

Institutional Investor



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The Asset Class No One Knows They Own

BY JULIE SEGAL

Soon after news that Volkswagen had cheated on emissions tests became public in September 2015, cutting the German carmaker's stock almost in half, Brian Bartow, the general counsel for the California State Teachers' Retirement System, called Irwin Schwartz, a litigation lawyer.

"How badly did we get hurt?" asked Bartow from his Sacramento office.

He wasn't concerned only about the losses from the 330,000 Volkswagen shares the plan owned. Bartow wanted to understand CalSTRS' options for getting involved in a legal action against VW to hold the carmaker accountable for the scheme that had allowed diesel cars to fraudulently pass strict emissions tests. The general counsel was asking because CalSTRS believes it's one challenge to buy stocks according to environmental standards, and another to do the dirty work of holding a company responsible for violating the pension plan's investment principles.

Pensions and other institutions have a hard time overseeing their exposure to securities fraud cases domestically. But VW common shares were traded outside the U.S., making it even more complicated for investors to figure out cost-effective options for recovering losses stemming from the scandal.

A few years before, CalSTRS had started using a Schwartz-founded



Illustration by Justin Renteria

A massive public pension is warning investors to rethink the status quo when managing securities litigation — a status quo that is enriching lawyers and litigation funders.

company called Dividex to identify and evaluate potential fraud claims from stocks purchased outside the U.S., as well as to collect more from settlements in domestic class action cases.

VW was one of the company's first big tests.

After Bartow's call on the scandal, Dividex handled everything from identifying multiple options for CalSTRS to sue VW in Germany to negotiating fee agreements for lawyers outside the United States. CalSTRS ultimately became a proposed lead plaintiff against

VW and chair of the steering committee for its group suing the automaker.

Now CalSTRS' chief lawyer wants other public pension plans to stop relying on outdated and conflicted practices to monitor and recover losses from securities fraud — when a company falsifies information to persuade investors to buy its stock. Bartow, with a full-on white beard and bachelor's and law degrees from the University of California, says public plans have a fiduciary duty to better manage securities litigation. A critical mass of investors will ultimately encourage more

competition among lawyers and drive down legal costs for beneficiaries.

Crucially, Bartow believes, pensions need to start treating securities litigation claims as an asset of their plans, just like any other portfolio holding.

Pension funds, endowments, asset managers, and other investors have generally relied on class action plaintiffs' lawyers to monitor their portfolios and alert them if any of the U.S. securities they hold are involved in fraud. Plaintiffs' lawyers are happy to provide the work for free, hoping to be hired if an investor chooses to be the lead plaintiff in a class action lawsuit.

Bartow says the practice is riddled with conflicts of interest — conflicts that, historically, have maintained a dangerous status quo.

"The plaintiffs' securities class action bar has an obvious economic incentive to bring cases to us. It's a Darwinian principle," notes Bartow.

"I appreciate that, but there's always an underlying question of bias," he explains. "This is even more pronounced because we are a large institutional investor, and merely adding our name and losses increases the potential value of a case to the plaintiffs' lawyers. As the portfolio manager, if you will, of litigation recoveries as an asset, I can't rely on that profit motive, Darwinian or not, to make me aware of and evaluate what's out there."

It gets even trickier when foreign companies like Volkswagen deceive investors. In 2010 the Supreme Court ruled in *Morrison v. National Australia Bank* that securities traded outside the U.S. are no longer under U.S. jurisdiction. Pensions interested in recovering any of their plans' international losses need to find, evaluate, and join cases filed in foreign jurisdictions. Investors face a long list of very different legal practices and potential risks as a result. For one thing, lawyers outside the U.S. can't work on a contingency basis. That means litigation funders will pay legal costs, but in exchange for that service they take exorbitant chunks of any settlement. (Litigation funder Bentham IMF is owned by Paul Singer's Elliott Management, a clear signal that the business is extremely profitable.)

Not long after Bartow became

CalSTRS' general counsel in 2010, he learned of a major new case and wanted to determine whether the California pension would want to seek lead plaintiff status, as the named party in a class action suit. Only one of the law firms that CalSTRS dealt with on securities litigation at the time would evaluate the merits of the case. The rest refused because they wanted a chance to represent CalSTRS if it decided to go ahead with the case. This was because CalSTRS — the second-largest U.S. pension fund — prevents law firms from doing both because of the inherent conflicts.

In addition, law firms were interested only if the plan wanted to be the lead plaintiff. There's little profit in going after settlements from class action suits that take years to work their way through courts.

"That experience made me realize that this model is not working," Bartow says.

He believes that the majority of institutional investors still use a free monitoring service and wait for so-called portfolio loss recovery opportunities to be brought to them by the plaintiffs' counsel. For cases overseas, plaintiffs' lawyers that are also litigation funders are the ones that bring cases to the attention of many pension plans.

Institutional investors have a lot at stake. In 2017 a record 432 cases were filed in federal courts, many of them driven by objections to mergers, according to Securities Class Action Services. So far, 350 cases have been filed in the U.S. in 2018, on pace to be another record year. In 2016 and 2017, SCAS, which is part of Institutional Shareholder Services, filed 2.4 million claims for clients. In 2018 the top 15 settlements totaled \$10 billion in shareholder recoveries.

Once Bartow decided to upend CalSTRS' model, he looked for an independent service that could identify and evaluate potential cases and help the pension recover more losses. But there wasn't one. Custodian banks and a number of vendors, including Financial Recovery Technologies and ISS, only track litigation and provide claims-filing services.

Securities lawsuits involving foreign companies plagued Bartow. Unlike in the U.S., in foreign cases investors can't be pas-

sive and still recover a share of a class action settlement. They need to opt into a case.

"What drove me early on to get involved in these foreign cases was the simple fact that if CalSTRS didn't participate, we would get nothing," Bartow says.

Litigation outside the U.S. is on the rise. Eleven non-U.S. cases have been settled this year through August, including Petrobras, the fifth-largest securities class action settlement to date, and Fortis, the biggest settlement ever in Europe, according to ISS.

Foreign cases also bring new risks. In the U.S. institutional investors can hire lawyers on contingency, meaning they don't pay legal fees unless they win. Many foreign jurisdictions don't allow contingency fee agreements, and some require losers to pay legal fees.

"For CalSTRS to get involved, it was important to find a risk-free model analogous to the U.S. class action system," explains Bartow.

As he looked for solutions to manage litigation as an asset of the plan, Bartow met Schwartz.

Schwartz had seen the problems firsthand at Massachusetts Pension Reserve Investment Management. He had been hired after the Boston-based investment fund stopped solely using plaintiffs' lawyers to monitor its portfolios. To be an independent adviser to PRIM, Schwartz needed to establish processes from scratch, developing a system with Bloomberg Analytics, for example, to detect large losses in the portfolio that could signal a coming lawsuit.

But not everybody cared about fixing the problem.

Irwin Schwartz says settlements of securities litigation are similar to dividends. Investors may get two cents a share, which sounds measly but can add up to significant amounts of money.

"When on Earth would you sue somebody if you thought you would get back two cents on a dollar? That's the mindset of many investors on this asset class, if you call it that," Schwartz says.

Bartow drafted a wish list of capabilities to help Schwartz build a system that could help the pension plan manage its securities litigation claims. In 2013, Schwartz created Dividex to meet CalSTRS' needs and later registered it as an investment adviser.

Now an increasing number of investors want independent advice on securities litigation. Last year the Teacher Retirement System of Texas started a search for what it calls investment-related litigation claims services, according to a public filing.

Dividex helps institutional investors identify and manage potential fraud claims for securities purchased outside the U.S., and it helps them do a better job of collecting on class action settlements in the U.S. Schwartz went a step further and formed a risk insurance company to provide what's called before-the-event adverse party cost insurance to protect clients that wanted to join cases in jurisdictions that re-

quired losers to pay all legal fees.

Dividex provides evaluations of potential securities fraud cases. But to avoid conflicts it does not provide legal services and won't represent a plan if it chooses to become the lead plaintiff in a class action lawsuit.

Bartow is pushing big investors to become more active now, because without them, lawyers and litigation funders — which are needed to fund legal costs for plaintiffs outside the U.S. — have too much pricing power. (The minimum price for litigation funders in London is return of capital plus 300 percent.)

The general counsel for one of the ten largest asset managers agrees that there's

a lot of room for improvement. "There are real opportunities for the institutional investor community to pursue progress in how these cases are pursued. Because institutional investors have been somewhat passive, I think an unreasonable percentage of the recoveries [has] flowed to litigation funders and law firms. There's an opportunity to put more money into individual investors' pockets," he says.

"After the *Morrison* case was decided, there were very few litigation funders that I was aware of — and their take-it-or-leave-it approach just got under my skin," Bartow says. "Since our first experience we have successfully negotiated with funders in this space, but I would like to see more competition."