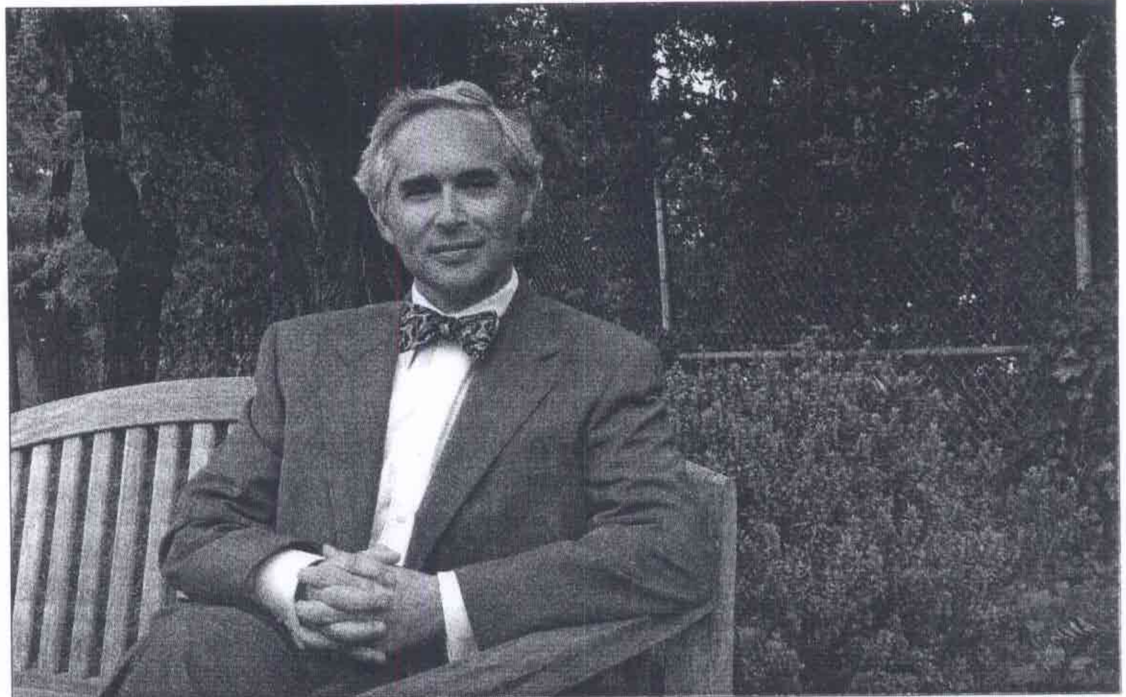
Opt-Outs Are a Threat

Institutional investors' single-minded approach could derail shareholder class actions.



BORIS FELDMAN — "Before institutional opt-outs become the new New Thing, institutional investors should consider the ramifications of that strategy for themselves, as well as for the system."

S. TODD ROGERS/Daily Journal

By Boris Feldman

In the Mars-Venus dialogue between plaintiffs and defense lawyers over shareholder class actions, both sides agree on one thing: The system has gotten better at providing meaningful recoveries to injured investors. One of the reasons for that improvement has been the involvement of the institutional investor community in shareholder lawsuits.

For decades, institutions had been free-riders. They rarely participated in shareholder class actions but regularly submitted claims forms to participate in the settlements. That pattern began to change in the late 1990s. The Private Securities Litigation Reform Act enhanced the role of institutions in running class actions. Moreover, the pandemic of accounting scandals after the high tech boom energized the institutional investor community to commit the time and energy to play a lead role in the lawsuits.

POINT

Ironically, institutional investors' newfound enthusiasm for shareholder litigation now threatens to undermine the class action recovery process. In a number of recent cases, institutional investors have opted out of the federal shareholder class action. They have sought instead to pursue their individual claims in state court, based on state law causes of action or on section 11 of the Securities Act of 1933. Sometimes, these institutions have banded together in groups as large as 49 — stopping short of the 50-plaintiff threshold that would trigger removal under the Securities Litigation Uniform Standards Act. The theory is that such state suits will move more quickly than federal cases and pose a greater threat to defendants — leading to faster and larger recoveries for the opt-outs than other class members obtain.

Before institutional opt-outs become the new New Thing, institutional investors should consider the ramifications of that strategy for themselves, as well as for the system.

The first downside involves discovery. As just another class member, an institution is almost certain not to be subjected to discovery in a shareholder lawsuit. Indeed, even when serving as lead plaintiff, an institution will normally face little discovery, given the reform act's preference for institutional plaintiffs. By contrast, if an institution pursues the opt-out route, the odds go way up that fund managers and analysts at the institution will be discovered upon. Many of the presumptions that apply in class actions would be unavailable. What the institution's employees thought and what they did — about this and other investments — will be fair game. Issues involving

A second tradeoff is the sacrifice of federal fraud claims under the Securities Exchange Act of 1934, and the accompanying Rule 10b-5. In many restatement situations, Securities Exchange Act claims provide powerful remedies for aggrieved investors — often better than comparable state causes of action. Claims under the 1934 act can be brought only in federal court. By eschewing the claims of this act to sue in state court, an opt-out may find its potential damages dramatically reduced.

If an institutional opt-out decides to go it alone, it can incur substantial costs in litigating the case. If, on the other hand, it decides to band with other (but fewer than 50) institutional opt-outs, then it sacrifices some of the individual control that may have made opting out attractive in the first place. In effect, the institution has moved from a large, officially sanctioned class to a rump class that may have a frosty relationship with the judge in charge of the overall litigation.

The fourth downside is perhaps the most disturbing. The institutional opt-out gambit threatens to undermine the shareholder class action system and lead to litigation gridlock.

Massive restatement cases are hard enough to settle already. The interplay of government enforcement proceedings, bankruptcy, insurance rescission and competing claimants creates multidimensional complexity. If you add to that mix a significant number of institutional opt-outs, then the process will grind to a halt. Lead plaintiffs in the class action will be reluctant to settle for an amount less than the opt-outs got or are likely to get. Insurance carriers will decline to fund the class settlement unless it buys them global peace. Defendants will not want to settle with the opt-outs first, because they know that that settlement will set a floor for their negotiations with the class. The opt-out phenomenon will create a chicken-and-egg problem, in which neither the class nor the opt-outs can settle. Resolution of class actions — which already proceeds at a Dickensian pace — will become downright Kafkaesque.

If one thing has become clear since the reform act, it's that the strategic ebb and flow of shareholder litigation is dangerous to predict. Nevertheless, here are a handful of ways in which defendants might respond to the opt-out phenomenon.

First, expect aggressive removal of cases from state court to federal. Defendants will very much want all related cases to be in one court, before one judge. Similarly, the judge overseeing a massive investor litigation may want to be in charge of the entire dispute, instead of having pieces of it proceeding in other venues at paces that may interfere

sive reading of the Securities Litigation Uniform Standards Act, or otherwise reach out under the All Writs Act, to freeze cases that might interfere with its jurisdiction.

Second, the opt-out parties will have difficulty in piggybacking on the discovery of the class. Defendants will try to prevent the opt-outs from moving ahead of the class, because that could undermine the defendants' stay rights under the reform act. If the class action settles and the opt-out case has not, defendants will encourage the class plaintiffs not to share their work product or the fruits of their discovery with the opt-outs. Class plaintiffs will probably be sympathetic to such requests, since the opt-outs will have weakened the lead plaintiff's position in the case.

Third, defendants will explore creative alternatives to prevent class members from opting out. Nearly all shareholder class actions are certified under Rule 23(b)(3), as a "common issues" type of class action. Such cases permit class members to opt-out. By contrast, Rule 23(b)(1) class actions, known as "limited fund" cases, do not permit opt-outs. Defendants may well seek to go the 23(b)(1) route, where damages are massive and available resources to pay a judgment are limited.

Finally, the timing of resolution of the class action and opt-out suits will be complicated. Defendants cannot settle the opt-out action first. If the company settles with an opt-out for 10 cents recovery on each dollar of loss, it will be difficult to persuade class plaintiffs to settle for less. The plaintiffs bar is competitive. Class counsel will not want to go into court seeking approval for a class settlement that is lower than the individual settlements that proceeded it.

If, on the other hand, the class settles first, class plaintiffs may well insist on "most favored nation" clauses that gross up the settlement in the event that a subsequent opt-out settlement provides a higher per-share recovery. In this scenario, it would be difficult for a defendant to settle with the opt-out for even a penny per share more than the class, because that would trigger a retroactive increase in the price of the class settlement.

In short, this new opt-out strategy — appealing as it may be in theory and in a particular situation — threatens to derail the shareholder class action resolution process. Class and opt-out cases will be caught in an endless loop. Instead of providing the opt-out institutions with a speedy, superior recovery, the strategy may delay even further the resolution of the cases and subject them to additional pain and expense along the way.