



Securities Class Action Opt-Out Claims: A Growing Problem

The exposure to Insureds and their D&O insurers from securities class action lawsuits has escalated greatly over the last ten years. Much has been written about the explosion in the magnitude of settlements in those lawsuits. Unfortunately, this exposure is now getting even larger and more complicated as a result of institutional investors opting out of the class action and individually pursuing their claims against the company and D&O defendants.

Under long-established rules governing the prosecution of class action lawsuits, any member of the class can opt-out of the class action and individually pursue its claims against the defendants. Historically, very few investors opted-out of securities class actions because it was prohibitively expensive to litigate the complex factual and legal issues on behalf of only one or a small number of investors. However, in recent years, large institutional investors are opting out of securities class actions with increasing frequency, which creates huge challenges and even larger exposures for the defendants and their insurers.

This recent trend has been driven principally by prominent plaintiffs' firms, who after being closed out of the position of lead counsel in the class action recruit large institutional investors to opt-out of the class action as an alternate means of recovering hefty attorneys' fees. For instance, according to the court in an opinion in the *Worldcom Securities Litigation*, Milberg Weiss "engaged in an active campaign to encourage pension funds not to participate in the class action and instead to file individual actions with Milberg Weiss as their counsel." Plaintiffs' counsel have been able to persuasively market to a growing number of institutional investors the legitimate and lucrative financial benefits of opting out of large securities class action settlements.

By opting out, the institutional investor has the opportunity to actively control the prosecution of its own claims, file the case in its own state and, most importantly, negotiate a larger recovery than it would have received as a passive participant in the class action. Some recent examples of lucrative opt-out claims include the following:

Worldcom. After the *Worldcom* class action was resolved, several large institutional investors opted out of the class settlement and negotiated separate settlements of over \$651 million. According to counsel for the opt-out plaintiffs, the institutions recovered 83% more than what they would have if they remained passive class members in the class action settlement.

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Moreover, unlike the class settlement, which was subject to a lengthy hearing and objection process, the opt-out plaintiffs presumably received their settlement funds shortly after their settlement was negotiated.

AOL Time Warner. Institutional investors who opted-out of the \$2.4 billion class settlement in *AOL Time Warner* also fared better than they would have as passive members of the class. For instance, in December 2006, Time Warner settled claims brought on behalf of certain Alaska investment funds for \$50 million based on claimed losses of \$60-\$70 million. Those institutions recovered between 71% and 83% of their loss, as opposed to the pennies on the dollar they would have recovered as members of the class settlement. Time Warner also agreed to pay five other institutional investors \$400 million to settle their opt-out claims. According to one of the institutions, the settlement represented 16 to 24 times as much as it would have received in the class action. To date, Time Warner has paid nearly \$800 million to opt-out plaintiffs and, based on its latest reserve adjustment, faces another \$3 billion in potential claims arising out of the same accounting improprieties that were “resolved” in the class action.

Qwest. After defendants and their insurers reached a \$400 million class settlement in the *Qwest* securities class action litigation, institutional investors with claimed losses of approximately \$2.8 billion opted-out of the settlement and ultimately recovered more than \$400 million (i.e. the opt-outs recovered more than the entire class settlement).

This trend of institutional opt-outs is likely to continue as institutions are able to leverage greater settlements than they would as members of a class, as plaintiffs’ counsel are able to reap huge fees in the opt-out claims, and as elected officials who control some of the public institutional investors tout the financial benefits of their recoveries for political gain. For instance, following settlement of opt-out suits filed on behalf of various Ohio pension funds against Time Warner, Ohio’s Attorney General was particularly vocal in parading to Ohio voters the recovery achieved on behalf of the funds and their Ohio-based pensioners. Because institutions have a duty to maximize recovery on behalf of their constituents, institutions may feel compelled to bring more opt-out lawsuits, especially where their recovery in such suits is likely to be greater than it would be in the class action.

Those opt-out claims present significant challenges for defendants and D&O insurers. For example, multiple class action lawsuits against a company and its D&Os usually can be consolidated into a single proceeding in one court. But multiple opt-out lawsuits usually cannot be consolidated. As a result, the defendants must defend multiple suits in multiple jurisdictions, increasing both the total defense costs and the likelihood of inconsistent judicial rulings.

Most importantly, the prospect of large opt-outs makes negotiation of the class settlement far more difficult. Typically, institutional investors do not opt-out of the securities class action until after the class settlement is negotiated (but before the class settlement is approved by the court). By waiting until that late date, the opt-out investor can benefit from the litigation efforts of the class counsel and can use the class action settlement as a proportionate floor for negotiating an individual settlement. In addition, class plaintiffs can use the threat that more investors will opt-out of an inadequate class action settlement as another weapon in negotiating a large class settlement.

From the perspective of the defendants and their insurers, this means they must negotiate the class settlement without knowing what additional money will be required to defend and settle possible opt-out claims. Since

both the company defendant and the insurers typically have finite amounts dedicated to resolve the litigation, it is now very difficult to evaluate what is a reasonable amount to pay for settlement of the class action and how much should be held in reserve for the unknown but likely opt-out claims.

There is no good solution to this new problem. Historically, to protect against excessive residual exposure, nearly all class settlement agreements contain provisions giving defendants the ability to terminate the class settlement if a certain percentage of class members (as measured by their number of shares) opt-out of the settlement. While this type of “blow provision” occasionally may be triggered based on large numbers of opt-outs, defendants very rarely elect to terminate the negotiated class settlement. Therefore, as a practical matter, a “blow provision” has limited utility in most securities cases. Terminating the class settlement will leave the defendants and the insurers with the same potential exposure they had prior to the settlement and renegotiating the settlement will not likely result in a substantial savings.

As another means of dealing with opt-outs, defendants and insurers are now trying to add unique provisions to the class settlement. For example, class settlements could include a claw-back provision, pursuant to which the amount of the class settlement is decreased based on the number and size of the opt-outs. However, class plaintiffs typically are unwilling to agree to such a provision since it reduces the size of the class settlement (and more importantly the size of the class plaintiffs’ attorney fee award) based on developments outside the control of class plaintiffs. Alternatively, the class settlement could be increased by a defined amount if there are no or a minimal number of opt-outs. Defendants and their insurers are typically unwilling to agree to that additional cost. Another approach is to require shareholders to declare their opt-out status before the class settlement is negotiated, thereby allowing the defendants and their insurers to make more informed decisions regarding the amount of a reasonable class settlement. There is doubt, though, whether such a mandatory early opt-out election is consistent with class action legal requirements and whether courts will support such a practice.

These opt-out claims also are particularly problematic with respect to D&O insurance for the following reasons, among others:

- 1. Claims Release.* As part of a settlement contribution, D&O insurers typically request and receive from the settling Insureds a release of all claims relating to the settled lawsuit. This type of claims release is intended to confirm that the insurer has completely fulfilled its obligations to the Insureds, and is typically an essential element of the settlement. However, in light of the heightened exposure to opt-out claims, Insureds are now frequently insisting on a carve-out to this insurer claims release to the extent opt-out claims are later filed. Insurers usually resist such a carve-out, particularly where the insurer has already stretched in agreeing to a large class settlement or where the insurer is compromising coverage defenses. Negotiating the scope of that claims release is becoming increasingly more difficult since neither the Insureds nor the insurers want to bear the risk of opt-out claims.
- 2. Conflicting Insureds.* As opt-out settlements grow, the likelihood that the D&O insurance limits of liability will be completely exhausted also increases. If different Insureds are defendants in the class action, the opt-out claims and other related litigation (such as shareholder derivative suits), conflicts may develop among those Insureds regarding who is entitled to what portion of the insurance limits. The priority of payment provision in most D&O policies requires the insurer to pay non-

indemnifiable loss first, but that provision does not address priority among Insureds for the same type of loss.

In addition, if some Insureds are concerned about accessing the remaining limits, those Insureds may be motivated to negotiate an inflated early settlement before other Insureds deplete the limits. Such an inflated settlement further jeopardizes the adequacy of the remaining limits for the other Insureds and can create a “race to settle” which only helps the plaintiffs.

3. Duration of Litigation. Opt-out claims are typically filed after the class settlement is announced, which typically occurs at least 3-4 years after the class action is first filed. The opt-out claims are ultimately resolved several years after they are filed. In other words, the opt-out phenomenon now requires Insureds and their insurers to litigate claims arising from one incident for 6-7 years or more. Much can happen over that long timeframe with respect to the financial strength, business relationship and key personnel at and between the Insured Company and the insurers. Plus, the continuing uncertainty for such a long time period as to the ultimate cost of the claims can impact the pricing and terms of renewal policies for many years.

4. Additional Limits. As liability exposure to opt-out claims increases without a corresponding decrease in liability exposure to securities class actions, a logical conclusion is that Insureds should increase their D&O insurance limits in response to this increased exposure. But simply increasing the limits for the overall D&O insurance program may not be an effective way to address this increased exposure since those increased limits may inflate the class action plaintiffs’ settlement expectation (i.e., the increased limits may be consumed in the class settlement). An alternative approach would be to purchase additional limits dedicated solely to any opt-out exposure. This would not only assure a minimum amount of insurance protection for any opt-out claims, but should also be less expensive than purchasing additional layers of standard excess coverage.

So far, significant opt-outs have occurred only in the larger securities cases. In the securities suits which settle below \$100 million, large numbers of opt-outs remain rare since there is less incentive for institutions and their counsel to invest the time and resources into prosecuting a separate action. Nevertheless, this trend of institutional opt-out lawsuits is and will continue to be an important and growing concern for both Insureds and their D&O insurers in securities class action lawsuits.