have been down in the first half of 2006, but commentators have cautioned against seeing this as a trend to less corporate malfeasance and fraud.[22] It could merely be the result of the market recovery. While the vast majority concern US domiciled companies, non-US based companies are increasingly involved. In 2004, 29 foreign-based companies were the subject of shareholder litigation, and 22 of these involved allegations of egregious accounting irregularities and fraud.[23] That is the highest number of such cases ever recorded, and is now proportionate to the number of foreign companies listed on US securities exchanges. Furthermore, the Parmalat fraud — standing at $17.2 billion — is bigger than that of Enron, and is often referred to as 'Europe's Enron.' As to the companies involved, they include many European corporations, as well as companies in China, Canada, Mexico and elsewhere.

[19] By contrast, many law firms will negotiate fee arrangements upfront.

[20] The authors have drawn on statistics provided by PricewaterhouseCoopers, particularly its Securities Litigation Study (various years). The authors have also drawn on the work of Cornerstone Research.

[21] It is not unusual to see differences in the literature as regards the number of cases filed each year, due to the different methodologies employed.

[22] 2005: A Year in Review, Securities Class Action Case Filings. Cornerstone Research, January 2006.

[23] PricewaterhouseCoopers Securities Litigation Study, 2004.

c. Investor losses and recoveries — both up

Investor losses also have risen to record levels. In 2004, the median market capitalisation loss for the defendant company reached $340 million per case. Through just the first six months of 2005 that figure rose to $416 million per case, representing a six-fold increase in the investor losses as compared to 1996. The other side of the coin is of course settlements. Prior to the passage of the PSLRA, settlements averaged $5 million per case with very few 'mega-settlements.' By 2003, the average had risen to $23.2 million, a 20 percent increase on the preceding year, rising again to reach $27.1 million in 2004.[24] That translates into a mean recovery for institutional investors of approximately $280,000 per case, a significant return.[25] As of the end of June 2006, there was in excess of $15 billion in settlement funds awaiting distribution to claimants.[26] Investors only share in these recoveries if they file timely claim forms.

Much more can be achieved. The recent growth in the size of investors' losses has yet to be matched by a commensurate rise in settlements. That suggests, on the one hand, the need for investors and their counsel to demand increased settlements. It also suggests the importance of fraud prevention and corporate governance improvements along with personal payments from egregious wrongdoers as part of a balanced investor shareholder litigation program.

Within the averages lies the trend to larger settlements on a case by case basis. In 2003, twenty-three settlements were valued at $20 million or over, with only six settlements exceeding $100 million.[27] Through 2004, nine settlements reached values of $100 million or more. Those, however, are dwarfed by the WorldCom settlement of $6.1 billion, and the yet to be seen final Enron settlement, currently standing at over $7 billion (with additional settlement dollars forthcoming from those defendant banks that have yet to settle).

Moreover, and as the data show, the headline grabbing cases alone do not explain the increase in average settlements. The explanations are not hard to find. On one hand, investor losses per case have increased, and on the other hand, the preparedness of institutional investors to become lead plaintiff has also increased. Studies have shown that when institutional investors serve as lead plaintiff their average settlements are typically one-third higher,[28] not to mention the additional intangible shareholder value as a result of corporate governance changes that are being demanded and obtained.

Similar increases apply to the size of total settlements. In 2001, the value of all settlements was $1.9 billion, but by 2004 the figure had risen to $5.5 billion. 2005's settlements were no less than $17 billion. Ironically, many European institutional investors will miss out on their portion of this significant sum of money due to their failure to file claims. According to independent academic research, a 2004 study showed that billions of dollars go unclaimed in class action settlements by institutional investors who fail to claim recoveries to which they are entitled.[29] Of course, those investors and their savers who do file claims will be happy about this state of affairs. Unclaimed money does not disappear or lie unclaimed; it is disbursed to those who do claim, thereby raising their financial returns. That, however, will be of scant reward to those continuing to miss out.

d. A warning flag for European investors not participating in shareholder litigation

European institutional investors may wish to take a keen look at a particular class action suit, launched in January 2005, against forty US mutual fund managers.

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[24] See 'Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements.' NERA Consulting, February 2005. (http://www.nera.com)

[25] 'Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements.' James D. Cox, Brainerd Currie Professor of Law, Duke University Law School, and Randall S. Thomas, John S. Beasley II Professor of Law and Business, Vanderbilt University Law School.

[26] Recovery amounts are tracked and reported by Securities Class Action Services (http://www.issproxy.com/institutional/analytics/scas50full2005.jsp).

[27] NERA Consultancy has estimated that the median ratio of settlements to investor losses stands at around 5 percent, reinforcing the need to pursue corporate governance reforms that will deter fraud and reduce losses as part of a balanced settlement negotiation process.

[28] Ibid.

[29] Op cit. James D. Cox and Randall S. Thomas.

Among other claims, they alleged that the funds had foregone up to $2 billion by failing to file settlement claims, and further alleges that this was in breach of their fiduciary duties. Support for the case is derived from the Delaware Chancery Court ruling in the Caremark Derivative litigation. Specifically, the Chancellor's ruling stated that directors had a duty to make '. . . a good faith judgement that the corporation's information will come to its attention in a timely manner as a matter of ordinary operations.'[30] By extension, by failing to make this good faith judgement, a fund or pension manager could be '. . . liable for losses caused by non-compliance with applicable legal standards.'[31] While these actions were subsequently dismissed for a variety of reasons, the ramifications of a successful outcome of such a case would be enormous, given that an estimated two-thirds of institutional investors currently forego the right to file claims in securities class action settlements. It is clear that all institutional investors are beholden to, at a minimum, collect on existing settlements as a part of their fiduciary responsibilities. This type of case simply highlights the importance of diligence with a fund's procedures in tracking securities class action cases.

e. Innovative settlements from shareholder litigation

A new trend in shareholder litigation is to require that individual officers and executives, who are seen as particularly culpable defendants, pay part of the agreed-upon settlements from their personal coffers, as opposed to allowing insurance to foot the bill. This trend acts as a more significant deterrent than just having the defendant corporation or insurance policies pay for the settlement. In January 2005, eighteen former non-executive directors of Enron agreed to settle one of the many cases brought by investors following the collapse of the company in 2001. Ten of those directors agreed to pay $13 million out of their own pockets.[32] That comes on top of the 2004 settlement where a dozen former Enron directors agreed to pay $1.5 million of their own money as well as over $85 million in insurance proceeds to settle liability in a case brought on behalf of former employees. In addition, ten former non-executive directors of WorldCom agreed to pay $20 million of their own money — an estimated twenty percent of their net combined wealth — to settle a $54 million class action case. That result arose when Alan Hevesi, the comptroller of New York state and trustee of its Common Retirement Fund (the lead plaintiff) stated early on that he wished to see culpable directors made personally responsible for the fraud, rather than being bailed out by insurance companies. Furthermore, the State of New Jersey and its Division of Investment acting as lead plaintiff in the shareholder litigation against Tenet Healthcare Corp. agreed to a $215 million settlement, contingent upon a personal contribution from two errant officers of the corporation, who ultimately agreed to contribute $1.5 million.

f. The real costs of pursuing shareholder litigation

Of all the issues associated with participating in shareholder litigation, probably the most confusion arises when discussing the real costs for institutional investors, especially as lead or co-lead plaintiff. As to the financial costs, depending upon the counsel you select, typically they are borne up-front by the lead law firm throughout the process. These costs include hiring investigators, forensic, accounting and damage experts, and all other expenses related to litigating the case. The law firms receive their fees, if and only if they win the lawsuit or achieve a settlement. This is commonly referred to as a contingency fee system whereby the law firm's payment is 'contingent' upon success. If the law firm loses the suit, the law firm bears its own costs and the lead plaintiff is not responsible for any payment of attorney's fees or costs for its own lawyers, or the fees of opposing counsel. In our view, concerns as to whether non-US plaintiffs in shareholder litigation are eligible for the benefits of the contingency fee system were a key determinant of their non-participation in the past. This is especially true in those countries where the 'English Rule' applies, wherein the loser bears the costs. It is worth repeating that the contingency fee system applies to all plaintiffs in US shareholder litigation, irrespective of their country of origin. In the event of a successful outcome, the law firm must also submit its fee request for approval to the Court to ensure its reasonableness prior to any payment of fees being made.

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[30] In re: Caremark International Inc. Derivative litigation, 698 A2d 959, 970 (Del. Ch. 1996).

[31] Ibid.

[32] See Bloomberg News, 7 January 2005.

There are, however, minor administrative costs for pension funds and other institutional investors. They vary according to the issue, and complexity of the case. For example, having a specialist firm monitor a European institutional investor's US portfolio simply requires a written request to that effect being conveyed to its custodian bank. Thereafter, fees for the advice offered by law firms regarding whether or not to seek to take a leadership role in applicable cases as they arise, along with the settlement claim service on offer, vary according to the particular firm. Becoming lead or co-lead plaintiff does extend the administrative costs since documentation must be produced and reviewed and portfolio managers or analysts may have to sit for a deposition. However, some US law firms will provide a full back-up service to ease the burden, including supplying staff with expertise in document recovery and other matters of interest.

By playing an active role in monitoring the litigation, pushing for a higher settlement, obtaining corporate governance improvements and negotiating a competitive fee agreement with lead counsel, institutional investors can produce benefits for themselves in the litigation that will more than offset their costs. In addition, out-of-pocket costs, such as travel expenses and fees of special advisors or independent evaluation counsel, can be reimbursed from the settlement fund upon court approval.

5. Concluding remarks

The intention of this paper has been to provide an objective view on the world of US based shareholder litigation, so as to enable European institutional investors to evaluate better the opportunities and challenges of participating in such actions. We hope that we have succeeded in both debunking some of the myths that have arisen around this issue, and to inform on current developments. Institutional investors have the opportunity to increase recoveries, reduce legal fees, deter future misconduct and enhance shareholder value through corporate governance reforms being won, or which could be won going forward. We hope we have succeeded on all fronts and will have sparked a broader and deeper debate within the European institutional investor community on these issues.