Morrison, IndyMac, and *Halliburton:* The Changing Landscape of Securities Fraud Class Actions and What It Means for Mutual Funds

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The law governing securities fraud class actions has continued to shift against the interests of investor plaintiffs, and the *Halliburton* case now pending before the U. S. Supreme Court could result in the most dramatic change in decades.[1] While much has been written about the impact of these developments on corporate defendants and the class plaintiffs' bar, the consequences could be just as significant for mutual funds.

Since the Supreme Court's 1988 decision in *Basic v. Levinson*,[2] funds with sizeable holdings in both domestic and foreign securities damaged by fraud have been free to choose between passive class participation and separate individual lawsuits to obtain a recovery for their losses. They also had the luxury of time, often waiting until the class action opt-out deadline to decide whether to stay in the class or opt out. The Supreme Court's 2010 decision in *Morrison* narrowed the boundaries considerably, foreclosing the right of investors to recover under the federal securities laws for stock bought on foreign exchanges.[3] In June of 2013, the Second Circuit shortened the timeframe for opt-out decisions, holding in the *IndyMac* mortgage-backed securities litigation[4] that the long-established *American Pipe*[5] class action tolling doctrine does not apply to the statue of repose under the Securities Act of 1933 (the "Securities Act"). Finally, in *Halliburton*, argued before the Supreme Court on March 5, 2014, the Court will consider the ongoing viability of the fraud on the market theory. The Court's decision in Halliburton could bring an end to most securities class actions, forcing funds holding securities damaged by fraud either to pursue their own actions or forego the right to recover.

These changes in the legal landscape come at the same time that many in the mutual fund industry are starting to reconsider their approach to securities fraud cases. While mutual funds typically chose to stay on the periphery of securities fraud litigation by passively participating in class action settlements, data showing low recovery rates for securities fraud class actions and a flurry of recent opt-out success stories have caused mutual funds to consider a new approach.

With increasing frequency, mutual funds, seeking to enhance their recoveries, are opting out of securities fraud class actions in favor of pursuing recovery outside of the class.

Morrison Forecloses Federal Securities Class Actions for Foreign Securities Losses

For years, U.S. investors relied on federal securities fraud class actions as a means of recovering losses sustained as a result of fraud in connection with securities traded on foreign stock exchanges. Instead of seeking recovery overseas, U.S. mutual funds could wait for a class plaintiff to secure a class-wide settlement on behalf of the U.S. investors who bought and sold shares on the foreign exchange and then submit a proof of claim to obtain their pro rata share of the settlement. However, in the 2010 *Morrison* case, the Supreme Court put an end to this when it ruled that Section 10(b) of the Exchange Act of 1934 (the "Exchange Act") only reaches fraud in connection with securities transactions on a U.S. stock exchange or securities transactions that take place in the U.S.[6] In the wake of *Morrison*, class plaintiffs can no longer pursue federal securities fraud class actions for fraud related to transactions on an overseas market. This means that the passive class participation approach is no longer an option for mutual funds and other institutional investors who fall victim to securities frauds involving stock traded on foreign exchanges, such as the major European and Asian exchanges. Instead, to the extent that they seek to pursue recovery for such losses, investors must evaluate each case and consider the available options, potentially including pursuing actions overseas. As a result of *Morrison*, there has been a noted uptick in the filing of securities fraud-related collective and group actions in foreign jurisdictions.[7] Although for most U.S. mutual funds these are unchartered waters, in light of *Morrison*, more and more funds are examining these options.

IndyMac Forces Early Consideration of Opt-Out Options

Investors have long relied on the class action tolling doctrine established by the United States Supreme Court in the *American Pipe* case to preserve their securities fraud claims while a putative securities fraud class action is pending. 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." [8] 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. Last June, however, 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.[9] Because the reasoning of *IndyMac* likely applies equally to other statutes of repose, the decision significantly changes the timeframe within which investors must decide whether to opt out of securities fraud class actions.

While acknowledging that statutes of repose, such as the three-year statute of repose under Section 13 and the five-year statute of repose applicable to securities fraud claims under Section 10(b) of the Exchange Act, are not subject to "equitable" tolling, most lower courts had construed *American Pipe* as a type of "legal" tolling, born out of the class action regime set forth in Rule 23 of the Federal Rules of Civil Procedure. Relying on this body of law, mutual funds often would wait until a class action settlement was reached and an opt-out deadline was imposed by the court before deciding whether to participate in the settlement or opt out. In the wake of *IndyMac*, this approach likely will not be available in many cases.

In *IndyMac*, the court rejected the oft-cited distinction between equitable and legal tolling as a basis for applying *American Pipe* to statutes of repose. The Second Circuit reiterated that statutes of repose "create a substantive right in those protected to be free from liability" and are not subject to equitable tolling.[10] However, the court went on to explain that even if characterized as "legal" tolling based on Rule 23, the *American Pipe* tolling doctrine cannot be applied to a statute of repose.[11] The court explained that Rule 23 cannot be construed to toll the Section 13 statute of repose because the Rules Enabling Act[12] prohibits a procedural rule from operating to "abridge, enlarge or modify any substantive right."[13] Based on this reasoning, the Second Circuit unequivocally held, "*American Pipe*'s tolling rule, whether grounded in equitable authority or on Rule 23, does not extend to the statute of repose in Section 13."[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.

Although the *IndyMac* decision only directly addresses the statute of repose applicable to claims under the Securities Act, the court'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 Exchange Act. Additionally, while the *IndyMac* decision is controlling authority only in the Second Circuit, the only contrary Circuit Court authority comes from the Tenth Circuit.[15] The Second Circuit is often the bellwether for legal trends in securities fraud litigation because more securities fraud cases are filed within the Second Circuit than any other circuit.[16] Accordingly, investors contemplating suit anywhere except within the Tenth Circuit would be wise to heed the *IndyMa*c decision. In the wake of *IndyMac*, mutual funds and other investors considering whether to opt out of securities class actions will need to decide more quickly.

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Halliburton: A Potential Sea Change in Securities Fraud Litigation

The *Halliburton* case, which was argued before the U.S. Supreme Court on March 5, 2014, may result in the most dramatic change to the securities fraud class action landscape in decades. In *Halliburton*, the Court is revisiting the "fraud-on-the-market" theory, which has been an essential element of securities fraud class action litigation for the last 25 years. Depending on the Court's ruling, *Halliburton* could be the death knell for securities fraud class actions as we know them.

Established by the Court's 1988 decision in *Basic*, the fraud-on-the-market theory 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.[17] The fraud-on-the-market presumption was intended to do away with the "unnecessarily unrealistic evidentiary burden" imposed by requiring securities fraud plaintiffs who traded on an impersonal market to prove actual reliance.[18] The presumption allows class action plaintiffs to establish reliance on a class basis with common proof, making it vitally important to class action plaintiffs seeking class certification. Without the fraud-on-the-market theory, a plaintiff in a securities fraud action based on a material misrepresentation must show that he or she actually relied on the alleged misstatement when deciding to buy or sell the stock. Because demonstrating actual reliance requires an individualized inquiry as to each investor, the reliance element presents a substantial – if not insurmountable – obstacle to certifying a class of aggrieved investors.

The Court's decision to revisit *Basic*'s fraud-on-the-market presumption was foretold in the *Amgen* case, decided by the Court last year. In that case, which addressed whether proving materiality is a prerequisite to class certification in a securities fraud case, four justices expressed interest in reconsidering the wisdom of *Basic*.[19] Justice Thomas authored a dissenting opinion, joined by Justices Kennedy and Scalia, in which he acknowledged that the Court had not been asked to revisit *Basic*'s fraud-on-the-market theory but nonetheless opined that the "*Basic* decision itself is questionable."[20] In a concurring opinion, Justice Alito noted that "recent evidence suggests that the [*Basic*] presumption may rest on a faulty economic premise" and suggested that "reconsideration of the *Basic* presumption may be appropriate."[21] Accordingly, no one was surprised when the Court granted certiorari in *Halliburton*.

Halliburton may well bring sweeping change to class action securities fraud litigation. If the Court overturns *Basic* and jettisons the fraud-on-the-market presumption of reliance, class action plaintiffs likely would no longer be able to bring class actions asserting claims under Section 10(b) based on alleged misrepresentations of fact. Without the presumption of reliance, individualized questions as to each class member's actual reliance on the alleged misrepresentation would prevent a class plaintiff from certifying an investor class. This is not to say that *Halliburton* threatens to do away with all securities fraud class actions. Class plaintiffs would still be able to bring class actions asserting claims under Section 11 of the Securities Act for misrepresentations in connection with registered securities offerings, where reliance is not a required element.

They could also assert claims under Section 10(b) based on material omissions instead of affirmative misrepresentations, relying on the *Affiliated Ute* decision.[22] Nevertheless, the elimination of the fraud-on-the-market presumption of reliance *Halliburton* would dramatically change securities class action litigation by foreclosing class actions in most traditional Section 10(b) cases. This would remove passive class participation as an option for defrauded investors in many instances, forcing mutual funds facing substantial losses due to apparent securities fraud either to bring their own securities fraud actions or forego any recovery.

The Economics of Securities Litigation

The changing legal landscape is not the only factor causing mutual funds and other investors to evaluate their options in the face of securities fraud-related losses. Even before *Morrison*, investors had already begun, with increasing frequency, to opt-out of securities fraud class actions in favor of individual and group actions. This shift has been driven largely by data showing low recovery rates for class actions, coupled with a series of impressive settlements obtained by opt-out plaintiffs. The opt-out trend was building momentum well before the *IndyMac* decision narrowed the time window within which investors must decide whether to opt out. And, regardless of the outcome of *Halliburton*, the economic considerations underlying the opt-out trend still give mutual funds and other investors incentive to examine carefully whether to opt out of securities class actions.

The Court's decision in Halliburton could bring an end to most securities class actions, forcing funds holding securities damaged by fraud either to pursue their own actions or forego the right to recover.

For years there has been a steady stream of securities fraud class actions. According to a recent study by NERA Economic Consulting, roughly 225 new securities fraud class actions are filed each year.[23] Over time, the size of securities fraud class action settlements has increased significantly. In the span of a decade, the median securities fraud class action settlement increased by more than 50% from $6.0 million in 2003 to $9.1 million in 2013.[24] In 2013, the average security fraud class action settlement was a record-high $55 million.[25] However, despite the robust number of cases and the increasing size of class settlements, securities fraud class actions typically recover only a very small portion of the aggrieved investors' losses. The median ratio of class action settlement to total investor losses has not exceeded 5% since 1997, and recovery rates have steadily declined over the years.[26] In 2013, the median ratio of class action settlement to investor losses was only 2.1%.[27] In other words, despite hundreds of cases and huge class action settlements (in the hundreds of millions, and even billions, of dollars), investor class members recover only pennies on the dollar.

Largely in response to this data, mutual funds confronted with major losses resulting from apparent securities fraud have been re-examining their options. With increasing frequency, and in an effort to enhance their recoveries, mutual funds are electing to opt out of securities fraud class actions in favor of individual or small group actions. In recent years, funds advised by Goldman Sachs Group, Federated Investors, Inc., Blackrock Inc., Merrill Lynch, Nuveen Investments, Franklin Templeton Investments, Northwestern Mutual, Russell Investments, Capstone Asset Management Co., Aberdeen Asset Management, Inc., Robeco Group N.V., and Sovereign all have opted out of securities fraud class actions in order to seek recovery for their losses separately from the class.

A comprehensive, long-term analysis of opt-out results is not available, for several reasons. First, the opt-out trend is fairly recent, particularly among institutional investors in major class actions. Second, unlike class actions, where the settlements are public and require court approval, many opt-out settlements are private and confidential. Nonetheless, the available anecdotal information about securities fraud opt-out recoveries is striking.

Dozens of investors opted out of the WorldCom class action settlement (the second largest in history at nearly $6.2 billion).[28] Among these opt-out plaintiffs were five pension funds that separately settled for $78.9 million on $130 million in alleged losses. This was estimated to be "three times more than they would have recovered if they had joined the class."[29]

The AOL Time Warner securities fraud provides another example where opt-out plaintiffs substantially beat the class in terms of recovery. 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."[30] CalPERS, another institutional investor that opted out of the AOL Time Warner class action settlement, recovered $117.7 million on claimed losses of $129 million, a 90 percent recovery rate, which CalPERS's general counsel described as "approximately 17 times what we would have recovered if we stayed in the class."[31] Similarly, the University of California estimated that its AOL Time Warner opt-out recovery was "16 to 24 times" what it would have realized in the class.[32] Five Ohio state pension funds, in turn, received $135 million more than they would have been entitled to under the class settlement.[33]

Plaintiffs that opted out of the $3.2 billion Tyco class action settlement likewise fared better than the class. Several New Jersey pension funds opted out and 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.[34]

The story is much the same for the Qwest securities fraud. Alaska' Attorney General claimed that his state's pension funds recovered 45 times what they would have received under the class.[35] Likewise, the Teachers Retirement System of Texas claimed a 40-to-one recovery, opt-out versus class. Plaintiff CalSTRS recovered 30 times more in its Qwest opt-out action than it would have recovered as a class member.[36]

These successes have not been ignored by mutual funds and other institutional investors. With increasing frequency, mutual funds are evaluating their options and, in appropriate cases, choosing to opt out of securities fraud class actions. This trend is likely to continue regardless of the outcome of the *Halliburton* case. Investors seeking to improve on the low recovery rates typical of securities fraud class actions will still have an incentive to consider opt-out opportunities.

Conclusion

The landscape of securities fraud class action litigation is changing for mutual funds and institutional investors. The *Morrison* and *IndyMac* decisions have already forced mutual funds to change their approach to recovering securities fraud losses. Now, the *Halliburton* case pending before the Supreme Court has the potential to force a sea change in securities fraud litigation. Should the Supreme Court eliminate the fraud-on-the-market presumption, mutual funds and other investors that suffer losses due to a fraudulent misrepresentation may be forced to file their own fraud actions or make no recovery at all. Even if the Supreme Court leaves the fraud-on-the-market presumption intact, recent opt-out successes and consistently low class action recovery rates nevertheless provide mutual funds with good reason to carefully consider their approach to seeking recovery for securities fraud losses.

ENDNOTES

* Keith Dutill's current engagements include representing the interests of mutual funds in claims relating to auction rate preferred share redemptions, defending investors victimized by a Philadelphia Ponzi scheme, representing seven mutual fund families in the Tribune bankruptcy litigation, and defending a Swiss electronics company against patent infringement claims relating to transistor design in high-speed logic circuits.

Mr. Dutill has tried more than 50 cases to verdict or final award. He has successfully defended both public and private companies in jury trials involving claims ranging from antitrust violations to theft of trade secrets. When his business clients have sued as plaintiffs, he has won verdicts or settlements in excess of $1 million on six separate occasions, recovering more than $100 million in the aggregate for his clients. His wins include the largest punitive damage jury verdict ever in a business case in one suburban Philadelphia county, as well as the complete exoneration of a broker dealer following a federal jury trial and appeal in a collective action securities fraud case. He has also defended clients in the securities and mutual fund industries before government agencies and self-regulatory organizations.

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1 Halliburton Co. v. Erica P. John Fund, No. 13-317.
2 Basic v. Levinson, 485 U.S. 224, 242-47 (1988).
3 Morrison v. National Australia Bank Ltd., 561 U.S. 247, 130 S. Ct. 2869, 2888 (2010).
4 Police and Fire Ret. Sys. of the City of Detroit v. IndyMac MBS, Inc., 721 F.3d 95 (2d Cir. 2013).
5 American Pipe & Construction Co. v. Utah, 414 U.S. 538 (1974).
6 Morrison, 130 S. Ct. at 2888.
7 Financial Recovery Technologies, "International Group Securities Litigation: Morrison v. National Australian Bank Changes Global Landscape," available at http://frtservices.com/download-international-group-actions-white-paper/.
8 American Pipe, 414 U.S. at 554.
9 IndyMac, 721 F.3d at 109.
10 Id. at 106.
11 Id. at 109.
12 28 U.S.C. § 2072(b).
13 IndyMac, 721 F.3d at 109.
14 Id.

15 See Joseph v. Wiles, 223 F.3d 1155 (10th Cir. 2000).

16 NERA Economic Consulting, supra, at 10.

17 Basic v. Levinson, 485 U.S. 224, 242-47 (1988).

18 Id. at 245.

19 Amgen Inc. v. Connecticut Ret. Plans and Trust Funds, 133 S. Ct. 1184 (2013).

20 Id. at 1208 n.4 (Thomas, J., dissenting).

21 Id. at 1204 (Alito, J., concurring).

22 Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 152-53 (1972).

23 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.

24 Id. at 28.

25 Id. at 26.

26 Id. at 33.

27 Id.

28 John C. Coffee, Jr., "Accountability and Competition in Securities Class Actions: Why 'Exit' Works Better Than 'Voice,'" 30 Cardozo L. Rev. 407, 426 (2008).

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30 Josh Gerstein, "Time Warner Case Finds a Surprise," N.Y. Sun, Dec. 7, 2006, at 1.

31 Gilbert Chan, CalPERS' "Time Strategy Pays Off: The State Pension Funds Gets $117.7 Million after Opting Out of Class Action against Media Giant," Sacramento Bee, Mar. 15, 2007.

32 Id.

33 "Time Warner Settles Lawsuit for $144 Million," *L.A. Times*, Mar. 8, 2007, at C6.

34 *See* Matthew P. Siben & David A. Thorpe, Recovering Investment Losses, at 6, available at http://www.dstlegal.com/downloads/Recovering-Investment-Losses.pdf.

35 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.

36 Coffee, *supra*, at 428.