

Better Go it Alone: An Extension of Fiduciary Duties for Investment Fund Managers in Securities Class Action Opt-Outs

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BETTER GO IT ALONE: AN EXTENSION OF FIDUCIARY DUTIES FOR INVESTMENT FUND MANAGERS IN SECURITIES CLASS ACTION OPT-OUTS

BRIAN J. SHEA *

ABSTRACT

Securities class actions provide a vehicle for plaintiffs to recover billions of dollars in settlement awards. Given the prevalence of institutional investors in the market for publicly traded securities, it is no surprise that large investment funds are often implicated as lead plaintiffs in securities class actions. Despite having recoverable claims in many of these settlements, these investment funds often fail to participate in the action on behalf of their beneficiaries (their investors). Some scholars argue that fund managers have a fiduciary obligation to participate in claim filing and monitoring processes in an effort to recover settlement awards and to maximize the value of their beneficiaries' investments. Courts have yet to hold fund managers liable for failure to do so.

This Note explores a separate but related phenomenon: the increased prevalence of class action "opt-outs" in which a plaintiff may choose not to be a part of the action in favor of pursuing a separate action, and hopefully recover more than would be available within the class action structure. Inherent in the opt-out calculus is the risk of receiving nothing at all. Given this phenomenon, this Note asks whether it would make sense to extend fiduciary duties to contemplate opt-out behavior in an effort to encourage fund managers to monitor those securities class actions that implicate their respective funds. According to this argument, a fund manager would have a duty to opt out when the recovery outside the class action was likely greater, and when there was a reasonable likelihood that such recovery could be obtained.

At the moment, such an extension would not be appropriate. A clear departure from case law related to fiduciary duties and officer liability, such an extension would also inject too much legally encouraged risk taking into the capital markets; it would undermine many of the valid policy objectives of the securities class action; and it would place an undue burden on fund managers to take monitoring obligations to unprecedented levels.

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INTRODUCTION

Today's securities class action settlement pipeline stands at \$18 billion.¹ Although the total number of securities class actions filed in 2013 was somewhat lower than in previous years, seven of the twenty-five largest settlements in history were approved in 2013.² The top settlements involved companies such as Bank of America, AIG, Lehman Brothers, Citigroup, Countrywide, Adelphia, and Schering-Plough,³ to name a few.

As owners of the majority of publicly traded equity securities in the United States, institutional investors—pension funds in particular—reaped the majority of these settlement profits. The Regents of the University of California, the California Public Employees' Retirement System (CALPRS), the New York State Common Retirement Fund, New York City Pension Funds, Plumbers & Pipefitters National Pension Fund, and United Association of Local Union Officers & Employees Pension were among the primary institutions to recoup large sums for their beneficiaries by participating in these actions.⁴

An overview of lead plaintiffs in the securities class action space would lead the casual observer to conclude that institutional investors like those mentioned above would be actively involved in filing claims on behalf of their beneficiaries. Nevertheless, several empirical analyses in this field of institutional behavior suggest the contrary—as of 2005, it was estimated that slightly more than \$1 billion was left on the table by non-filing institutions each year.⁵ Several possible explanations exist as to why

¹ *Securities Class Action Services*, INSTITUTIONAL SHAREHOLDER SERVICES INC. (ISS), <http://www.issgovernance.com/governance-solutions/securities-class-action-services/> (last visited Jan. 24, 2015). ISS, which is the source of much of the data in this Note, is a large proxy advisory and corporate governance firm. In March of 2014, ISS was acquired by Vestar Capital Partners, a leading middle-market private equity firm. See *Vestar Capital Partners Completes Acquisition of Institutional Shareholder Services*, REUTERS (Apr. 30, 2014, 11:51 AM), <http://www.reuters.com/article/2014/04/30/ny-vestar-capital-idUSnBw306292a+100+BSW20140430> (including company profiles of both ISS and Vestar).

² See Cornerstone Research, *Securities Class Action Filings, 2013 Year in Review 1* (2014), available at <http://securities.stanford.edu/research-reports/1996-2013/Cornerstone-Research-Securities-Class-Action-Filings-2013-YIR.pdf> [hereinafter *2013 Cornerstone Report*] (“Plaintiffs filed 166 new federal class action securities cases (filings) in 2013—fourteen more than in 2012. This number is 13 percent below the historical average of 191 . . . between 1997 and 2012.”).

³ See *Securities Class Action Services, The SCAS 100 for 1H 2014*, INSTITUTIONAL SHAREHOLDER SERVICES, INC. 4 (2014), available at <http://www.issgovernance.com/library/securities-class-action-services-top-100-settlements-1h-2014/> (listing the top 100 settlements as of July, 2014).

⁴ See *id.* at 11 (listing institutional lead plaintiff participation for the top 100 settlements).

⁵ See James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to*

institutional investors with provable losses failed to file claims on behalf of their investors.⁶

Some scholars argue that failure on the part of pension fund managers to pursue these settlements should be evaluated as potential breaches of fiduciary duty under Delaware's *Caremark* decision.⁷ As applied, this standard holds that institutional investors have a good faith obligation to ensure that their fund has adequate monitoring systems in place to identify and process claims—in essence, to monitor the settlement pipeline and participate when appropriate—and to periodically update these systems as problems arise.⁸ Courts have yet to codify this fiduciary obligation as it applies to investment fund managers; however, there is some evidence that it has been adopted in practice.⁹

This Note expands upon the argument advanced by these scholars and practitioners in the context of class action “opt-outs.” Current empirical research suggests that the larger the award at stake in a securities class action, the more likely it is that at least one member of the class will choose to go it alone—opt out—in order to pursue a separate lawsuit against the defendant.¹⁰ According to this research, the primary reason that class action participants choose to pursue individual actions is the potential for a larger recovery in the end.¹¹ The study is keen to point out that the legal strategy

Participate in Securities Class Action Settlements, 58 STAN. L. REV. 411, 412 (2005). The Cox and Thomas study was the first to explore the fiduciary obligations of fund managers in this context. Their study was empirical in nature, although the authors openly acknowledge their small sample size. *Id.*

⁶ *Id.* at 413; see *infra* Part II.

⁷ *Id.* (citing *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996)).

⁸ *Id.*

⁹ See, e.g., *About Class Actions*, SPECTOR ROSEMAN KODROFF & WILLIS, P.C. (2011), <http://www.srkw-law.com/about-class-actions.html> (“While the duties of an institutional investor will depend greatly on the jurisdiction where the investor is located and on the specific facts of the situation, acting as Lead Plaintiff may help ensure that the trustees of the fund are discharging their fiduciary duties.”); *Leaving Money on the Table? Investment Advisor Responsibility for Client Class Action Claims*, EDWARDS WILDMAN LLP (Apr. 10, 2005), <http://www.edwardswildman.com/insights/PublicationDetail.aspx?publication=3426> (“Advisors should now be reviewing existing advisory relationships and establishing and implementing new procedures”).

¹⁰ See Amir Rozen et al., *Opt-Out Cases in Securities Class Action Settlements*, CORNERSTONE RESEARCH 1, 1 (2013), available at <http://www.cornerstone.com/getattach ment/7cf8bd53-9e0b-45be-b4b3-3d810dfe2be3/Opt-Out-Cases-in-Securities-Class-Action-Settlement.aspx>. This study was a joint effort of Cornerstone Research and Latham & Watkins to analyze public information regarding judgments and settlements from opt-outs between 1996 and 2011. *Id.*

¹¹ See *id.* at 5.

of opting out also carries with it greater risks of receiving no settlement award at all.¹²

To what extent should the fiduciary duties of fund managers (principally those of large pension funds) extend to opt-outs in securities class actions?¹³ This Note posits and assesses the argument that fund managers, as trustees, owe an extended fiduciary responsibility to their beneficiaries that includes, at minimum, monitoring standards to determine whether the potential recovery could be greater if the fund opts out of a given class action. This duty would require fund managers to consider the potential recovery and assess the risks and rewards involved in opting out. As the law currently stands, there is no clear legal precedent available to hold fund managers liable for failure to file a claim in a particular class action—although investors have sued under such theories—not to mention failure to assess the risks and rewards involved in opting out. *Caremark* provides some guidance to investors, although this Note readily acknowledges Delaware courts' reluctance to broaden the scope of fiduciary duties to corporate inaction of this nature.¹⁴

It is undoubtedly reasonable for an investor to expect that those who manage his or her portfolio will remain vigilant as to potential class action claims, especially given the recent trend toward larger settlements. Although some might advocate for a full expansion of liability to include opt-out assessment under a modified *Caremark* standard,¹⁵ such a solution is inappropriate and unfeasible. This approach is improper for several reasons: First, it frustrates the purposes of shareholder class actions by encouraging strategic behavior. Second, it places an unnecessary burden on fund managers to do more than simply monitor their involvement in shareholder litigation and to file claims on behalf of their beneficiaries. Last, it exposes investors to risky speculation that may result in substantial loss, which, if reeking of gross negligence, may in and of itself constitute a breach of duty of care.¹⁶

¹² *Id.* (“In addition to giving up their share of the class action settlement ... the plaintiffs were forced to pay the defendant’s legal fees.”).

¹³ This Note does not distinguish at great length between managers of specific types of funds or consider their qualification as investment advisers under the Investment Advisers Act. Rather, the discussion broadly refers to “fund managers” as those individuals who are responsible for implementing a fund’s investing strategy and managing its portfolio. These individuals serve as the trustees on behalf their investors. *See generally* Definition of Fund Manager, INVESTOPEDIA, <http://www.investopedia.com/terms/f/fundmanager.asp>.

¹⁴ *See* *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *McPadden v. Sidhu*, 964 A.2d 1262, 1273 (Del. Ch. 2008); *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

¹⁵ *See* Cox & Thomas, *supra* note 5, at 413.

¹⁶ Furthermore, this Note does not distinguish between various levels of risk that may attach to specific funds. Of course, behavior that is proper for a high-risk investment fund

Part I provides a brief background on the current securities class action environment, followed by an overview of the mechanics of filing claims in securities class actions. Part II discusses current scholarship as it relates to the fiduciary duties of fund managers and the analytical framework that has been adopted following *Caremark*. Part III then applies that framework to the behavior of fund managers in large-scale securities class actions and considers the optimal strategies that should be pursued by these managers on behalf of their beneficiaries, ultimately concluding that the current framework as articulated by Delaware courts is insufficient to address the risks inherent in class action opt-outs.

I. THE CURRENT SECURITIES CLASS ACTION ENVIRONMENT

Each year, well over 100 securities class actions are filed in the United States.¹⁷ According to Cornerstone Research, 166 federal securities class action cases were filed in 2013, a slight increase over 2012, although roughly thirteen percent below the national average observed since the 1995 Private Securities Litigation Reform Act (PSLRA).¹⁸ Broadly speaking, class actions resulting from alleged securities fraud appear on a daily basis in notable business news publications and remain a centerpiece of the national discourse surrounding the right of investors to recover for corporate wrongs.¹⁹

may be inappropriate for certain low-risk pension funds. Acknowledging these distinct risk profiles further supports the conclusion of this Note, as its discussion of fiduciary duties proceeds with the low-risk pension fund manager in mind. For a greater discussion of duty of care cases, *see infra* note 128.

¹⁷ *See* 2013 Cornerstone Report, *supra* note 2, at 3.

¹⁸ *Id.* at 1.

¹⁹ *See, e.g.*, Adam Liptak, *New Hurdle in Investors' Class Actions*, N.Y. TIMES (June 23, 2014), http://www.nytimes.com/2014/06/24/business/Justices-rule-on-class-actions-for-securities-fraud.html?_r=0 (discussing the Supreme Court's controversial ruling in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014), which was considered a minor victory for corporate defendants at the expense of investor plaintiffs seeking to bring class action claims); Greg Stohr, *Investor Class Actions Seen at Risk in Halliburton Case*, BLOOMBERG (Feb. 27, 2014), <http://www.bloomberg.com/news/2014-02-27/investor-class-actions-seen-at-risk-in-halliburton-case.html> (referring to the Supreme Court's grant of certiorari in *Halliburton*).

Securities fraud cases have become an industry unto themselves even as Congress has tried to rein them in. More than 4,000 class-action suits have been filed since 1996, producing almost \$80 billion in settlements Accords involving Enron Corp. and WorldCom Inc. alone totaled more than \$13 billion, and Bank of America Corp. last year agreed to pay \$2.4 billion to settle investor claims over its Merrill Lynch & Co. acquisition. Pfizer Inc. (PFE), Vivendi SA and Amgen Inc. (AMGN) are among the companies with pending lawsuits that could be affected by the high court case.

Federal courts have exclusive jurisdiction over securities fraud class actions since the enactment of the Securities Litigation Uniform Standards Act of 1998 (SLUSA).²⁰ As a practical matter, almost all securities class actions settle before trial.²¹ A number of key trends emerged in 2013: (1) the majority of claims were brought under SEC Rule 10b-5, the catch-all provision for securities fraud; (2) the median lag time between the end of the alleged class period and the filing date of the lawsuit became shorter; (3) health care, biotechnology, and pharmaceutical companies represented the largest industry group among class action targets; and (4) the vast majority of filings occurred in the Second and Ninth Circuits.²²

The class action is a powerful legal tool used to provide relief to multiple individuals who otherwise would not have the incentive to pursue their claims individually; in the aggregate, these claims address widespread harm resulting from corporate fraud in connection with the purchase or sale of securities.²³ Since the codification of Fed. R. Civ. P. 23, scholars have widely debated the justifications and effects of these actions.²⁴ The academia repeats several major policy justifications for this device, including: (1) class actions provide a solution to the economic obstacle of gathering many small claims together into an amalgamation that can support the *cost of litigation*,²⁵ (2) class actions arguably create a *level playing field* for

Id.; see generally Brief for Financial Economists as Amici Curiae in Support of Respondents, Erica P. John Fund, Inc. v. Halliburton Co., 718 F.3d 423 (5th Cir. 2013) (No. 13-317); Brief for DRI—The Voice of the Defense Bar as Amicus Curiae in Support of Petitioners, Erica P. John Fund, Inc. v. Halliburton Co., 718 F.3d 423 (5th Cir. 2013) (No. 13-317).

²⁰ See Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. 105-353, § 16(b)–(c), 112 Stat. 3227, 3228 (codified as amended at 15 U.S.C. § 78bb(f)(2012)).

²¹ See Kevin M. LaCroix, *Rare Securities Suit Trial Produces Jury Verdict Against Former Longtop Financial CEO*, THE D&O DIARY (Nov. 24, 2014), <http://www.dandodiary.com/2014/11/articles/securities-litigation/rare-securities-suit-trial-produces-jury-verdict-against-former-longtop-financial-cfo/> (“[T]rial in securities class action lawsuits [are] extremely rare [T]here have been only 24 securities class action lawsuits that have gone to verdict since Congress enacted the [PSLRA].”). LaCroix estimates that less than half of one percent of all cases filed during this period have gone to trial. *Id.* He explores various explanations for this settlement preference beyond the fear of an exorbitantly large jury verdict, e.g., fraud exclusions in D&O insurance policies. *Id.*

²² See 2013 Cornerstone Report, *supra* note 2, at 1.

²³ See Janet Cooper Alexander, *An Introduction to Class Action Procedure in the United States*, Presented Conference: Debates over Group Litigation in Comparative Perspective, Geneva, Switzerland, at 1, July 21–22, 2000 [hereinafter Alexander Presentation]; see generally FED. R. CIV. P. 23.

²⁴ See, e.g., Alexander Presentation, *supra* note 23; BERNSTEIN LITOWITZ BERGER & GROSSMAN, LITIGATING SECURITIES CLASS ACTIONS § 1.01 (2014) (providing a history of securities class actions beginning with the 1966 amendments to Rule 23).

²⁵ *Id.* at 1.

individuals with less economic power, who might otherwise be disadvantaged under the legal system;²⁶ (3) class actions also serve the valuable social goals of *deterrence* and *compensation*, thus providing the appropriate incentives for corporations and corporate actors to pay for and internalize the true cost of their conduct;²⁷ and (4) they also eliminate the need to re-litigate common claims in similar small-scale cases, thus bringing *efficiency* to the overall court system.²⁸ From a practical standpoint, class actions create incentives for attorneys to represent and aggressively advocate on behalf of individuals who would not otherwise be able to obtain meaningful representation due to the costs associated with litigation.²⁹

In the United States, class actions are governed by the Federal Rules of Civil Procedure.³⁰ Although all class actions are governed by the same rule, several distinct categories of actions have emerged: consumer rights, securities and antitrust, environmental, mass torts, and civil rights.³¹ It is worth denoting these categories in order to cabin the discussion of opt-outs within the securities context. Needless to say, civil rights and environmental class actions deal with completely distinct issues that are beyond the scope of this Note.

A. *The Private Right of Action for Securities Fraud*

In general, securities class action claims in the U.S. are alleged as violations of the federal securities laws based on misrepresentations concerning the financial and business conditions of a company.³² These claims are often brought under section 17(a) of the Securities Act of 1933 (“Securities Act”), section 10(b) of the Exchange Act of 1934 (“Exchange Act”), and SEC Rule 10b-5.³³ The statutes and rules prohibit fraud by any “person” in connection with purchase or sale of a security.³⁴ Because securities are sold in

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.* at 2.

³⁰ FED. R. CIV. P. 23.

³¹ See Alexander Presentation, *supra* note 23, at 2–3.

³² See generally BERNSTEIN, *supra* note 24.

³³ See Securities Act of 1933, 15 U.S.C. § 77q (2012); Exchange Act of 1934, 15 U.S.C. § 78j (2012); 17 C.F.R. § 240.10b-5 (2014).

³⁴ A corporation may be liable for violations of the Exchange Act based on the definition of “person” under Section 3(a)(9). See 15 U.S.C. § 78c (2012). Section 20(a) gives rise to joint and several liability for a person who controls any person liable under the Exchange Act. See 15 U.S.C. § 78t (2012). It is worth noting that some courts have imposed 10b-5 liability under the tort doctrine of respondeat superior, which renders an employer liable for wrongs by an employee committed within the scope of employment. See generally Hollinger

large numbers or blocks to many disparate investors, it is easy to understand why the class action is a useful vehicle to remedy the harm felt by many individual investors who would not otherwise have the means or the incentive to bring a direct action against the company. It is also easy to understand why the class action might be ill-suited or disadvantageous to institutional investors who hold a larger portion of the securities sold, and who would otherwise have an incentive to bring a separate action.

Section 17(a) provides the following:

It shall be unlawful for any person in the offer or sale of any securities ... by the use of any means or instruments of transportation or communication in interstate commerce ... directly or indirectly—
 (1) to employ any device, scheme, or artifice to defraud; or
 (2) to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
 (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.³⁵

The statute broadly prohibits (1) the employment of any device, scheme, or artifice to defraud (2) in the offer or sale of any securities.

Similarly, section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange
 ...
 (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.³⁶

Thus, section 10(b) prohibits (1) using any manipulative or deceptive device in contravention of the SEC's rules (2) in connection with the purchase or sale of securities.³⁷ As written, section 10(b) does not limit itself merely to deception *of a purchaser or seller*, but rather applies to any deception used "in connection with the purchase or sale of any security."³⁸

v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990); *In re Network Equip. Tech., Inc., Litig.*, 762 F.Supp. 1359 (N.D. Cal. 1991).

³⁵ 15 U.S.C. § 77q(a) (2012) (emphasis added).

³⁶ 15 U.S.C. § 78j(b) (2012) (emphasis added).

³⁷ *Id.*

³⁸ *United States v. O'Hagan*, 521 U.S. 642, 651 (1997).

The SEC adopted Rule 10b-5 pursuant to its rulemaking authority:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud, [or]

...

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.³⁹

In essence, a private right of action for damages under these provisions can be broken down into the following elements: (1) a material misrepresentation or omission; (2) scienter; (3) in connection with a purchase or sale of a security; (4) reliance, often referred to as “fraud-on-the-market” in public securities cases; (5) economic loss; and (6) loss causation, that is, a causal connection between the material misrepresentation and the loss.⁴⁰ Materiality in the securities fraud context is a determination of whether there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁴¹ “Scienter” is defined as “intent to deceive, manipulate, or defraud.”⁴²

From a historical standpoint, although the relevant provisions of the federal securities action had their genesis in the ’33 Act, the securities class action did not take hold until Rule 23 of the Federal Rules of Civil Procedure was fundamentally changed in 1966.⁴³ Under these 1966 changes, the outcome of a class action became binding on nonparticipating class members who received notice of the action and were given the opportunity to opt in.⁴⁴ Provided the case satisfies Rule 23’s requirements, the court may certify the class action and the outcome is binding.⁴⁵

Corporations and the defense bar became critical of securities class actions in the 1980s and 1990s on the basis that the class action structure

³⁹ 17 C.F.R. § 240.10b-5 (2014).

⁴⁰ *See, e.g., Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

⁴¹ *See Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988).

⁴² *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

⁴³ *See BERNSTEIN, supra* note 24, at § 1.01[1][a].

⁴⁴ *Id.* at § 101.1[1][b].

⁴⁵ These requirements include numerosity of the class, commonality of legal or factual questions, adequacy of representative plaintiffs, and the requirement “that the questions of law or fact common to class members predominate over any questions affecting only individual members,” and that the class action is superior to other available methods of adjudication. *Id.*

was unfairly biased in favor of plaintiffs.⁴⁶ Congress responded with the Private Securities Litigation Reform Act of 1995 (PSLRA), which imposed a number of procedural reforms and enhanced pleading standards.⁴⁷ Following the PSLRA, a plaintiff in a securities fraud case must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”⁴⁸ The Supreme Court in 2007 held that in order for an inference of scienter to qualify as “strong,” it “must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.”⁴⁹ Circuits are split as to how plaintiffs may give rise to a strong inference of scienter: in some, plaintiffs must allege facts to show that defendants had both motive and opportunity to commit fraud; in others, courts require facts constituting strong circumstantial evidence of conscious misbehavior or recklessness; and others apply a “totality of circumstances” test for which a showing of motive and opportunity may be relevant but not dispositive.⁵⁰

B. Filing a Claim and Giving Notice

Once a class action has been filed in federal court, the law firm representing the filing plaintiff publishes notice that the action has been filed.⁵¹ Both the filing plaintiff and other plaintiffs implicated in the action then have sixty days to file lead plaintiff motions.⁵² The court appoints lead plaintiffs who are then authorized to select lead counsel and file a consolidated amended complaint.⁵³ This determination is generally made with consideration for the interests of the plaintiff with the largest potential losses.⁵⁴ The process of selecting a lead plaintiff generally involves many plaintiff groups representing a variety of interests, while defendants play little role in the initial organization of the class action.⁵⁵ In cases in which multiple lawsuits are filed by multiple plaintiffs, whichever party is selected

⁴⁶ *Id.* at § 101.1[2][i].

⁴⁷ See Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

⁴⁸ See BERNSTEIN, *supra* note 24, at § 101.1[2][i][i].

⁴⁹ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007).

⁵⁰ See, e.g., *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 237 (3d Cir. 2004); *Kalnit v. Eichler*, 264 F.3d 131, 138–39 (2d Cir. 2001).

⁵¹ See Alexander Presentation, *supra* note 23, at 8.

⁵² *About Class Actions*, SPECTOR ROSEMAN KODROFF & WILLIS (2011), <http://www.srkwlaw.com/about-class-actions.html>.

⁵³ See Alexander Presentation, *supra* note 23, at 7.

⁵⁴ See *supra* note 49.

⁵⁵ See Alexander Presentation, *supra* note 23, at 7.

as lead plaintiff files a consolidated complaint including new claims and new defendants.⁵⁶

C. Legal Standard for Class Certification

A party seeking class certification must demonstrate four prerequisites: “(1) numerosity of plaintiffs; (2) common questions of law or fact ... ; (3) the named plaintiff’s claims and defenses are typical; and (4) the named plaintiff can adequately protect the interests of the class.”⁵⁷ A district court must employ a rigorous analysis to determine whether the party seeking certification has met these prerequisites.⁵⁸ The party must provide specific facts to satisfy the requirements for class certification rather than resting on mere allegations.⁵⁹

After satisfying the four initial requirements, a party must demonstrate either: (1) a risk that separate actions would create incompatible standards of conduct for the defendant or prejudice individual class members not parties to the action; (2) the defendant has treated the members of the class as a class, making appropriate injunction or declaratory relief with respect to the class as a whole; or (3) common questions of law or fact predominate over questions affecting individual members and that a class action is a superior method for fairly and efficiently adjudicating the action.⁶⁰

The trial court is given broad discretion as to whether to grant or deny a motion for class certification.⁶¹ In doing so, the requirements of Rule 23 should be construed liberally to recognize the rule’s policy in favor of class actions, and should not involve an inquiry into whether the plaintiff is likely to succeed on the merits of the case.⁶²

⁵⁶ *Id.*

⁵⁷ *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 508 (9th Cir. 1992); *see* FED. R. CIV. P. 23(a).

⁵⁸ *See Middlesex Ret. Sys. v. Quest Software, Inc.*, No. 06-6863, 2009 U.S. Dist. LEXIS 132650, at *6, (C.D. Cal. Sept. 8, 2009).

⁵⁹ *Id.*; *see also* *Valentino v. Carter-Wallace, Inc.*, 97 F.3d 1227, 1233 (9th Cir. 1996) (finding decertification is appropriate where the rigorous analysis standard is not met); *In re Am. Med. Sys.*, 75 F.3d 1069, 1079 (6th Cir. 1996) (finding mere designation as a class in the pleading does not suffice to maintain a class action); *Doninger v. Pac. Nw. Bell, Inc.*, 564 F.2d 1304, 1309 (9th Cir. 1977) (finding class certification requires a statement of basic facts in addition to the Rule 23 allegations).

⁶⁰ *See* FED. R. CIV. P. 23(b).

⁶¹ *See* FED. R. CIV. P. 23(c)(1); *see also* *Kilgo v. Bowman Transp., Inc.*, 789 F.2d 859, 877–78 (11th Cir. 1986) (finding the district court has broad discretion in interpreting the prerequisites for class certification).

⁶² *See* *Yamamoto v. Omiya*, 564 F.2d 1319, 1325 (9th Cir. 1977); *see also* *Schwartz v. Harp*, 108 F.R.D. 279, 281 (C.D. Cal. 1985) (discussing the policies underlying Rule 23).

D. Certification of the Class and Opting Out

The required notice distributed to class members must inform them of their right to opt out of the class.⁶³ A plaintiff would generally choose to opt out if, for whatever reason, (1) he decided that he did not want to be a part of the class, (2) he would rather bring his own suit separately, or (3) he is not amenable to the terms of the proposed settlement.⁶⁴ In some cases, a settlement agreement may permit the defendant to cancel the settlement if too many class members opt out.⁶⁵ It is worth noting that this is really only an issue applicable to large-scale class actions, generally those arising from securities fraud or products liability.⁶⁶ In small claims class actions, such as those arising from some consumer protection claims, individual suits are economically infeasible given the small amount of damages at stake.⁶⁷

After discovery commences, the lead plaintiff(s) generally ask the court to certify the class, permitting the action to proceed as an action on behalf of one or more classes.⁶⁸ Once a class is certified, all plaintiffs/class members are bound by the outcome of the proceeding, unless those individuals choose to opt out.⁶⁹

E. Settlement

According to Rule 23(e), a class action may not be dismissed or settled without prior notice to the class and approval by the court.⁷⁰ As mentioned above, very few securities class actions go to trial; almost all settle prior to trial.⁷¹ The mechanics of these settlements may take many different forms, although they generally involve counsel from all interested parties, including insurers.⁷² Once the terms of the settlement are determined, parties file

⁶³ See Alexander Presentation, *supra* note 23, at 9.

⁶⁴ See *id.*

⁶⁵ See *id.*; see also, e.g., *In re Cmty. Bank of N. Va.*, 418 F.3d 277, 318 (3d Cir. 2005) (finding opt-outs by a specific percentage of the class members in a mortgage fraud class action may allow the settling defendants to terminate the settlement), *vacated and remanded on other grounds*.

⁶⁶ See Alexander Presentation, *supra* note 23, at 9; see also, e.g., *In re Cmty. Bank of N. Va.*, 418 F.3d at 286.

⁶⁷ See Alexander Presentation, *supra* note 23, at 9.

⁶⁸ See FED. R. CIV. P. 23(c)(1).

⁶⁹ See FED. R. CIV. P. 23(c)(3); see also *Am. Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 548–49 (1974) (“[I]n Rule 23(b)(3) actions the judgment shall include all those found to be members of the class ... who have not requested exclusion.”).

⁷⁰ See FED. R. CIV. P. 23(e).

⁷¹ See *Franklin v. Kaypro Corp.*, 884 F.2d 1222, 1225 (9th Cir. 1989).

⁷² See MANUAL FOR COMPLEX LITIGATION (FOURTH) § 13.11 (2004).

extensive briefs on the fairness of the settlement, and the court must preliminarily approve them.⁷³

After the settlement is approved, all class members are provided with notice and a hearing at which they have the opportunity to argue that the settlement is inadequate.⁷⁴ The settlement is not officially approved until after the “fairness hearing.”⁷⁵ It is not uncommon for judges to take an active role in the crafting of the settlement terms; they will often—especially in large class actions—insist on modifications in the interest of fairness to absent class members.⁷⁶

F. Measuring Damages

Measuring damages in securities class actions can be a difficult task and often involves large sums of money. There are several tools that plaintiffs use to estimate damages in the class action context, among these, the “constant dollar inflation model” and the “constant percentage model.”⁷⁷ Under the constant dollar method, damages are calculated based on available public information used to measure the decline in the value of a company’s stock as a result of the alleged “corrective disclosure” (i.e., the disclosure alleged to have revealed the alleged fraud) and assumes that that decrease is the actual measure of artificial inflation resulting from fraud.⁷⁸ Alternatively, the constant percentage model takes the percentage decline of the residual drop, and applies that percentage to the stock price throughout the entire class period.⁷⁹ In general, securities class actions settle for a small fraction of the actual estimated damages.⁸⁰

⁷³ See Alexander Presentation, *supra* note 23, at 9.

⁷⁴ See *id.* at 8.

⁷⁵ See FED. R. CIV. P. 23(e)(2); see also *Armstrong v. Bd. of Sch. Dirs.*, 616 F.2d 305, 314 (7th Cir. 1980) (holding that district court’s review of a class action settlement includes a preliminary, pre-notice hearing and a fairness hearing at which class members and all interested parties have an opportunity to be heard), *overruled by Felzen v. Andreas*, 134 F.3d 873, 875 (7th Cir. 1998) *on other grounds*; Alexander Presentation, *supra* note 23, at 9.

⁷⁶ See Alexander Presentation, *supra* note 23, at 9.

⁷⁷ See, e.g., Jeff G. Hammel & B. John Casey, *Sizing Securities Fraud Damages: ‘Constant Percentage’ on Way Out?*, 241 N.Y.L.J. 1, 1 (2009).

⁷⁸ See *id.*

⁷⁹ See *id.* at 1–2. For a greater discussion of damage calculations in the securities context, see *Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 343 (2005) (finding considerations in economic loss calculation may include not only an inflated purchase price but also other factors, such as “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events . . .”).

⁸⁰ See, e.g., John D. Finnerty & Gautam Goswami, *Determinants of the Settlement Amount in Securities Fraud Class Action Litigation*, 2 HASTINGS BUS. L.J. 453, 461, 479

II. FIDUCIARY OBLIGATIONS OF FUND MANAGERS

This Part sets forth the groundwork for this Note’s discussion of opt-outs in terms of fiduciary duties. Section A provides an in-depth summary of the seminal Cox and Thomas study along with its criticisms, which provides a useful framework for analyzing opt-outs. Section B gives an overview of the recent Cornerstone study that sheds new light on the role of opt-outs in securities class actions.

A. Participation Failure in Securities Class Action Settlements: Cox & Thomas Study

The empirical study by Cox and Thomas was the first to explore the participation—or surprising lack thereof—of financial institutions in the securities class action settlement environment.⁸¹ Following a preliminary survey of institutional investors, the study proffers four broad hypotheses as to why this problematic inaction may exist.

First, the study identifies a host of issues associated with what it terms “[s]leeping with the [e]nemy.”⁸² The realities of agency costs often result in perverse actions on the part of managers seeking to maximize their own utility rather than that of the firm’s owners or beneficiaries.⁸³ Further, the study recognizes the complexity of the financial services industry and the inevitability of conflicts that result from managers asserting their rights to a certain share of settlement funds in a given case.⁸⁴ Classes of financial institutions—banks, mutual funds, and insurance companies, for example—often cater to companies and accounting firms in the course of their business, the very institutions that are often the targets of securities class action law suits.⁸⁵ It is easy to see how such relationships among market participants through social forces could engender conflicting attitudes with respect to filing class action claims by “align[ing] themselves with protagonists of their

(2006) (explaining an empirical study involving data sets between 1995 and 2005 indicates that the settlement amount averages approximately 3.60% of the estimated damages).

⁸¹ See Cox & Thomas, *supra* note 5, at 425. Part II of that article delves deeper into the settlement methodology and results, which involves, among other information-gathering tactics, conversations with market participants. For the purposes of this Note, we set aside the in-depth methodology and raw results of the authors’ study.

⁸² *Id.*

⁸³ See *id.* The study notes that a host of regulatory efforts have aimed to shape the incentives of fund managers, particularly those related to proxy rules and significant shareholder disclosures for publicly traded companies. See *id.* at 425–26.

⁸⁴ See *id.* at 427.

⁸⁵ See *id.*

clientele.”⁸⁶ Further evidence indicates that an institution that considers its principal purpose to be something other than establishing and monitoring procedures to ensure its participation in class action settlements may be inherently unlikely to institute such practices.⁸⁷

The second hypothesis identified by the study may be categorized as the practical and logistical considerations inherent in the claim filing process. A survey of class action settlements finds that on average settlement notices are not circulated until more than twenty-six months after the end of the class action period.⁸⁸ Practically speaking, this means that there often passes in excess of three years between the time at which an institution trades in securities giving rise to the action, and when notice of that action is actually brought to the institution’s attention.⁸⁹ The implication of such a delay undoubtedly affects whether an institution is likely to file a claim. Cox and Thomas point out that most financial institutions do not actually manage their own funds; rather, these funds are managed by a variety of different investment advisors.⁹⁰ A given investment fund frequently reviews the performance of its subsidiary advisors, “terminating its relationship with underperforming advisors and substituting in their places those who emerge from ongoing beauty contests.”⁹¹ The role of investment advisers in client class action claims is undoubtedly a complicated one that varies from firm to firm.⁹²

The study also found that many institutional investors relied on custodian banks to conduct their claim filing, which also changed with relative frequency.⁹³ The flux in investment advisors and custodian banks is particularly important in that these are often the institutions responsible for back-office duties such as filing claims.⁹⁴ It has never been the custom of departing investment advisors or banks to forward trading records necessary to evaluate whether provable claims exist; in essence, information is unavailable to assess the claim-worthiness of a particular trade.⁹⁵

⁸⁶ *Id.* Cox and Thomas note that no recorded case exists where a bank or insurance company acted as lead plaintiff in a securities class action case. *Id.* They also note the prevalence of “strike suits” and recognize that institutions may have perverse incentives to participate in a case that they believe is just extorting the company. *Id.*

⁸⁷ *See id.* at 428 (“[S]ubmitting claims is likely to be viewed as subsidiary to what the firm perceives to be its primary operations.”).

⁸⁸ *See id.* at 429.

⁸⁹ *See id.*

⁹⁰ *See id.*

⁹¹ *Id.*

⁹² *See infra* note 109 and accompanying text.

⁹³ *See Cox & Thomas, supra* note 5. at 429.

⁹⁴ *See id.*

⁹⁵ *See id.*

These problems are only compounded when one considers the additional challenges of providing notice of a class action to a terminated investment advisor; not surprisingly, notice, if not lost to the passage of time, is difficult to achieve.⁹⁶ Incentives in this complex structure are likewise often perverse in that a terminated advisor is unlikely to reap any benefit for calling a former client's attention to an arisen claim.⁹⁷

The third hypothesis stems from public perceptions of securities class actions, even following the PLSRA, which remain predominantly negative.⁹⁸ In general, this perception involves small monetary awards for class members and substantial fees for plaintiffs' attorneys.⁹⁹ This is generally supported by recovery statistics that suggest that settlements yield small recoveries of ten cents per each dollar of provable losses.¹⁰⁰ Given this perception, it is understandable why fund managers would be hesitant to devote substantial financial resources to monitoring systems for class action claims.

Some managers might argue that it is not cost-effective to institute such processes, which would include identifying and processing a claim, when weighed against their primary role as securities traders.¹⁰¹ Cox and Thomas offer no evidence as to the prevalence of this perception among fund managers; however, they do suggest that such concerns may be overstated and/or underexplored given the low administrative costs required to identify and process claims.¹⁰²

The fourth and last hypothesis functions as a catch-all for a lack of monitoring by the management of a given institution.¹⁰³ Such failures may be remedied by clearly specifying in the contracts with custodians, advisors, or brokers the procedures for which one should file a claim.¹⁰⁴ Unclear obligations, requirements, and mutual misunderstandings as communicated by financial institutions clearly function as a barrier to effective claim monitoring. The study further suggests that lines of authority are often blurred within institutions.¹⁰⁵

B. Results of the Cox & Thomas Study

In fact, the Cox and Thomas study spurred a wave of litigation against mutual fund advisers in federal courts across the country for failure to file

⁹⁶ *See id.* at 430.

⁹⁷ *See id.*

⁹⁸ *See id.*

⁹⁹ *See id.*

¹⁰⁰ *See id.*

¹⁰¹ *See id.* at 431.

¹⁰² *See id.*

¹⁰³ *See id.* at 432.

¹⁰⁴ *See id.*

¹⁰⁵ *See id.*

claims on behalf of their funds and their shareholders.¹⁰⁶ The claims were brought under the theories articulated by Cox and Thomas against mutual fund companies, individual fund directors and trustees, and fund advisers and sub-advisers, seeking monetary damages, disgorgement of fees, punitive damages, and lawyers' fees.¹⁰⁷ Many of these cases were voluntarily dismissed "because the complaints were based on bad facts" and because the courts were reluctant to take an expansive reading of section 36(a) of the Investment Company Act, as well as other technicalities.¹⁰⁸

The Securities & Exchange Commission (SEC) reacted to the Cox and Thomas article as well by "seeking information on advisers' procedures for identifying, evaluating and pursuing legal class action claims for securities held in client accounts and related records."¹⁰⁹ The SEC's Office of Compliance Inspections and Examinations (OCIE) sought information on (1) adviser processes for identifying situations in which clients may be eligible to participate in class actions; (2) policies and procedures for such; and (3) the number and amount of previous class action recoveries in which the advisers' clients participated.¹¹⁰

Practitioners interpreted these inquiries as a signal to investment advisers that the SEC believed they had a "legal responsibility to monitor for class actions involving their clients' portfolio securities and to decide whether to participate"¹¹¹ Stone and Helmrich articulate several reasons why acting on class actions exceeds the typical responsibility and authority of investment advisers:

- The authority for handling class action claims rests with the client and does not flow accordingly to the investment adviser unless specified by contract. This comes down to an issue of custom in the drafting of advisory agreements, which do not generally grant power of attorney to the adviser to pursue litigation on behalf of the client.¹¹²

¹⁰⁶ See Steven Stone & Ryan F. Helmrich, *The Role of Investment Advisers in Client Class Action Claims*, 12 THE INVESTMENT LAWYER 10, at 17 (2005). Stone and Helmrich note that this series of lawsuits identified over 130 class actions for which mutual fund advisers failed to submit proofs of claims to collect settlement proceeds. *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 18. As of publication in 2005, Stone and Helmrich note that "this may signal the beginning of the end of the recent wave of class actions against large fund groups and their advisers on processing class action claims" *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.* ("[I]t is troubling when the OCIE enters the fray, hinting at responsibilities that are not established as a matter of law").

¹¹² *Id.* at 18–19 ("[S]uch authority [to execute a proof of claim], for example, 'cannot be established by stockbrokers *only demonstrating that they have discretionary authority to trade stock in another's accounts.*'").

- Cox and Thomas fail to “parse the fine distinctions between the roles of different in-house and outside fiduciaries.”¹¹³ As discussed above, in the mutual fund context, the roles of various advisers, managers, and custodians are defined in a way that is dissimilar to that of, for example, ERISA, which defines the duties of such actors differently vis-à-vis class action participation.¹¹⁴
- Whether a client participates in a class action is beyond the expertise and abilities of an investment adviser, who is charged solely with the question of whether investment in a given security is prudent.¹¹⁵

Stone and Helmrich sum up their analysis with a series of “Best Practices” for, presumably, ’40 Act attorneys and their clients, which suggest careful attention to the contractual obligations of the adviser in its investment adviser agreement, as well as a clear designation of the parties responsible for receiving and transmitting class action notices.¹¹⁶

C. Complications Resulting from Opt-Outs: What Does This Mean for Fund Managers?

The recent Cornerstone study looking at opt-out cases in securities class action settlements is the impetus behind this Note.¹¹⁷ Expanding upon previous work from Stanford’s Securities Class Action Clearinghouse, the report provides a comprehensive analysis of publicly available information on securities class actions in which at least one class member has opted to pursue a separate lawsuit against the defendant.¹¹⁸ The report surveyed

¹¹³ *Id.* at 19.

¹¹⁴ *Id.* It is worth noting that Stone and Helmrich, though not directly addressing the question of manager responsibilities, acknowledge that managers may have fiduciary duties to participate in class actions: “This position does not invariably mean that this responsibility flows with the appointment of an investment manager down to an adviser” *Id.*

¹¹⁵ *Id.* at 19–20. In relation to this argument, Stone and Helmrich make note of the complicating analysis posed by opt-outs, which they assume as a matter of fact is well beyond the expertise of an investment advisor. *Id.* at 20.

¹¹⁶ *Id.*

¹¹⁷ See Rozen, *supra* note 10, at 1; see also *Opt-Outs: A Worrisome Trend in Securities Class Action Litigation*, 2 OAKBRIDGE INSIGHTS, 1, 1 (2007), http://clients.oakbridgeins.com/newsletters/April_Opt-OutsAWorrisomeTrendinSecuritiesClassActionLitigation.pdf (suggesting in response to the massive Time-Warner opt-out that the “recent wave of ... opt-out settlements could completely change the way securities fraud lawsuits are resolved in the future”).

¹¹⁸ See Rozen, *supra* note 10, at 1.

1,272 securities class action settlements from between 1996 and 2011, identifying thirty-eight settlements in which at least one plaintiff opted to pursue a separate case against the defendant.¹¹⁹ A summary of the report's key findings follows:

- Plaintiffs were more likely to bring opt-out cases when larger class action settlements were at stake.¹²⁰
- Opt-out settlements represented 12.5 percent of the value of the class action settlements, and a median of 3.8 percent of the value.¹²¹
- Between 1996 and 2006, there were six cases in which the opt-out settlements represented more than twenty percent of the total settlement value.¹²²
- For the period surveyed, Cornerstone found seven opt-out cases with settlements above ten million dollars.¹²³
- Pension funds were the most frequent to opt-out, followed by other types of asset management companies.¹²⁴
- Overall and based on the anecdotal evidence obtained in the survey, opting-out carries a greater risk, but with the potential for significantly greater reward, depending upon the circumstances of the case.¹²⁵

In general, most securities class action cases are either dismissed or settled.¹²⁶ As the study finds, the amount of the settlement is the greatest predictor of whether opt-outs will follow—as the settlement gets larger, plaintiffs are more likely to opt out.¹²⁷ The frequency of opt-outs may increase in light of the U.S. Supreme Court's recent reversal of its decision to hear a case concerning the timing of investor opt-out rights.¹²⁸ The

¹¹⁹ *Id.*

¹²⁰ *Id.* Of those cases with settlements of \$500 million or more, fifty-three percent involved an opt-out case, compared with three percent of all securities class actions. *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.* at 2.

¹²⁷ *Id.* at 3. The study notes that this may not be indicative of trends in securities class actions throughout the course of recent history. *Id.* For example, following the Private Securities Litigation Reform Act in 1995, studies suggested that plaintiffs opted out of class actions for other reasons than to pursue their own legal action. *Id.* at 2.

¹²⁸ See Stephanie Russell Kraft, *Securities Cases to Watch in 2015*, LAW360 (Jan 2, 2015, 3:07 PM), <http://www.law360.com/articles/600266/securities-cases-to-watch-in-2015> (“In a brief order, the high court dismissed as improvidently granted its writ of certiorari to

reversal leaves in place a split between the Second and Tenth Circuits as to whether a timely filed class action operates to suspend the statute of limitations as well as the '33 Act's statute of repose.¹²⁹ The result of this, as some have suggested, is to encourage litigants in securities class actions who "fear they won't be able to bring their claims after an unfavorable settlement is reached" to opt out.¹³⁰ There is currently no indication whether the Supreme Court will reassess this issue in 2015.

In terms of settlement amounts for the publicly available cases surveyed, the average total opt-out was \$85.4 million, or 12.5 percent of the average class action settlement in these cases.¹³¹ More specifically,

The largest set of opt-out settlements related to a single case was *AOL Time Warner, Inc.*, where the \$764 million of opt-out settlements was 30.6 percent of the size of the class action settlement. The largest opt-out settlement amount as a percentage of the class action settlement was *Qwest Communications International Inc.*, where the \$411 million opt-out settlement was 92.4 percent of the final class action settlement.¹³²

The study suggests that the potential for larger class action settlements in the future may signal a greater frequency of opt-outs to come.¹³³ By virtue of their size, these settlements engender significant publicity, as was the case in *Time Warner* and *Qwest*.

the Public Employees' Retirement System of Mississippi, which had been looking to overturn a 2013 Second Circuit decision that blocked it and other plaintiffs from intervening in a putative class action accusing IndyMac [and others] of misrepresenting certain mortgage-backed securities.").

¹²⁹ *Id.*

¹³⁰ *Id.* (quoting Stephen Tountas, founding partner at Bleichmar Fonti Tountas & Aud LLP: "With what's in play right with IndyMac, any opt-out that happens after the statute of limitations and statute of repose runs the risk of getting nothing"); see also Kevin LaCroix, *The Top D&O Stories of 2014*, THE D&O DIARY (Jan. 6, 2015), <http://www.dandodiary.com/2015/01/articles/director-and-officer-liability/the-top-ten-do-stories-of-2014-2/> ("If the filing of a class action lawsuit does not toll the statute of repose, current practice regarding class action opt-outs could be significantly affected.").

¹³¹ See Rozen, *supra* note 10, at 2. These numbers are skewed by the small sample size and wide distribution of settlement amounts.

¹³² *Id.*

¹³³ *Id.* at 3; see also Bailey Cavalieri LLC, *Securities Class Action Opt-Out Claims: A Growing Problem*, available at <http://www.baileycavalieri.com/articles.html> (discussing the growing trend in opt-outs and its implications for director and officer defendants).

The 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.

Id.

From a strategic standpoint, the study suggests that fund managers and their custodian banks should pay greater attention to the frequency of such opt-outs, and adjust their management practices accordingly. As discussed earlier, many of the recurring plaintiffs in opt-out cases were pension funds, which accounted for sixteen of the thirty-four cases studied.¹³⁴ Fourteen opt-out cases involved mutual funds, hedge funds, or other investment companies.¹³⁵ All of these plaintiffs undoubtedly consulted with their legal counsel on the risks and rewards of opting out. Several plaintiffs' law firms have correspondingly published on the topic.¹³⁶ As Blair Nicholas and Ian Berg of Bernstein Litowitz Berger & Grossman LLP discuss, "institutional investors should remain selective in the cases they decide to opt out from and carefully consider the upside and downside of the factors impacting the success of a particular opt-out action"¹³⁷ They further outline the potential factors that sophisticated institutional investors should consider when formulating an opt-out strategy, such as (1) the opportunity for increased recovery, (2) broader claims for recovery in a direct state court action, (3) levels of control over the litigation and settlement, (4) availability of alternative claims, and (5) ability to overcome certain jurisdictional issues, among other factors.¹³⁸

The array of factors that an institutional investor plaintiff *should* consider in its opt-out strategy is boundless. And while pressure to opt out may increase in the face of large-scale opt-out recoveries in the news, institutional investors should be equally mindful of the risks of pursuing individual claims.¹³⁹ This means a "thorough factual and legal analysis of the merits of the potential opt-out claims for recovery"¹⁴⁰ The question

¹³⁴ See Rozen, *supra* note 10, at 3. Seven of nineteen cases brought between 1996 and 2005 involved the Florida State Board of Administration. *Id.*

¹³⁵ *Id.* ("Fifteen opt-out cases involved individual shareholders who were not identified as former employees or subsidiaries, and four involved shareholders of companies that were brought by or otherwise affiliated with the defendant.").

¹³⁶ See, e.g., Blair A. Nicholas & Ian D. Berg, *Why Institutional Investors Opt-Out of Securities Fraud Class Actions and Pursue Direct Individual Actions*, PRAC. LAW INST. (Oct. 15, 2009), available at http://www.blbglaw.com/news/media_mentions/00104.

¹³⁷ *Id.* at 7.

¹³⁸ See *id.* for a greater discussion of the less obvious benefits of opting out. The myriad jurisdictional and governance related benefits discussed by Nicholas and Berg are beyond the scope of this Note; however, they serve to further highlight the complex calculus that institutional investors should engage in when confronted with a large-scale securities class action.

¹³⁹ *Id.* Nicholas and Berg discuss the opportunity for increased recovery in the context of the highly publicized *AOL/Time Warner*, *Qwest*, and *Tyco International* securities litigations. *Id.* at 2.

¹⁴⁰ *Id.* at 7.

arises whether an institutional investor can be held liable for failure to engage in such a comprehensive analysis with respect to opt-out possibilities. One might also ask whether an institutional investor can be held liable for failing to opt out when it is clear that doing so would reap a greater settlement award (in some cases, perhaps as large as the overall class action settlement). And lastly, if an institutional investor takes a risk and opts out only to receive nothing, should beneficiaries be able to sue for their estimated portion of the class action settlement? The following discussion suggests a legal framework within which to consider these questions.

D. Caremark, the Duty of Good Faith, and Monitoring Obligations

1. Caremark Background

Given the dearth of scholarship related to class action claim filing and the role of fund managers,¹⁴¹ it is difficult to devise an appropriate legal standard with which to analyze their duties in the opt-out context. While traditional approaches to the duty of loyalty and duty of care may be applicable or instructive in some cases, Cox and Thomas suggest that *Caremark* should be the appropriate standard.¹⁴² Although not entirely distinguishable from the canon of duty of care and loyalty cases, *Caremark* stands for the proposition that corporate officers have a duty to make a good faith effort to assure that corporate information and reporting systems are adequate and up-to-date, and that failure to do so may render a director liable for losses.¹⁴³

Caremark involved employees' alleged violations of federal and state laws governing health care providers, namely the Anti-Referral Payments Law (ARPL), which prohibits health care providers from paying remuneration to induce Medicare and Medicaid patient referrals.¹⁴⁴ *Caremark* was actively involved in contracting for services through consultation agreements and research grants with physicians, who then recommended *Caremark* products and services to Medicare and Medicaid patients.¹⁴⁵

Caremark's uniqueness stems from the company's pre-existing internal controls, as well as its actions following investigations by both the United

¹⁴¹ See generally Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Cox & Thomas, *supra* note 5; Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

¹⁴² See Cox & Thomas, *supra* note 5, at 439–40.

¹⁴³ *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996).

¹⁴⁴ *Id.* at 960.

¹⁴⁵ *Id.* at 962.

States Department of Health and Human Services (HHS) and the Department of Justice (DOJ).¹⁴⁶ Prior to both investigations, Caremark had distributed an intra-company Guide to Contractual Relationships to all employees, which set forth the company's policy that "no payments would be made in exchange for or to induce patient referrals."¹⁴⁷ Furthermore, Caremark asserted that in the year prior to the commencement of the DOJ action, it had made active attempts to increase supervision and oversight by centralizing its management structure.¹⁴⁸ Once the investigations were initiated, Caremark instituted multiple corporate actions aimed at improving its employee monitoring mechanisms overall.¹⁴⁹

The company ultimately entered into a settlement agreement with federal authorities and several private insurance companies in which no senior officers or directors were charged with corporate wrongdoing.¹⁵⁰ The settlement terms proposed, among other provisions: (1) that Caremark undertake not to pay any compensation to third parties, physicians, or business combinations in which it had a financial interest in exchange for referrals; (2) that the Board semi-annually discuss material changes in government healthcare regulations and their effect on relationships with healthcare providers; (3) that patients receive written disclosure of any relationship between Caremark and health care providers making referrals; (4) that the Board establish a compliance and ethics committee to monitor business segment compliance with the APRL; and (5) that corporate officers responsible for various business segments report to the compliance and ethics committee and get advanced approval of any new forms of contract.¹⁵¹

2. *Legal Standards*

The court in *Caremark* reviewed the settlement terms to determine whether they were "fair and reasonable," ultimately concluding that they

¹⁴⁶ *Id.* at 965.

¹⁴⁷ *Id.* at 962. The case further notes that general confusion existed amongst Caremark's management as to the legality of their contracting activities, even though they were unaware of any kickbacks or remuneration. *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* at 962–63. Among these actions, Caremark: (1) announced that it would no longer pay management fees to physicians for services to Medicare and Medicare patients; (2) revised and published an updated version of its Contractual Relationships Guide, requiring regional officers to approve transactions entered into with physicians; (3) hired PriceWaterhouse to conduct an assessment of its control structure (of which they found no material weaknesses); and (4) increased staff education with regard to the ARPL and use of Caremark's form contracts. *Id.*

¹⁵⁰ *Id.* at 965.

¹⁵¹ *Id.* at 966.

were in light of their perceived “positive consequences,” regardless of what the court identified as an overall “weakness of the plaintiffs’ claims.”¹⁵² In discerning an appropriate legal standard under which to judge the settlement, the court acknowledged that the complaint “[did] not charge either director self-dealing or the more difficult loyalty-type problems arising from ... suspect director motivation”¹⁵³ The court highlighted the appropriate standard for duty of care cases, which is “whether there was good faith effort to be informed and exercise judgment,”¹⁵⁴ noting that this formulation does not necessarily apply to the *Caremark* case.

Rather, the court considered liability for the failure to monitor in the *Caremark* context, which implicated a loss not as a result of a particular decision made by management, but rather from unconsidered action.¹⁵⁵ This alternative theory recognizes that the vast majority of the decisions that a corporation makes stem from its employees acting on its behalf as agents, not from corporate officers.¹⁵⁶ Because the actions of agents—whether they are employees, traders, or fund managers—inevitably have the ability to affect the welfare of the corporation, the appropriate inquiry should be to ask, “what is the board’s responsibility with respect to the organization and

¹⁵² *Id.* at 970, 972.

¹⁵³ *Id.* at 967 (“The theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment. There are good policy reasons why it is so difficult to charge directors with responsibility for corporate losses for an alleged breach of care, where there is no conflict of interest or no facts suggesting suspect motivation involved”) (citing *Gagliardi v. Tri-Foods Int’l Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996)). There are two contexts in which breach of fiduciary duty may arise in connection with a corporate loss: (1) from a situation in which the Board makes a decision that results in loss because that decision was either ill-advised or negligently made; or (2) from a failure of the Board to act in a situation in which due attention would have prevented a loss. *See Veasey & Seitz, The Business Judgment Rule in the Revised Model Act*, 63 TEX. L. REV. 1483, 1484–93 (1985). *See generally* *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006); *In re Soporex, Inc.*, 463 B.R. 344, 367 (Bankr. N.D. Tex. 2011) (discussing how the duty of loyalty now encompasses cases where the fiduciary fails to act in good faith). As the *Soporex* court notes, the duty to act in good faith is relatively uncharted, even given the wealth of case law addressing it. *Id.* at 368.

¹⁵⁴ *Caremark*, 698 A.2d at 968 (summarizing Judge Learned Hand’s formulation in *Barnes v. Andrews*, 204 N.Y.S. 326 (N.Y. App. Div. 1924)). The court discusses duty of care cases at greater length in the context of the business judgment rule. *Id.* While the breadth of case law surrounding the business judgment rule is beyond the scope of this Note, the *Caremark* court notes that a proper understanding of the rule’s application requires “consideration of the good faith or rationality of the process employed [by the Board].” *Id.* at 967 (discussing *Aronson v. Lewis*, 473 A.2d 805 (Del. Supr. 1984)).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 968.

monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?”¹⁵⁷ The claim, in such a case, is that the directors or officers should have known about the insubordinate behavior of its employees, and if they had known, then they would be under a fiduciary duty to bring the employees into compliance and spare the company the loss.¹⁵⁸

The court in *Caremark* revisited its previous ruling in *Graham*, concluding that corporate boards cannot satisfy their obligation to be reasonably informed about corporate activities (including those of its agents)

without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.¹⁵⁹

Articulating the new standard, Chancellor Allen concluded that directors have a duty to attempt in good faith to assure (1) that corporate information gathering and reporting systems exist, (2) that the board has concluded that such reporting systems are adequate, and (3) that failure to do so—under circumstances not articulated in *Caremark*—may render a director liable for losses.¹⁶⁰ Admittedly, this test for liability presents a high burden, requiring a “lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight”¹⁶¹

The Delaware Supreme Court goes on to explain that a demanding test for liability in cases like *Caremark* is justified in the oversight context, and is beneficial overall to classes of shareholders in that it “makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.”¹⁶² This notion

¹⁵⁷ *Id.* at 968–69.

¹⁵⁸ *See, e.g., Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 132 (Del. 1963). Notably in *Graham*, the court found no basis for concluding that the directors had breached their fiduciary duty to remain informed of the ongoing operations of the firm, based on the facts presented. *Id.* *Graham* represents the Delaware Supreme Court’s initial reluctance to extend director liability to cases involving failure to monitor. *Id.* As the court in *Caremark* points out, more recent case law with regard to takeovers highlighted the evolving role of the corporate board, and the increased monitoring obligations required of board members. 698 A.2d at 970 (citing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Paramount Communications v. QVC Network*, 637 A.2d 34 (Del. 1994)).

¹⁵⁹ *Caremark*, 698 A.2d at 970.

¹⁶⁰ *Id.*

¹⁶¹ *Id.* at 971.

¹⁶² *Id.*

of encouraging qualified and competent leaders to serve on boards and in management roles is one that comes up frequently in the fiduciary duties cases and serves as a relevant consideration in the context of opt-outs.

Affirming and clarifying the court's ruling in *Caremark*, *Stone v. Ritter* explicitly approved the standard for oversight liability.¹⁶³ The court outlined the necessary conditions for director oversight liability:

(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.... Where directors fail to act in the face of a known duty to act ... they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.¹⁶⁴

Decisions since *Stone* have not added much additional factual or legal basis for determining when and under what circumstances a fiduciary's failure to act constitutes a breach of duty.¹⁶⁵ Most recently in *In re Citigroup Shareholder Derivative Litigation*, the Court of Chancery of Delaware seemed to signal a retreat to the business judgment rule instead of extending the director oversight liability to claims alleging failure to monitor business risk.¹⁶⁶

The case involved Citigroup's participation in the subprime mortgage market in the years leading up to the 2008 financial crisis and whether the board ignored "red flags" resulting in inappropriate business risk.¹⁶⁷ The court acknowledged and affirmed the duties of oversight that emerged from *Caremark*, but was reluctant to extend them to the factual circumstances of the case.¹⁶⁸ Rather, the court suggested that the theory should be constrained to those cases that do not look to make directors "personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company."¹⁶⁹ The court held that the obligation to implement and monitor a system of oversight

does not eviscerate the core protections of the business judgment rule—
protection designed to allow corporate managers and directors to pursue

¹⁶³ *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006).

¹⁶⁴ *Id.* at 370.

¹⁶⁵ *See, e.g., In re Massey Energy Co.*, No. 5430-VCS, 2011 Del. Ch. LEXIS 83, 2011 WL 2176479 (Del. Ch. May 31, 2011); *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009); *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007).

¹⁶⁶ 964 A.2d 106, 129–30 (Del. Ch. 2009).

¹⁶⁷ *Id.* at 124.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

risky transactions without the specter of being held personally liable if those decisions turn out poorly.... [T]he burden to show bad faith is even higher.... [A]nd the difficulty of proving a *Caremark* claim ... function[s] to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk.¹⁷⁰

In sum, there is no doubt that Delaware courts, as the preeminent creators and enforcers of corporate law, recognize an obligation of good faith in connection with corporate monitoring and oversight systems following *Caremark* and *Stone*. Nevertheless, the particular factual circumstances under which a director or officer may be held liable under this theory remain unclear, as does the degree to which that theory might be extended to other contexts, such as the monitoring of class action claims. As *Citigroup* suggests, at least in recent years, Delaware courts are unlikely to extend monitoring standards to factual circumstances that would otherwise receive traditional business judgment rule treatment. This careful balancing of the business judgment rule alongside *Caremark* and its progeny gets at the heart of this Note and the unique circumstances that influence a fund manager's decision to opt out of a class action.

III. SHOULD FIDUCIARY DUTIES EXTEND TO CLASS ACTION OPT-OUT SCENARIOS?

A. *Caremark* in the Opt-Out Context: Expanding Monitoring Obligations?

In discussing whether fiduciaries should be exposed to liability for failure to monitor the risks and rewards of opt-outs, I begin by setting forth a potential claim under the *Caremark* standard. Accordingly, I address a host of issues unique to securities class actions that make such an extension of liability inappropriate.

Again, it is worth noting that fiduciary duties have never been extended to the claim filing process, neither to encourage investment fund managers to file claims in the first place nor to impose additional duties to assess recovery prospects in connection with a potential opt-out.¹⁷¹

¹⁷⁰ *Id.* at 125 (holding that to entertain claims brought under these facts would undermine the long-established protections of the business judgment rule).

¹⁷¹ *See, e.g.,* *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 132 (Del. 1963); *In re Citigroup Shareholder Deriv. Litig.*, 964 A.2d 106, 129–30 (Del. Ch. 2009).

1. Failure to Implement Monitoring Systems

As the law currently stands under *Caremark*, a claim against an investment fund fiduciary would have to allege that the directors failed to implement any monitoring or information system or controls with respect to claim monitoring.¹⁷² This clearly fits more squarely with the obligations suggested by Cox and Thomas: “[I]n order to satisfy their oversight responsibilities, the trustees of institutional investors must, in good faith, insure that their fund has an adequate system in place to identify and process the funds’ claims.”¹⁷³

Cox and Thomas go on to claim that the standard is in no way onerous, which is compelling in the case of “opt-ins,” although much less so in the case of opt-outs.¹⁷⁴ Recognizing the differences between the two alternatives at issue, it is much easier to argue that monitoring obligations extend to some activity that actually involves some form of monitoring, that is, staying abreast of potential claims to which the fund might be entitled to recover as a class member. This type of monitoring would not require drastic alterations in business practice,¹⁷⁵ and would likely only reshape the roles of current employees involved in the fund’s daily trading activities.¹⁷⁶

As a practical matter, the Delaware courts would first have to recognize a fiduciary duty to file claims in a securities class action before it would be possible to extend the theory any further. Alleging failure to implement a particular system related to opt-outs would not only presume the existence of a well-functioning system to process and track claims initially, but would also prove unduly onerous when compared with the system advocated for by Cox and Thomas.¹⁷⁷ All of the steps that they outline to achieve better monitoring practices in this context, with the exception of creating a centralized clearing house, serve as mere modifications to existing systems.¹⁷⁸ For example, 13F filing requirements already exist, regardless of whether institutions abide by them. Nudging fund managers toward compliance

¹⁷² See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

¹⁷³ Cox & Thomas, *supra* note 5, at 440 (“[T]hey [fiduciaries] should establish a monitoring mechanism to insure that this system is adequate, and if they learn it is inadequate, they must take measures to fix the problems.”).

¹⁷⁴ *Id.* at 440–41.

¹⁷⁵ *Id.* at 441.

¹⁷⁶ *Id.*

¹⁷⁷ See generally *id.* at 442–49 (outlining several easy steps to ensure that institutions receive their fair share, including establishing a centralized information clearinghouse, standardizing trading documentation and claims forms, improving institutional monitoring and claims filing, strengthening institutions’ 13F filing requirements, and improving claims filing systems overall).

¹⁷⁸ *Id.*

under existing frameworks presents a much more feasible solution than one which requires development of an entirely new system altogether.

Opt-outs involve an inherent level of uncertainty and risk that makes them unfit for traditional fiduciary liability. To be sure, very few plaintiffs' law firms currently in practice offer opt-out counseling and analysis as a substantive practice area.¹⁷⁹ Of those that do, many go out of their way to stress the degree of balancing that an opt-out analysis requires.¹⁸⁰ Without question, there is a potential for greater recovery; however, with the potential for similar losses, there is little reason to thrust such a calculus upon a given fund manager.¹⁸¹

The other issue that stems from extending this duty to fund managers is the degree to which a fiduciary's decision-making process would still be subject to the business judgment rule. Imagine a scenario where the fund manager, acting as trustee on behalf of his investor clients determines, based on his own calculus, that it would be advantageous to opt out of a particular class action and pursue a separate private action in the hopes of gaining a greater recovery. He acts on this calculation, and it turns out that his separate action is not permitted. The plaintiff beneficiary receives nothing. Should the fiduciary be liable for the extent of the damages that would have been recovered had he not opted out? The flip side of this hypothetical is that corporate actions by fiduciaries are generally subject to the business judgment rule¹⁸² and would be given deference under that standard, even if they resulted in an aggregate loss. Nevertheless, requiring fund managers to increase their level of risk taking in an activity that currently lacks scholarly or legal acceptance is problematic.

2. Failure to Monitor Systems Once Implemented

The alternative to the "failure to implement" claim under *Caremark* would be to argue that after having implemented such a system or controls, the fiduciary consciously failed to monitor or oversee its operations,

¹⁷⁹ An exhaustive search of firms that market themselves as having knowledge in the realm of opt-outs yields surprisingly abysmal results. *See, e.g.*, Nicole Lavalley, *Practical Matters: When Should Funds Opt-Out of a Class Action?*, BERMAN DIVALERIO (last visited Sept. 2, 2014), <http://www.bermandevalerio.com/NEWS/FIRM-NEWSLETTER/67-PRACTICAL-MATTERS-WHEN-SHOULD-FUNDS-OPT-OUT-OF-A-CLASS-ACTION> ("Each fact pattern gives rise to unique issues and there is no one-size-fits-all solution."); *Representing Opt-Outs in Class Actions*, BERGER & MONTAGUE, P.C. (last visited Sept. 2, 2014), <http://www.bergermontague.com/PRACTICE-AREAS/REPRESENTING-OPT-OUTS-IN-CLASS-ACTIONS>.

¹⁸⁰ *See supra* note 136 and accompanying text.

¹⁸¹ *See* Lavalley, *supra* note 154; *see also* *Representing Opt-Outs*, *supra* note 154.

¹⁸² *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

thus failing to discharge his or her duty of good faith.¹⁸³ Similarly, this claim rests on the preexistence of some sort of monitoring system, one that would both identify claims as they arise, and then weigh their subjective risks and rewards.¹⁸⁴ Given the dearth of current scholarship on opt-out valuation,¹⁸⁵ it is unlikely that such a claim would prevail under Delaware law as it stands.

Beyond the inapplicability of Delaware law, the fundamental policy rationales behind Rule 23 and the PSLRA likewise point away from extending fiduciary duties.¹⁸⁶ As discussed previously, the class action is a device meant to solve a collective action problem that recognizes both individual plaintiff and defendant limitations in light of large-scale damages.¹⁸⁷ Anything that diminishes the predictability of the class action model or that systematically undermines its ability to distribute limited settlement funds, is likewise contrary to Congressional intent in drafting the rules.

CONCLUSION

“Letting Billions [of dollars] Slip Through [anyone’s] Fingertips,” as the Cox and Thomas title indicates, in whatever context, is cause for alarm for those who may have access that money. As previously discussed, in the securities class action space, the primary market participants who are concerned with foregone settlement profits are large institutional investors who manage vast portfolios on behalf of smaller investors. Given the sums at stake in today’s securities fraud settlements—and the even greater sums potentially available to opt-out plaintiffs—there is little doubt that fund managers with claims in securities class actions should be actively engaged in the process on behalf of their beneficiaries. This Note concurs with the thrust of the Cox and Thomas article, that extending fiduciary liability to fund managers to monitor class action claim filing would be minimally invasive in terms of adopting and integrating new policies, and would yield a positive result for both managers and investors. Delaware law has already extended such duties to similar factual circumstances in *Stone* and *Caremark*; thus, it would not signal a significant legal departure from existing case law. Furthermore, it would satisfy expectations of most investors who entrust

¹⁸³ See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

¹⁸⁴ *Id.*

¹⁸⁵ See generally Rozen, *supra* note 10; Keith Sharfman, *Valuation Averaging: A New Procedure for Resolving Valuation Disputes*, 88 MINN. L. REV. 357, (2003).

¹⁸⁶ See *Schwartz v. Harp*, 108 F.R.D. 279, 281 (C.D. Cal. 1985); see also Private Securities Litigation Reform Act, *supra* note 43; Cox & Thomas *supra* note 5, at 416–21.

¹⁸⁷ See FED. R. CIV. P. 23.

their fund managers with the task of maximizing their portfolios through prudent management.

Despite the growing trend of opting out of securities class actions, fiduciary duties as the courts have traditionally recognized them are not the proper vehicles to ensure that plaintiffs receive the maximum recovery. Opting out—despite its potential rewards—may be incompatible with the fund manager’s fiduciary role. Under a regime that scrutinizes managers’ assessment of opt-out risks and rewards, managers may be incentivized to risk significant portfolio value on the possibility of success in a direct action, rather than relying on a proportional share of the class action settlement. Moreover, on the aggregate, extending fiduciary duties to the opt-out sphere would likely encourage strategic behavior, particularly among the largest institutional investors, which would undermine the collective benefits of the class action system—either so many plaintiffs would opt out that settlements would be frequently vacated, or the pool of assets available for recovery would become less certain overall. Under this scenario, unsophisticated investors without the financial resources to opt out would likely suffer, as would the judicial system as a whole.

Perhaps the most compelling argument against extending fiduciary duties is that Delaware law as it stands does not properly square with the factual circumstances necessary to bring an action for failing to opt out, or as a more extreme example, opting out and then receiving nothing. Monitoring is reasonable in the opt-in context for which systems can be readily developed to file class action claims, the risks are minimal to investors, and the probability of increasing the value of the underlying portfolio is nearly certain. It would be impractical to encourage the development of monitoring systems to assess the risk of opting out given the complexity of the risk calculus, and the many other factors that may influence a given institutional investor’s probability of success. A prudent fund manager with substantial resources would engage legal counsel to explore opt-out possibilities, but he or she should not be liable for choosing not to do so, or for preferring the predictability of the existing class action proceeding.