RECOVERING INVESTMENT LOSSES

The Investment Community Routinely Complains About Class Action Securities Fraud Settlements, But What Is A Hedge Fund Manager To Do About It?

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Adding insult to injury, victims of securities fraud regularly suffer the double indignity of both being duped by unscrupulous company management and then receiving meager "compensation" for their investment losses, while, at the same time, the class action lawyers make out like bandits. In the United States, securities class actions are the predominate means by which defrauded investors exercise their legal rights to reclaim investment losses. The general consensus, however, is that the class action system is not serving the best interests of investors. But, what is a hedge fund manager to do about it? Hedge funds with large, fraud-related investment losses need not accept this status quo.

There is an alternative to participating in class action litigation, and a small minority of institutional investors is proving that this alternative is very attractive.

Imagine an investment vehicle with a track record of regularly returning between 3 to 50 times the capital invested over a relatively short time horizon. Further, this investment vehicle is, at least according to the empirical data, low risk. Nonsense? A scam? Illegal? To the contrary, a number of public pension funds have publicly reported achieving equivalent results by "opting out" of securities fraud class action cases and pursuing individual legal actions to recover their investment losses. While securities fraud class actions have (as detailed further herein) historically settled for between 2% to 3% of investors' losses, public pension funds that have opted out of class actions have regularly reported achieving settlements recouping from 30% to nearly 90% of their losses. Moreover, in many instances, the public pension funds have reported receiving their recoveries before the investors who remained in the class action. Further still, the empirical evidence indicates only a remote risk of a negative return.[1]

The amount of money at issue is significant. Public pension funds that have opted out of securities class actions have reported recoveries of tens, and sometimes hundreds, of millions of dollars. For instance, in one opt out action several Ohio public pension funds recovered $144 million after fees versus a recovery of only $9 million had they remained in the class action. In another opt out action, The Teachers Retirement System of Texas recovered $61.6 million versus a recovery of only $1.4 million had it remained in the class action. Additional examples abound.

Certainly, seasoned investment professionals may be (indeed, ought be) skeptical of any "investment vehicle" claiming such historic returns on equity invested – particularly when coupled with claims of low risk. Here, however, the numbers (while subject to some dispute on the margins) are real and there are several logical explanations for opt out plaintiffs' outsized returns. In this paper we explore some of the reasons why opt out plaintiffs have achieved such outstanding results versus investors who remained members of the class. We note, that while historic recoveries in securities opt out actions are the result of the specific facts in those cases, and are no guarantee that future opt out plaintiffs will obtain similar results, the reported results should

[1] With only one exception that could have been avoided, the authors of this article are unaware of any instance in which an opt out plaintiff recovered less than what it would have received had it remained in the class action.

give hedge fund managers with large, fraud-related investment losses ample food for thought.

With so much money to be gained, many fund managers wonder why other professional money managers are not filing opt out cases to recover their own investment losses? While not widely known, many prestigious institutional investors – including Vanguard, PIMCO, BlackRock, Federated, and others – are filing individual legal actions to recover investment losses. These cases have been settled quietly and confidentially.

Hedge fund managers that wish to recover a significant portion of their fraud-related investment losses oftentimes are concerned about publicity, confidentiality, and the burdens of discovery in litigation. In our experience, these concerns have not proven problematic in practice.

Hedge funds with significant, fraud-related losses should, consistent with fiduciary obligations, at least consider legal options available to them. As detailed herein, whether a fund should file an individual action to recover its investment losses is dependent upon a number of factors that experienced counsel can aid fund managers in evaluating. This paper aims to provide hedge fund managers with sufficient information to be informed participants with legal counsel in making this important decision.

Class Action Securities Fraud Settlements: The Numbers Do Not Lie

Securities class actions settle too cheaply. According to a December 2008 paper published by NERA Economic Consulting, which examined the relationship between class action securities fraud recoveries and the size of the economic loss suffered by investors, "the ratio of median settlements to investor losses . . . stayed relatively steady ***in the 2-3% range over the past few years***." Stephanie Plancich, PhD., Svetlana Starykh, *2008 Trends in Securities Class Actions*, NERA Economic Consulting, at 15 (Dec. 2008). The NERA study, which is consistent over many years, confirms what many institutional investors already know from experience: securities class actions do not obtain meaningful recoveries for investors.

Interestingly, "mega-fraud" cases with massive investor losses settle for even less than the median 2-3%. NERA found that "as investor losses increase, settlements increase at a much lower rate: a 1.0% increase in investor losses results in an approximately 0.4% increase in the size of the expected settlement, other factors being held constant." *Id.* at 13. Recoveries of between two to three pennies on the dollar are the norm in relatively small cases, but as damages increase investors see their recoveries decline. Based on securities settlements between January 1, 2006 and December 31, 2008, a "case with $1 billion in investor losses is expected to settle for $12 million, only 1.2% of losses." *Id.* The fact that mega-fraud cases typically settle more cheaply than the median securities class action settlement does not bode well for expected recoveries in the current wave of securities class actions over the collapse of America's largest financial institutions.

Why do securities fraud class actions settle so cheaply? It is ***not*** because these cases are without merit. It is ***not*** because the defendants are insolvent, though this may explain the small recoveries in some actions. According to John C. Coffee, Jr., the Adolf A. Berle Professor of Law at Columbia University Law School and probably the most respected commentator on securities litigation, the answer lies in the fact that class action lawyers maximize their own personal interests rather than their clients' interests. It is an agency problem. Professor Coffee recently wrote:

> [N]o meaningful principal/agent relationship exists between the plaintiff's counsel and its clients. As a consequence, the plaintiff's attorney can behave less as an agent serving a principal and more as an independent entrepreneur . . . .

* * *

Absent client control, the plaintiff's attorney will predictably deviate from the clients' preferences to pursue the attorney's own interests. Why? The short answer is that when the plaintiff's law firm is able to act as a rational and unconstrained entrepreneur, it has very different interests, risk preferences, and incentives than those of its clients, the class members, and conflicts become inevitable.

* * *

This thesis, that plaintiff's attorneys tend to be motivated to settle "cheaply" on terms that class members, if they had perfect knowledge and full control over their "agent," would reject, is corroborated by the extraordinarily low rate of recovery in securities class actions.

John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better Than "Voice"*, 30:2 Cardozo L. Rev. 407, 411-14 (2008) (referred to herein as "*Accountability and Competition*") (emphasis in original).

Respected jurist and economist Richard Posner, Chief Judge of the Seventh Circuit, has similarly written on the conflict between class members and their appointed attorneys.

> [T]he class action device has its downside, or rather downsides. There is first of all a much greater conflict of interest between the members of the class and the class lawyers than there is between an individual client and his lawyer. The class members are interested in relief for the class but the lawyers are interested in their fees, and the class members' stakes in the litigation are too small to motivate them to supervise the lawyers in an effort to make sure that the lawyers will act in their best interests.

Thorogood v. Sears, Roebuck & Co., 547 F.3d 742, 744 (7th Cir. 2008).

The principal/agent theory as to why class action securities fraud cases settle cheaply can also explain why the proportion of losses recovered in class actions declines as the size of the investors' losses increases. Professor Coffee explains that "because plaintiff's [attorneys'] fee awards are typically a declining percentage of the recovery, the attorney benefits less from an increase in the recovery than does his or her clients." *Accountability and Competition* at 413.[2]

So what should a hedge fund (the principal) do when the class action lawyers (the agents) are not acting in the best interest of the hedge fund? Fire the lawyers. What many hedge fund managers do not realize is that they have the right to "fire" the class action lawyers and hire a new agent – one that will act in the client's best interest – and pursue an individual action to recover the fund's investment losses.

[2] The reader may be wondering: (i) Why doesn't the court-appointed lead plaintiff monitor the class action lawyer's conduct and prevent cheap settlements? or, (ii) If class action lawyers settle so cheaply, why aren't they displaced by competitors who actually litigate the cases properly? Professor Coffee seems to suggest that the problem lies with the fact that the plaintiffs' securities class action bar is an oligopoly as a result of its client relationships. Professor Coffee writes: "Today, it is the common practice for the larger plaintiffs' firms to entertain the officials of public pension funds (often lavishly) and to make political contributions to the elected public officials who control the fund's decision. . . . [T]he net result of this 'pay to play' system of exchanging political contributions for lead plaintiff designations is to rent the pension fund as a lead plaintiff to the highest contributors. It may do little damage to the pension funds, but it does effectively exclude smaller firms and new entrants who have not previously made contributions." *Accountability and Competition* at 422.

Investors Have The Right To "Opt Out" Of Securities Class Actions: But First, What Exactly Is A Securities Class Action And What Is An "Opt Out"?

Hedge fund managers that want to recover investment losses caused by fraud do ***not*** need to understand the intricacies of the federal securities laws and civil procedure. A basic understanding of a few fundamentals, however, may be helpful to appreciating the myriad options available.

The overwhelming majority of securities fraud cases prosecuted today are (i) class actions, (ii) brought in federal courts, (iii) pursuant to specific federal securities laws that do not require individual proof of reliance. These fundamental facets of the current securities litigation landscape exist for a reason – and, as is explained further herein, these common attributes limit the recoveries possible in securities class action litigation.

A class action is simply a lawsuit in which the court authorizes a single investor or group of investors to represent the interests of all the investors who bought a particular security (or securities) during a given period of time. Securities class actions seek to serve a diverse group of investors' interests, and the interests of the class as a whole may not necessarily be consistent with the interests of specific investors within the class. Class action securities litigation came about to preserve judicial resources, promote consistency, and to create economies of scale for plaintiffs. While these first two reasons for litigating securities fraud cases as class actions concern the court system,[3] the third reason has more to do with investors' interests. Class action securities fraud cases became the norm to address the perceived needs of retail investors with small investment losses. "[C]lass actions commonly arise in securities fraud cases as the claims of separate investors are often too small to justify individual lawsuits, making class actions the only efficient deterrent against securities fraud." *In re Adobe Sys., Inc. Sec. Litig.*, 139 F.R.D. 150, 152-53 (N.D. Cal. 1991). In our experience, depending on the circumstances, this rationale for utilizing the class action mechanism to recover investment losses loses credibility when an individual hedge fund, or a group of funds, has losses exceeding $10 million. That is, institutional investors oftentimes have large enough investment losses to justify an individual suit and the economies-of-scale argument for class actions is inapplicable as to these plaintiffs.

Securities class actions must be brought in federal court under federal law pursuant to the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). SLUSA was passed in an effort to prevent securities class action lawyers from filing cases in state courts, which were (and continue to be) perceived as a better forum for plaintiffs. Moreover, while the vast majority of states have (oftentimes liberal, plaintiff friendly) securities laws to protect investors, SLUSA prevents securities class actions from taking advantage of these state statutes.

Finally, securities class actions are limited to proceeding under the federal securities laws that do not require the plaintiff to prove actual reliance on the defendants' fraudulent conduct, *i.e.* the plaintiff need not prove he/she heard or read the defendants' false and misleading statements. It would simply be infeasible to obtain and adduce at trial evidence that each of the thousands of investors in the class actually relied on the false statements at issue. Accordingly, class actions with thousands of investors are limited in the types of legal causes of action available to them.

[3] Overseeing one action on behalf of thousands of investors, rather than adjudicating one investor action at a time, is clearly easier for our overworked (and underpaid) judges and their staffs. Moreover, consolidating the claims of all investors into a single class action limits the possibility that investors with seemingly identical claims of fraud against the same corporate issuer are treated to wildly different results because different judges and juries see the case differently.

Opt out litigation is best defined by its contrast to the predominant federal securities class actions. An opt out action is merely a securities lawsuit brought by an individual investor that has chosen to not proceed as part of a larger class action purporting to represent the interests of a wide array of investors damaged by defendants' conduct. Investors have a legal right to opt out of securities class actions, but may be restricted in when they may do so.

Investors can opt out of a securities class action case at various times during the lifecycle of a case. Some investors decide to opt out of class actions immediately, filing their own case as soon as a fraud is revealed. Other investors have opted out at a later date – after the factual record had become better established and/or after the court in the class action rejected defendants' initial attempts to dismiss the case – but before formal certification of the action as a "class action."[4] Finally, many investors have chosen to opt out only after a settlement in the class action, upon learning what they might recover if they remain in the class. Investors who do not opt out before class certification risk being bound by negative rulings in the class case. The point at which the investor opts out of the class action is a critical tactical decision and the specific factors in any given case prevent us from us recommending a one-size-fits-all course of action.

[4] Whether or not the statute of limitations is tolled for individual claims filed before class certification is a matter of much legal dispute, and should be carefully considered in light of the applicable law and the facts of the particular case. *See, e.g., Wyser-Pratte Mgmt. Co. v. Telxon Corp.*, 413 F.3d 553, 568 (6th Cir. 2005) (finding "a plaintiff who chooses to file an independent action without waiting for a determination on the class certification issue may not rely on the *American Pipe* tolling doctrine"). *But see also Cal. Pub. Employees Ret. Sys. v. Caboto-Gruppo Intesa BCI (In re WorldCom Sec. Litig.)*, 496 F.3d 245, 254 (2d Cir. 2007) (overturning district court holding that plaintiffs opting out before class certification were denied benefit of tolling of the statute of limitations).

Institutional Investor Opt Outs Have Recovered Far More Of Their Investment Losses, Oftentimes More Quickly, Than The Class Action Plaintiffs

"For decades, institutions did not opt out." *Accountability and Competition* at 425. In the last few years, things have changed dramatically. "Institutional investors have seen that large recoveries are possible in individual suits and are now prepared to sue. . . . When institutional investors exit the class and sue individually, they appear to do dramatically better – by an order of magnitude!" *Id.* at 417.

The first significant opt outs were filed in connection with the *WorldCom* securities fraud. The *WorldCom* opt out plaintiffs, like many of the initial opt out plaintiffs, were the pre-existing clients of the large plaintiffs' securities class action law firms, particularly public pension funds and Taft-Hartley funds.

Most of what is publicly known about opt out settlements in connection with *WorldCom* and other cases is the result of public pension funds and/or their lawyers issuing press releases touting their achievements in recovering constituents' losses. Most hedge funds and mutual funds have settled opt out litigation on confidential terms. The publicly available data, however, is quite compelling.

In 2005, CalPERS, CalSTRS, and the Los Angeles County Employee Retirement System settled their *WorldCom* opt out claims for $257.4 million and five New York City pension funds settled their claims for $78.9 million – about 61% of their damages. Though disputed by the lawyers for the *WorldCom* class action, the New York City funds claimed their settlement was "about three times bigger than what they would they would have gotten as part of the wider class-action case." Michael Cardozo, the New York City funds' corporate counsel, said in a statement: "This settlement fully validates the decision of the funds' trustees to opt out of the class action to pursue an individual case."

The Retirement Systems of Alabama also opted out of the *WorldCom* class action, settling for, according to its counsel's website, "$111 million, or 89 percent of what it lost from investing in the company." Apparently not satisfied with one opt out action, the Retirement Systems of Alabama recovered $49 million of its $57 million Enron loss by suing several of Enron's banks under Alabama state law.

In March 2007, several Ohio public pension funds settled an opt out action against AOL/Time Warner for $175 million ($144 million after fees). According to Ohio's then-attorney general, even after attorneys' fees the settlement was $135 million more than the pension funds would have received had they remained a party to the class action suit. Ohio's net recovery in the opt out settlement represented 16 times more than the $9 million Ohio would have recovered from the class settlement. After fees, Ohio recovered 36% of its estimated $400 million investment loss. In justifying Ohio's decision to opt out of the class action, Ohio's attorney general explained: "The class-action lawsuit, you get peanuts at the end of it . . . The only guys who make money are the lawyers."

Several New Jersey public pension funds opted out of the *Tyco* securities class action, settling claims against the company and its auditor PricewaterhouseCoopers for $79.1 million. This represented a nearly 80% recovery, according to press reports that New Jersey suffered investment losses of $100 million. New Jersey's reported 80% recovery stacks up well compared to the recovery in the class action, which one commentator reported to represent "only 3% of the drop in market capitalization over the Class Period."

At the risk of beating a dead horse, the following chart summarizes some of the more significant opt out settlements announced by public funds. As shown in the chart, these public pension funds with significant losses settled for amounts many times greater than they would have received by remaining in the class:

Fund & Case	Opt-Out Settlement (Millions)	Estimated Class Recovery	Opt-Out Recovery Multiple
Alaska Funds *AOL/Time Warner*	**$50**	**$1**	**50x**
Alaska Funds *Qwest*	**$19.0**	**$0.4**	**44.5x**
Texas Teachers *Qwest*	**$61.6**	**$1.4**	**44.0x**
Colorado Pub. Empl. Ret. Assoc. *Qwest*	**$15.5**	**$0.4**	**38.8x**
CalSTRS *Qwest*	**$46.5**	**$1.6**	**30x**
New Jersey *Tyco*	**$73.25**	**$4.2**	**17x**
U.C. Regents *AOL/Time Warner*	**$246**	**$14.5**	**16-24x**

While the publicly available data on opt out plaintiffs' settlements primarily concerns results achieved by public pension funds, we understand that private institutional investors have settled similar opt out cases for large premiums over what they would have received had they remained members of the class action.

Investment advisors, hedge funds and mutual funds are now recognizing the benefits of pursuing their own actions to recover investment losses. The list of funds that have filed individual securities actions includes some of the most prestigious and/or recognizable names in the investment industry, including: Vanguard, PIMCO, AIG, BlackRock, Janus, Russell Investments, Federated Investors, Fred Alger & Company, Rabobank, Nuveen Investments, Capstone Asset Management, Munder Capital, Stichting Pensionenfonds ABP, Oaktree Capital

Management, Trust Company of the West and AUSA Life Insurance Company. (Note: The names of certain funds have been left off this list in accordance with the funds' desire to avoid publicity.) Even more interesting, some of these large institutional investors have been so pleased with the results they have opted out of a number of securities class actions.

Investors who file individual actions not only obtain significantly larger recoveries of their investment losses, but they also may recover their losses faster than do class members.[5] Once a settlement is reached in an opt out case, the plaintiff is typically paid in a few weeks (the terms of which are negotiated by counsel). In securities class action settlements, it takes far longer to distribute money to the thousands of members of the class. A series of court approvals is required. After the court grants preliminary approval, notice is sent to all class members who are given an opportunity to object to the settlement before final approval by the court can be granted. After the court's final approval, funds are not distributed to class members until after all of the class members have an opportunity to fill out claim forms that must be filed with the claims administrator. The forms must then be processed by the claims administrator to assure there are no fraudulent or incorrect applications. From the time of the class action settlement, court approval of the settlement and the claims process typically takes over a year and sometimes longer than two years before class members receive any payments.

The adoption of opt out litigation by traditional institutional investors is still in its early stages. Many professional money managers do not even know opting out of a class action is an option. Nonetheless, empirical evidence of the extreme divergence in settlement results is difficult to dispute. Indeed, the "dramatic disparity between the opt out recoveries and the class recovery" gives Professor Coffee reason to wonder about the "prospect . . . that the securities class action may be relegated to a secondary role: that of serving as a vehicle of last resort for smaller retail investors." *Accountability and Competition* at 429, 435. We are a long way from the day when all institutional investors opt out of securities class actions to maximize their recovery of investment losses via an individual action. However, the implicit assumption in Professor Coffee's hypothesis – that opting out of class action settlements makes sense for all institutional investors – should give open-minded hedge fund managers food for thought.

Why Have Opt Outs Done So Much Better Than Investors In <u>Class Action Securities Settlements?</u>

While many professionals, from fund managers to academics to mediators, query why it is that opt out plaintiffs are able to achieve such significant recoveries of their investment losses versus the results obtained by class actions, the simplest answer appears to be that class actions are simply setting the bar low. Beating the historical class action recovery rate of 2% to 3% is hardly an insurmountable task. Notwithstanding this basic explanation, there are several factors contributing to the strength of reported opt out recoveries worth considering.

• Eliminating The Principal/Agent Problem Of Class Actions

In explaining why opt out plaintiffs do "significantly better" than investors that remain in class action securities litigations, Professor Coffee concluded "the one variable that can most logically explain this different in outcome is the different relationship that these 'opt out' plaintiffs have with their attorneys." *Accountability and Competition* at 414. Plaintiffs in individual actions are better able to monitor their lawyers, eliminating lawyer-driven settlements that are not in the best interest of aggrieved investors. Simply by participating in the litigation process and holding counsel accountable, institutional

[5] For instance, counsel for the Retirement System of Alabama boasted of obtaining recoveries in its *Enron* and *WorldCom* opt out litigation years before the class action settlements were distributed.

investors motivated to maximize their own recoveries are able to achieve settlements that are multiples over what class members receive.

• Securities Class Actions Suffer From "Diseconomies of Scale"

Ironically, whereas class actions are supposed to create economies of scale when plaintiffs' claims are too small to be litigated individually, the reality is that class actions involving massive investor losses actually suffer from diseconomies of scale. The percentage of investors' aggregate losses that can be recovered via a class action is limited by the sheer size of the amount the defendants would have to pay to make the plaintiff class whole. Notably, many of the successful opt out actions have been filed in mega-fraud cases where investors lost billions, if not tens of billions, of dollars. When plaintiffs have lost tens of billions of dollars, defendants are simply incapable of providing a meaningful recovery to the entire class. To the contrary, defendants can be forced to make whole an individual investor – even an institution with a large loss exceeding $100 million. Professor Coffee explains:

> [T]he settlement of opt out cases is seldom insolvency constrained. As a practical matter, the defendant in the [opt out] action cannot utilize its limited solvency as a defense or threaten a bankruptcy filing. In contrast, a "mega" securities class action in federal court may hypothetically seek $5 billion in damages, and the defendants' strongest argument may be that the corporation simply cannot pay such an amount and would file for bankruptcy before doing so. Similarly, the federal judge and/or a mediator may push for a settlement within a "realistic" range. But, if instead an individual action is brought in state court, the maximum damages will be much smaller. Few major corporations can seriously threaten to turn to bankruptcy to avoid only a $100 million claim.

Accountability and Competition at 432.

• Availability Of Legal Claims Not Available To Securities Class Actions

As set forth above, securities class actions are constrained in the types of legal claims that they can bring. Securities class actions cannot assert state law causes of action and cannot successfully bring claims that require individualized proof of reliance. As a result, securities class actions primarily rely on §§ 11, 12(a)(2) and 15 of the Securities Act of 1933 and §§ 10(b) and 20(a) of the Securities Exchange Act of 1934. Opt out plaintiffs, on the other hand, have an array of legal claims available to them that are easier to prove and/or expose defendants to additional liability. For instance, opt out plaintiffs regularly bring claims under § 18 of the Securities Exchange Act.

> [U]nlike a Section 10(b) claim, liability under Section 18 requires proof of reliance ***but does not require proof of scienter***. A section 18 plaintiff . . . bears no burden of proving that the defendant acted with scienter or any particular state of mind. Instead, ***the burden of proving state of mind falls upon the defendant***, who must demonstrate good faith and lack of knowledge that the statement on the filing was false or misleading.

In re Able Labs. Sec. Litig., No. 05-2681 (JAG), 2008 U.S. Dist. LEXIS 23538, at *92 (D.N.J. Mar. 24, 2008) (emphasis added and internal citations omitted). Because § 18 claims do not require the plaintiff to prove the defendant acted with intent to deceive, these claims are far easier to bring than standard fraud claims.

Individual opt out plaintiffs can also bring claims under favorable state laws. Many states allow for aiding-and-abetting claims, enabling opt out plaintiffs to seek a recovery from solvent third parties that knowingly acted in furtherance of the fraud, whereas such claims are not actionable under federal law. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S. Ct. 761 (2008). Similarly, a number of the institutional investors that opted out of the *Tyco* securities class action brought claims under New Jersey's RICO Statute, N.J.S.A. 2C:41-1, *et seq*., which allows for treble damages. Federal securities class actions cannot bring RICO claims under either federal or state law. The availability of alternative causes of action not available to the class action, in our experience, has been of moderate assistance to opt out plaintiffs in obtaining premium recoveries versus class members.

• State Courts And The Powerful Potential For Offensive *Collateral Estoppel*

Opt out plaintiffs may – under certain circumstances – also take advantage of bringing an action in state court. State courts, as compared to federal courts, provide at least three, interrelated benefits to the aggrieved investor: (i) less onerous pleading standards, (ii) earlier trial dates, and (iii) the potential for offensive *collateral estoppel* (a very powerful, but underutilized, tactical advantage available to early opt out plaintiffs).

State courts typically apply a more liberal pleading standard in securities actions than do federal court. As a result of the passage of the Private Securities Litigation Reform Act (the "PSLRA") in 1995, federal courts require plaintiffs to plead the details of a defendant's fraud in excruciating detail. "Exacting pleading requirements are among the control measures Congress included in the PSLRA." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007). Moreover, as Justice Stevens wrote in dissent, the Supreme Court has taken a "mistaken hostility towards the § 10(b) private cause of action" for securities fraud under federal law. *Stoneridge*, 128 S. Ct. at 779. *See also Alaska Elec. Pension Fund v. Flowserve Corp.*, 2009 U.S. App. LEXIS 13280, at *35 (5th Cir. June 19, 2009) ("To be successful, a securities class-action plaintiff must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action."). The level of detail required by federal courts to plead a claim for violation of the securities laws, however, is rare in state court proceedings.

State courts, which spend far less time scrutinizing a plaintiff's pleadings, move quicker than federal courts. Justice delayed is justice denied. State courts' faster dockets typically benefit plaintiffs by encouraging defendants to enter into serious settlement discussions or risk trial and a negative verdict. For example, under California law, plaintiffs are generally entitled to a trial within one year from the date of filing an action. Court Rule 7.0(d) of the Superior Court of California, County of Los Angeles sets forth trial delay reduction guidelines to dispose of "90% of all civil cases within one year of filing, 98% within 18 months of filing and 100% within two years of filing." No similar provision exists under federal law, and the class action claims could remain pending without a trial for many years. "[I]f an action is brought on a non-class basis in state court . . ., the time necessary to reach the trial stage (and hence settlement) may be substantially shortened." *Accountability and Competition* at 431.

Beyond the obvious time-value-of-money benefit of obtaining a speedy recovery, an early trial date is a significant tactical advantage to plaintiffs in securities fraud actions, and particularly favors opt out litigants. If an opt out plaintiff obtains a ruling on the merits in state court prior to the securities class action going to trial, the doctrine of offensive *collateral estoppel* likely would prevent the defendants from being able to defend themselves in the federal class action case. *Collateral estoppel* prevents a person from relitigating an issue decided by a court of competent jurisdiction. "'Under *collateral estoppel*, once a court has decided an issue of fact or law necessary to its judgment, that decision may preclude relitigation of the issue in a suit on a different cause of action involving a party to the first case.'" *San Remo Hotel L.P. v. City and County of San Francisco*, 545 U.S. 323, 336 n.16 (2005). Offensive *collateral estoppel* is a "no win" situation for defendants. A favorable ruling in state court would subject defendants to liability not only for the individual opt out plaintiff's losses, but to all of the damages suffered by investors.[6] As a result, it is our experience that defendants settle opt out cases with early trial dates for a high percentage of the plaintiff's loss, rather than risk a catastrophic legal ruling.

Did Your Fund Buy Unregistered Securities? Options? Bonds Traded In The Over-The-Counter Market? Do Not Expect The Class Action To Represent Your Fund's Interests

Hedge fund managers with significant investment losses should not merely assume they are fulfilling their fiduciary duties to their clients by participating in class action recoveries. There are many instances in which an aggrieved investor's interests will not be protected or otherwise represented in a class action. In such instances, a hedge fund may have a perfectly valid legal claim worth tens of millions of dollars or more that – because of the complexities of class action litigation in federal court – will expire worthless if the fund manager does not act. While we cannot detail here all the various possibilities in which a hedge fund's valid legal claims might be left out of a securities class action, fund managers should consider the following examples.

Purchasers of unregistered securities issued to qualified institutional buyers pursuant to Rule 144A, 17 C.F.R. § 230.144A, rarely, if ever, recover investment losses in securities class actions. This is a peculiarly legal problem with *class action* litigation.[7] Numerous institutional investors have successfully brought individual actions against underwriters of Rule 144A offerings. For example, suing in the Superior Court of California, Los Angeles County under California and federal law, several investment funds recently recovered 100% of their investment losses (plus interest) from CIBC for its role in underwriting a Rule 144A offering (the $32.1 million judgment reflected the jury's $52 million verdict adjusted for settlements that the plaintiffs received from other sources). The jury verdict, upheld by an appellate court in a published opinion, evidences the efficacy of pursuing complicated securities actions in state court rather than federal court and further demonstrates that purchasers of Rule 144A securities can recover investment losses even though their interests are not represented in class action cases. *See OCM Principal Opportunities Fund, L.P. v. CIBC World Markets Corp.* (2007) 157 Cal.App.4th 835.

A number of financial institutions and other companies that recently collapsed amid alleged accounting improprieties, issued massive amounts of unregistered Rule 144A (and similar Regulation S) securities that are now nearly worthless in value. Many of these Rule 144A securities were issued at the same time the companies were issuing registered securities that are part of securities class action cases. Purchasers of the unregistered securities were damaged by the same alleged fraud as were the purchasers of the registered securities. Purchasers of the Rule 144A

[6] Significantly, a state court ruling in an opt out case could prevent defendants in the class action from mounting a defense in federal court, but any ruling in state court would not be binding on the plaintiffs in the federal securities class action as they were not a "party to the first case."

[7] Why? As set forth above, securities class actions are generally limited to specific federal securities statutes: primarily §§ 11 and 12(a)(2) of the Securities Act and § 10(b) of the Securities Exchange Act. Rule 144A offerings are exempt from § 11 and, though it is still an open issue, many courts have found Rule 144A offerings to be exempt from § 12(a)(2). *See, e.g., In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 625 (S.D.N.Y. 2007). Because many experts believe Rule 144A securities do not trade in an efficient market, bringing § 10(b) claims on behalf of a class of Rule 144A purchasers faces significant difficulties in proving reliance.

securities may have valid legal claims to recover their investment losses against the issuers of the securities and/or the underwriters of the securities, but these claims will expire worthless unless the purchasers file an individual action. Accordingly, hedge funds with large losses in Rule 144A securities should consult with counsel to determine whether an individual action is in the fund's best interests.

Like purchasers of unregistered securities issued under Rule 144A, class actions do not normally represent the interests of investors who purchased options and/or bonds traded in the over-the-counter market.

By no means have we attempted to provide an exhaustive list of situations in which a hedge fund's valid legal claims to recover investment losses may not be pursued as part of a securities class action. Hedge fund managers may ascertain whether their fund's legal claims are being asserted in the class action by either reviewing the class action complaint or consulting experienced counsel. In light of the recent, large economic losses suffered by many hedge funds, including losses resulting from trading in options, over-the-counter bonds, and Rule 144A securities, hedge funds should consult with experienced counsel to determine whether the funds have an opportunity to recover these losses.

Publicity, Confidentiality, And Discovery: Should The Aspiring Opt Out Plaintiff Worry?

If your fund files an opt out action, is the media going to publicize the filing and the fund's losses? Will your fund's proprietary trading models be publicly available to anyone with access to the court's docket? Are you going to have to turn over every document your fund ever generated? On the one hand, these concerns have proven unfounded in our experience. With all due respect to President Truman, who famously demanded a one-handed economist, we note that fund managers ought to consider what is on the other hand. There are legitimate risks associated with publicity, confidentiality and discovery that you and, more importantly, your counsel ought to consider and address when commencing opt out litigation.

Before addressing these potential pitfalls of litigation, it is important to note that both formal and informal safeguards minimize most of the risks that might worry the hedge fund manager seeking to file opt out litigation. Procedural rules and a vast body of case law protect litigants from the disclosure of proprietary business information (such as trading and valuation models) and abusive discovery practices. Additionally, appropriate confidentiality agreements are typically negotiated by the parties to prevent the disclosure of sensitive information.

Discovery burdens in opt out litigation can also be minimized by intelligent counsel. Discovery is a two-way street, and defendants in securities fraud actions have more to lose from scorched-earth litigation strategies. Defendants typically have more documents to be produced, more employees to be deposed, and more secrets to hide from the light of public scrutiny. By contrast, discovery of opt out plaintiffs is typically limited to documentation evidencing the plaintiffs' trading in the securities at issue and evidence relevant to whether the plaintiff knew of the alleged fraud but, nonetheless, purchased the security at issue. In our experience, many opt out plaintiffs have been able to settle individual actions on excellent terms without producing any witnesses for deposition or producing any formal discovery.

Publicity has not been a problem for opt out litigants. The vast bulk of media attention to opt out litigation has involved public pension funds that specifically sought to publicize their recoveries to highlight the work of public officials. Many institutional investors have been able to litigate their claims without publicly disclosing the size of their losses, have settled individual actions on confidential terms, and have been able to avoid any public attention whatsoever. Indeed, many, if not most, professional money managers remain ignorant to the fact that certain of their professional colleagues have filed litigation to recover investment losses.

Before commencing opt out litigation, it is important that you ask some simple questions. Hedge fund managers must inquire, "Did our fund have access to and/or trade on material, nonpublic, inside information?" Further, there can be no guarantee that the fund's most senior officers will be able to escape sitting for deposition. Is this acceptable? If you are comfortable with the answers to these basic questions, opt out litigation may be in your fund's best interests.

Liability; Damages; Collectability; Costs; Timing: What Should A Hedge Fund Consider Before Filing An Opt Out Action?

Whether your fund should file an individual legal action to recover its investment losses will depend on a number of factors. Among other considerations, hedge funds should discuss the following issues with counsel: (i) the merits of the legal action; (ii) the size of the fund's damages; (iii) how much the defendants can afford to pay; (iv) costs to prosecute the action, including attorneys' fees; and (iv) the various advantages and disadvantages of when to file suit. The importance of these considerations is fairly self-evident, but not without call for some elaboration.

In individual opt out actions the amount of damages the plaintiff suffered as a result of the defendants' conduct is typically highly contested. "Damages" compensable under the law may not, and likely will not, (depending on the legal causes of action available to the plaintiff in a particular case) be the same as the plaintiff's economic loss. The federal courts have issued a divergent array of rulings interpreting what constitutes "loss causation" under the federal securities laws. Accordingly, a number of legal and factual issues may determine how much of your loss is compensable. Experienced counsel, with the aid of a damages expert as necessary, should carefully examine a fund's trading records before recommending a course of action.

Before commencing an individual action, consider the likely costs of prosecution versus the potential recovery. Costs will vary significantly depending upon a number of factors, including: (i) at what stage of the litigation the investor opts out of the class action; (ii) whether costs can be shared among a number of plaintiffs all represented by the same counsel, or if the opt out action is consolidated with the class action or other similar cases proceeding against defendants; (iii) whether the plaintiff can "piggy back" on the work done by governmental entities; (iv) the need for experts (at a minimum consider the costs of accounting and damages experts); and (v) the number of depositions necessary to prepare the case for trial.

Many funds inquire as to how much in economic losses a plaintiff must have to make an individual action economical. The answer depends, and various commentators have given far ranging opinions.[8] We tend to believe that, under the right circumstances, investors need not have suffered eight figure losses to justify an opt out action. Indeed, a number of investors with relatively small losses (some as little as $100,000) have successfully opted out of various class actions by coordinating or filing actions with other investors and sharing costs. In our experience, efficient counsel can prosecute individual actions at costs far less than that charged by class action counsel without sacrificing the quality of representation.

[8] Professor Coffee notes that a prominent class action attorney estimates counsel must represent plaintiffs with aggregate damages of at least $1 billion for an opt out action to be profitable. Nonetheless, Professor Coffee speculates that "if an opt out counsel could aggregate a half-dozen claimants into a consolidated action in state court seeking, say, $50 million in damages and could settle that case for, say, $20 million, it could charge a negotiated fee of 33 1/3% (or $6.67 million) and still earn an acceptable return." *Accountability and Competition* at 436.

When an investor should/can opt out of the class action is both an important tactical decision, and subject to a number of factors and legal concerns. Many investors wait until the class action settles before opting out, presumably because they are unhappy with the amount of the announced settlement. Opting out after a settlement in the class action may substantially limit the options available to the opt out plaintiff, as certain causes of action (such as remedies available under state law) may have expired. On the other hand, opting out at the later stages of the class action case typically involves less risk – the plaintiff has the benefit of seeing how the facts develop and the court's rulings over time. Opting out during the early stages of the class action may enable the individual plaintiff to bring additional claims that would otherwise expire, and/or take advantage of offensive *collateral estoppel* by obtaining an early trial date. In our experience, investors are best served by consulting with experienced counsel early in the process so as to preserve all available options.

Conclusion

By many accounts, securities class actions fail investors. Institutional investors that opt out of securities class actions have shown, at least thus far, that exiting the class action mechanism is in the best interests of investors with large, fraud-related losses. Opt out plaintiffs have recovered many multiples over what comparably situated class members have received – oftentimes gaining access to these recovered losses more quickly than their class action counterparts. Noted securities law commentator, Professor Coffee of Columbia Law School, believes that opt out litigation will grow in importance as more institutional investors recognize that they can recover large portions of their investment losses. Moreover, Professor Coffee suggests opt out litigation may finally prove to remedy some of the problems inherent to class action securities litigation; "by encouraging opt outs, public policy can stimulate greater competition and compel class attorneys to become more faithful champions" of investors' interests. *Accountability and Competition* at 408. In our view, opt out litigation holds significant untapped potential to compensate aggrieved hedge funds and deter future wrongdoing for the benefit of all investors. Accordingly, we believe hedge funds with significant, fraud-related losses should consult with experienced counsel to determine whether opting out of a particular class action is in the fund's best interests.

* *Messrs. Siben and Thorpe are founding partners of Dietrich Siben Thorpe LLP – a law firm specializing in the representation of institutional investors in individual securities fraud actions. Both Messrs. Siben and Thorpe are experienced litigators, having successfully prosecuted some of the largest securities fraud and opt out actions ever filed. To contact Messrs. Siben and Thorpe, please email matthew@dstlegal.com or david@dstlegal.com, or call 760.579.7368. For more information, please visit www.dstlegal.com.*