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Opt-Outs: A Worrisome Trend in Securities Class Action Litigation

The culminating event in a securities fraud class action lawsuit has always been a class settlement in which the consolidated claims of aggrieved investors were resolved. However, a recent wave of massive class opt-out settlements could completely change the way securities fraud lawsuits are resolved in the future. The recent opt-out settlements could also have important implications for D&O insurers' severity assumptions and for policyholders' selection of limits.

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This article reviews the recent opt-out settlement developments, takes a look at whether or not the current trend will continue, and examines what the trend may mean for D&O carriers and policyholders.

Background

When a securities class action lawsuit is settled, individual investors have the opportunity to accept the class action settlement or to "opt-out" and pursue individual claims on their own behalf. There have always been some investors who have chosen to opt-out of class settlements, but in the past the opt-outs have usually done so for philosophical or personal reasons. An opt-out pursuing its own claim was relatively rare, and a significant opt-out settlement was even more unusual.

What has changed is that now many more investors, representing significant investment interests, are concluding that it is in their financial interest to opt-out of the class settlement, often at the urging of prominent plaintiffs' securities firms. For example, the Lerach, Coughlin, Stoia, Geller, Rudman & Robins law firm, most often seen representing lead plaintiffs in class action litigation, convinced 65 investors to opt-out of the $6.1 billion WorldCom class settlement. The Lerach Coughlin firm also persuaded 93 investors to pursue separate lawsuits rather than participating in the $2.65 billion Time Warner securities class action settlement.

Over the last several months, a series of public pension funds and other large investors have announced the settlement of their individual opt-out claims, typically accompanying their announcement with the assertion that their opt-out recoveries exceeded what they would have recovered in the class settlement by many multiples.

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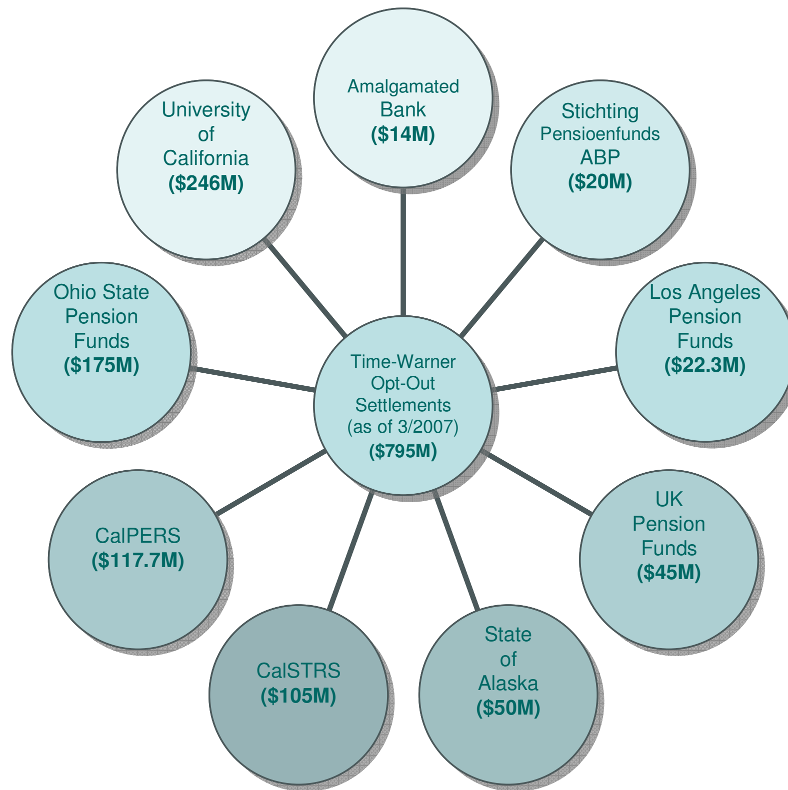

Time Warner Opt-Out Settlements as of March 2007

The case with the highest number of publicly reported opt-out settlements so far (as well as the highest total value of opt-out settlements) is the Time Warner securities litigation. The above illustration lists the publicly available information about the Time Warner opt-out settlements. In addition to the settlements listed above, two foreign institutional investors, DEKA Investment GmbH and Norges Bank, have also settled their individual opt-out actions against the Time Warner defendants, but are not included because the amount of these settlements has not been publicly disclosed.

Most of the Time Warner opt-outs that have settled their individual actions have stated that their opt-out recovery far exceeded what they would have recovered in the $2.65B Time Warner class settlement. Thus, the State of Alaska said that its settlement represented "50 times what we would have recovered" from the class. The California State Retirement System (CalSTRS) said its settlement represented 6.5 times what it would have recovered from the class. The University of California said its recovery was between 16 and 24 times what it would have recovered in the class settlement. And the State of Ohio said its $144 million opt-out recovery (net of attorneys' fees) represented $135 million more than the $9 million it would have recovered in the class settlement, so

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its net opt-out recovery was about 16 times what it would have recovered by remaining in the class.

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The $6.1 billion WorldCom class action settlement was also one of the largest class action settlements ever, yet numerous investors elected to opt-out. Relatively fewer of the WorldCom opt-out settlements have been resolved so far. In late 2005, the California Public Employee Retirement System (CalPERS) announced that it, CalSTRS and the Los Angeles County Employee Retirement System had settled their opt-out claims for a combined $257.4 million. In addition, five New York City pension funds settled their opt-out claims for $78.9 million; an amount the City's counsel claimed represented "three times more than they would have recovered if they had joined the class."

In addition to the Time Warner and WorldCom settlements, CalSTRS also recently announced a $46.5 million settlement in the opt-out action it filed against the Qwest Communications defendants. CalSTRS said that its individual recovery was "about 30 times more than it would have recovered" if it had participated in the $400 million Qwest Communications class action settlement.

The scale of these opt-out settlements is enormous. Indeed, the aggregate $795 million in Time Warner opt-out settlements (so far) not only represents a large percentage of the $2.65 billion class settlement, but in and of itself would represent one of the largest class settlements ever. There are many more Time Warner opt-out cases as yet unresolved, including one brought by Janus Capital Group, which owned over 10% of Time Warner and 3% of America Online when the two companies announced their merger in September 2000. When all is said and done, the total value of the Time Warner opt-out settlements could rival, if not exceed, the $2.65 billion of the class action settlement.

As the various opt-out settlements emerge, new standards for individual shareholder recoveries seem to be developing. For example, in the press coverage surrounding the Ohio opt-out settlement with Time Warner defendants, Ohio's outside counsel, Bill Lerach, disclosed that the state's Attorney General was unwilling to settle the state's case for anything less than the 36 percent of the investment loss that the University of California had recovered in its opt-out settlement. This 36 percent recovery stands in stark contrast to the 2.2% of investor loss that NERA Economic Consulting (NERA) reported as the average class action settlement recovery in 2006.

Discussion and Analysis

If investors believe they can substantially improve their recoveries by proceeding individually rather than as part of the class, the utility of class action litigation could be substantially undermined.

Without question, the recent wave of opt-out settlements represents a significant development in securities fraud litigation. If investors believe they can substantially improve their recoveries by proceeding individually rather than as part of the class, the utility of class action litigation could be substantially undermined. Indeed, at some point, if too many investors opt-out, the defendants might seek to invoke the "blow up" provisions - a typical settlement provision specifying that if a certain number of class members opt-out of the settlement, the settlement agreement will be terminated. And the court might decline to approve a class settlement with a large number of opt-outs; for example, in February 2007, a federal judge in New Jersey postponed a $195 million settlement between KPMG and tax shelter investors because more than 60 of the 284 investors had chosen to pursue their own litigation.

Even if the number of opt-outs does not forestall a class settlement altogether, it could still substantially increase the total litigation cost. If a defendant must defend itself against both a class action and multiple individual lawsuits, the costs of defense and of ultimate case resolution could escalate, potentially enormously.

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The disparity between the average class action recovery as a percentage of investment loss and the elevated percentage of investment loss recoveries in the opt-out cases could have an impact on future class action negotiations, as the parties struggle to fashion a settlement that would discourage or deter investors from opting out. At the same time, pension fund fiduciaries, with an obligation to maximize their recovery, may feel obliged to pursue their own cases unless the class settlement produces a certain level of investment loss recovery, simply to substantiate their efforts on the pensioners' behalf.

All of these considerations could make the emergence of significant opt-out activity a serious problem for both D&O insurers and their policyholders. Insurers base their pricing and their claims reserves on data derived from past claims activity. With the emergence of the new opt-out settlements, past claims activity may no longer be indicative of likely future severity. It may now also be necessary for insurers to take into account the defense expense and possible settlement costs of opt-out actions. This additional potential exposure also has important implications for policyholders' limits

selection. Defense expense and settlement exposure could now be greater (perhaps significantly greater) than previously had been assumed, as the result of the emergence of significant opt-out activity and settlements.

Nevertheless, there may yet be reason to question whether the recent wave of opt-outs represents anything other than a temporary phenomenon. All of the recent opt-outs have come from the "mega-cases" associated with the corporate scandals from earlier in the decade. It is possible that once the mega cases have worked their way through the system individual investors will be less interested in pursuing individual actions.

The incentive for an individual investor to pursue an opt-out action may be limited to only the largest cases. According to NERA, the median 2006 securities class action settlement was $7.3 million. With half of all cases settling below $7.3 million, there may not be many cases where the potential benefit from pursuing an individual action will be worth the effort.

On the other hand, there are a couple of considerations that suggest the opt-out actions may not be a mere passing trend. The first is the size of the attorneys' fees the plaintiffs' lawyers have recovered in the opt-out settlement. The plaintiffs' attorneys' fee in the Ohio opt-out settlement with the Time Warner defendants was $31 million. It is entirely possible that the collective attorneys' fees in the Time Warner opt-out settlements will exceed the fee recovery of the lead plaintiffs' counsel in the class settlement. With these kinds of incentives, the plaintiffs' bar will be highly motivated to encourage investors to pursue opt-out settlements.

The second consideration is the political reality for the large pension funds and their representatives. The opt-out settlements have produced great publicity for the public officials who are responsible for the public pension funds. For example, when the Ohio Attorney General announced the settlement with the Time Warner defendants, he accompanied the announcement with extensive statements about what the settlement accomplished for plan participants (who also happen to be voters). With this political incentive, and the plaintiffs' lawyers' financial lure, it seems likely that we could continue to see opt-out cases in the future.

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It may be some time before it is clear whether or not the presence of significant opt-out settlements will remain a permanent feature of securities litigation. In the interim, it is hard to disagree with Columbia Law School professor John Coffee, who recently called the emergence of the large class action opt-outs "probably the most significant new trend in class action litigation."

About the Author

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To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to regularly refer to The D&O Diary, the author's Internet weblog. You can access the weblog via our website at *www.oakbridgeins.com*.

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