Learning Curve

Fraud Recovery for Mutual Funds: A Brave New World?

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Mutual funds faced with substantial losses resulting from apparent securities fraud historically have adopted a passive approach to recovery. Typically, after class plaintiffs outside the fund industry obtained a recovery through a securities fraud class action, mutual funds submitted proofs of claim and collected their pro rata share of the settlement. By staying on the periphery, mutual funds maintained a low litigation profile while still obtaining a measure of compensation for fraud-related losses. With remarkable consistency, however, the data demonstrate that securities fraud class actions typically recover only a very small percentage of investors' losses. For this reason, fund directors looking to maximize value for their funds have started to consider whether there is a better approach, and, with increasing frequency, funds are opting out of securities class actions in favor of seeking their own recoveries outside the class.

Changes in the law also are prompting directors to reconsider their approach to securities fraud losses. The Second Circuit's recent decision in the *IndyMac* mortgage-backed securities litigation has significantly changed the timeframe within which mutual funds and other investors must decide whether to go the passive class participation route or opt out,[1] and an appeal before the U.S. Supreme Court in the securities class action pending against the **Halliburton Company** ("*Halliburton*")[2] has the potential to eliminate the passive class participation approach altogether in many cases.

Class Action Recoveries & The Rise Of Opt-Out Cases

Since the global financial crisis in 2007-2008, there has been no shortage of securities class actions. **NERA Economic Consulting** reports that more than 200 new securities fraud class actions are filed each year.[3] The size of securities fraud class action settlements has also increased over time.[4] In 2013, the average securities fraud class action settlement hit a record high of $55 million.[5] These numbers, however, can be deceiving. Despite the filing of hundreds of class actions and record-high settlements in the hundreds of millions, and even billions, of dollars, the investor class members typically recover only pennies on the dollar. In fact, the median ratio of class action settlement to total investor losses has not exceeded 5% since 1997, and over the past 10 years, it has hovered around 2.5%.[6]

In light of this data, it is not surprising that fund directors have started to reexamine their funds' options. With increasing frequency, and in an effort to enhance their recoveries, mutual funds and other investors are electing to opt out of securities fraud class actions in favor of individual or small group actions. For example, funds advised by **Goldman Sachs Group**, **Federated Investors**, **BlackRock**, **Merrill Lynch**, **Nuveen Investments, Franklin Templeton Investments**, **Northwestern Mutual**, **Russell Investments**, **Capstone Asset Management Co.**, **Aberdeen Asset Management**, **Robeco Group**, and **Sovereign** all have opted out of recent securities fraud class actions in order to separately seek recovery for their losses.

While a comprehensive analysis of opt-out results is not available, largely due to the fact that many opt-out settlements are private and confidential, the available anecdotal information about securities fraud opt-out recoveries is striking. By way of example:

Five pension funds that opted out of the $6.2 billion **WorldCom** class action settlement separately recovered $78.9 million on $130 million in alleged losses;[7] the recovery was estimated to be "three times more than they would have recovered if they had joined the class."[8]

The State of Alaska opted out of the $2.6 billion **AOL Time Warner** class action settlement and separately recovered $50 million, which it announced was "50 times more than what we would have received if we

had remained in the class."[9]

Several New Jersey pension funds that opted out of the $3.2 billion **Tyco** class action settlement separately recovered 80% of their claimed losses, while the total recovery for class members was estimated by some to represent only 3% of the loss of the market capitalization resulting from the fraud.10

Alaska's attorney general claimed that his state's pension funds that opted out of the **Quest** securities fraud class action recovered 45 times what they would have received as members of the class.11

In light of the recent successes of opt-out plaintiffs, and given that class action settlements typically result in small recoveries for investors, it is not surprising that fund directors are more closely scrutinizing the approach to seeking recovery for securities fraud-related losses.

IndyMac Shortens Window For Opt Out Decisions

At the same time that fund directors are giving increased consideration to the possibility of opting out of class actions in an effort to maximize their funds' recoveries, the Second Circuit has issued a ruling in the *IndyMac* mortgage-backed securities litigation that changes the timetable for investors to decide whether to opt out. Investors have long relied on the tolling doctrine established by the U.S. Supreme Court in the *American Pipe* case to preserve their securities fraud claims during the pendency of a putative securities fraud class action.[12] In *American Pipe*, the Court held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action."[13] Relying on *American Pipe* and the lower court cases that followed it, mutual funds and other institutional investors have tended to wait to see how the pending class actions played out before deciding whether to opt-out. *IndyMac* may well put an end to that approach.

In *IndyMac*, the Second Circuit held that the *American Pipe* tolling doctrine does not apply to the three-year statute of repose under Section 13 of the Securities Act of 1933 (the "Securities Act").[14] This means that regardless of the pendency of a class action, investors must bring their Securities Act claims within three years of the alleged Securities Act violation; they cannot wait while the class action proceeds. While the *IndyMac* decision only directly addresses the statute of repose for claims under the Securities Act, the Second Circuit's reasoning should apply equally to other statutes of repose, including the five-year statute of repose applicable to securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). Additionally, although the *IndyMac* decision is controlling authority only in the Second Circuit, it is likely to carry significant influence throughout the country; more securities class actions are filed within the Second Circuit than any other circuit,[15] and the Court has come to play a central role in shaping the federal securities laws. Thus, in the wake of *IndyMac*, mutual funds and other investors considering whether to opt out of a securities fraud class action will need to decide more quickly.

Halliburton

While *IndyMac* represents a significant change in how quickly investors decide whether to passively participate in a class action or pursue a separate opt-out action, the *Halliburton* case, which is due to be argued before the Supreme Court on March 5, may determine whether passive participation is even an option for investors. The Supreme Court in *Halliburton* is revisiting the "fraud-on-the-market" theory, which has been a cornerstone of securities fraud class action jurisprudence for 25 years. Depending on the Court's ruling, *Halliburton* could bring an end to securities fraud class actions based on affirmative misrepresentations of fact.

In its 1988 decision in *Basic v. Levinson*, the Supreme Court approved the fraud-on-the-market theory, which creates a rebuttable presumption that public information (such as a material representation in a public company's financial statements) is reflected in the price of a stock traded in an open and developed market, and that investors rely on the market price when deciding whether to buy or sell the stock.[16] The fraud-on-the-market presumption is essential to class action plaintiffs seeking to certify a class of aggrieved investors in a securities fraud action because the presumption allows investors to establish reliance on a class basis with common proof.

The Supreme Court's decision to reconsider *Basic*'s

fraud-on-the-market presumption comes as no surprise. Last year, in a decision addressing whether proving materiality is a prerequisite to class certification in a securities fraud case, four justices expressed interest in reconsidering the wisdom of *Basic*.[17] In the *Amgen* case, Justice Thomas authored a dissenting opinion, joined by Justices Kennedy and Scalia, in which he stated that the "*Basic* decision itself is questionable."[18] In a concurring opinion in the same case, Justice Alito opined that "recent evidence suggests that the [*Basic*] presumption may rest on a faulty economic premise" and, accordingly, "reconsideration of the *Basic* presumption may be appropriate."[19]

If the Supreme Court overturns *Basic* and eliminates the fraud-on-the-market presumption of reliance, the *Halliburton* decision arguably would foreclose securities fraud class actions under Section 10(b) of the Exchange Act based on alleged misrepresentations of fact. The individualized questions as to each class member's actual reliance on the alleged misrepresentation would make it impossible for the class plaintiffs to certify an investor class. Class plaintiffs still would be able to bring class actions asserting claims under Section 11 of the Securities Act for misrepresentations in connection with registered securities offerings because reliance is not an element of the claim. Class plaintiffs also could recast traditional Section 10(b) fraud cases as actions based on omissions instead of affirmative misrepresentations, relying on the *Affiliated Ute* decision, which allows plaintiffs to assert securities fraud claims based on an omission of material fact.[20] Nonetheless, elimination of the fraud-on-the-market theory would dramatically change securities class action litigation. In many cases, mutual funds facing substantial losses due to apparent securities fraud could be forced to either bring their own securities fraud action or forego any recovery.

In recent years, fund directors have both examined and pursued alternatives to passive participation in securities fraud class actions. Historical data on low class action recovery rates and recent success by opt-out plaintiffs led some boards to opt out of class actions in favor of separate lawsuits. Now, the Supreme Court is poised to issue a ruling that may dramatically diminish the ability of class plaintiffs to pursue securities fraud class actions. If that happens, the passive class participation approach will no longer be an option in many cases, and fund directors may be forced to either approve the commencement of litigation by funds or forego the opportunity to recover for losses caused by fraud.

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[1] Police and Fire Ret. Sys. of the City of Detroit v. IndyMac MBS, Inc., 721 F.3d 95 (2d Cir. 2013).
[2] Halliburton Co. v. Erica P. John Fund, No. 13-317.
[3] NERA Economic Consulting, "Recent Trends in Securities Class Action Litigation: 2013 Full-Year Review," available at http://www.nera.com/67_8394.htm, at 2.
[4] Id. at 26.
[5] Id.
[6] Id. at 33.
[7] John C. Coffee, Jr., "Accountability and Competition in Securities Class Actions: Why 'Exit' Works Better Than 'Voice,'" 30 Cardozo L. Rev. 407, 426 (2008).
[8] Id. (citing Kevin LaCroix, "Opt-Outs: A Worrisome Trend in Securities Class Action Litigation," InSights, April 2007, at 3).
[9] Josh Gerstein, "Time Warner Case Finds a Surprise," N.Y. Sun, Dec. 7, 2006, at 1.
[10] See Matthew P. Siben & David A. Thorpe, "Recovering Investment Losses," at 6, available at http://www.dstlegal.com/downloads/Recovering-Investment-Losses.pdf.
[11] Press Release, Alaska Dep't of Law, "Department of Law Announces $19 Million Settlement in Securities Fraud Claims against Qwest Communications International," Nov. 21, 2007, available at http://www.law.alaska.gov/press/releases/2007/112107-QwestComm.html.
[12] American Pipe & Construction Co. v. Utah, 414 U.S. 538 (1974).
[13] Id. at 554.
[14] IndyMac, 721 F.3d at 109.
[15] NERA Economic Consulting, supra, at 10.
[16] Basic v. Levinson, 485 U.S. 224, 242-47 (1988).
[17] Amgen Inc. v. Connecticut Ret. Plans and Trust Funds, 133 S. Ct. 1184 (2013).
[18] Id. at 1208 n.4 (Thomas, J., dissenting).
[19] Id. at 1204 (Alito, J., concurring).
[20] Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 152-53 (1972).

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