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The Dangers of Relying on Custodians to Collect Class Action Settlement Payments

written by Eduard Korsinsky, Managing Partner, Attorney, Levi & Korsinsky LLP

Institutional investors—including public pension funds, Taft-Hartley funds, mutual funds, and hedge funds—have a fiduciary obligation to recover monies lost through investments in public securities as the result of corporate mismanagement and/or fraud. These losses are often recouped through class action litigation, which pays out billions of dollars to defrauded investors each year. [1]When these lawsuits are settled, however, institutional investors often assume that their custodian will file a claim and collect the funds on their behalf. Unfortunately, this approach almost always leaves such institutions short, and benefits more savvy-minded institutional investors who often pick-up the money left on the table by those relying on their custodians.

Custodians May Not Notify Clients of Every Settlement

Once a securities class action is settled, the court almost always requires notice of the settlement to investors. This process is typically handled by a claims administrator which distributes notices to brokerage firms, banks, institutions, and other third-parties that may hold securities on behalf of investors in "street name." Notices directed to a custodian bank, however, may not be received or, if received, may not be forwarded to the correct individual at the fund. Notice may be forwarded past the filing deadline. Not infrequently, notice is sent to the fund's former custodian, and not to the fund itself or its current custodian bank.

[1] *See, e.g., Cornerstone Research, Securities Class Action Settlements—2020 Review and Analysis, https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Settlements-2020-Review-and-Analysis*

Notice is also typically published in the financial press but, as described further below, without clearly defined roles set forth in the parties' contract, custodians may not have any obligation to monitor these sources for information regarding settlements. Without receiving notice of a settlement, there is obviously no way for a fund to claim its share of a settlement.

Custodians' Roles are Typically Not Clearly Defined

A custodian bank can be important in the claims filing process, both as a source of information about settlements and as the party responsible for filing the claims. But if the role of the custodian is not clearly defined in its contract with the institutional investor, the investor could easily miss out on opportunities to participate in settlement recoveries.

For example, some custodians will only hold title for the securities of their customers, without having any active involvement in the claims filing process. These custodians would need to ensure that their customers receive notice of class action settlements, which would certainly include forwarding any notice received from a claims administrator. Absent a contractual undertaking to do so, however, it is not likely that such a custodian's obligation would include an affirmative obligation to actively review publications such as The Wall Street Journal for notices of settlements.

Custodian banks may, of course, take on the additional functions of screening publications for possible settlements involving their clients, filing claims, or providing adequate information to the party that files the claims on behalf of the institutional investor. In order to ensure that these functions are handled effectively, institutional investor must clearly specify in their contracts with their custodian banks the procedures to be followed with respect to handling possible claims. Absent such definitive protocols, an institution may believe its interest is being addressed by its custodian, while the custodian believes it has no responsibility to monitor settlement notices.

Changes in Custodians May Result in Missed Opportunity

Many institutional investors regularly change their custodian as part of their obligations to monitor the costs and performance of their vendors. If an institution relies upon its custodian bank to collect settlement payments, these changes in custodian can easily cause a breakdown in the claims administration process. This becomes particularly troublesome when institutional investors do not address in their contracts with custodians the obligations that will flow from the custodian to the fund after their relationship has been terminated.

A departing custodian, for example, will not usually forward to either the institution or the succeeding custodian the transactional history for the portfolio it has previously handled. Therefore, neither the succeeding custodian nor the institutional itself will possess sufficient information to evaluate whether it has a provable claim that can be submitted to the claims administrator. Instead, the institutiona will need to depend on its former custodian to provide this data. Whether the subsequent custodian files a claim on behalf of the institutiona may rest upon whether it has received necessary trading records from the prior custodian.

Moreover, there is little incentive for an institutional investor's former custodian to diligently monitor and pursue possible claims on behalf of its former clients. Indeed, in the absence of an explicit agreement that the former custodian would continue to monitor publications for possible settlement notices, the former custodian's obligations to its former client would likely cease immediately upon termination of its contract with the institution. Absent any such contractual agreement, the institution would need to assure itself that its trading records and other support documents were transferred to it or to its new custodian so that reasonable monitoring for future settlements could occur.

Custodians are Not Financially Incentivized to File Claims

Unfortunately, even an institution's current custodian bank typically has financial disincentives to file claims on behalf of its clients. For example, if the custodian receives a fixed fee for its services but pays all of the costs of filing claims without reimbursement from the institution, as seems to be the norm with institutional investors, then the custodian's financial interests would mandate as little filing as possible. This leads to clear conflicts of interest with the institutions who rely on custodians to file claims. Moreover, this problem could remain undetected if the institution fails to properly monitor claims filed on its behalf.

The claim forms are complicated for even the most sophisticated investors. Resembling tax forms, they can be ten or more pages, with detailed instructions requiring the claimant to list all of her transactions in the relevant securities during the class period, along with the dates and purchase or sale price. If the claimant purchased both common and preferred stock in the issuer, or purchased stock in both the primary and secondary markets, it may have to list those transactions separately. Claims must also attach documentation of all listed transactions, and among other things, certify, upon penalty of perjury that the claim information is correct.

Consequently, many institutional investors have begun relying on third party claim filers and law firms for claims filing services and litigation analysis.

Institutional Investors Have Little Recourse against Custodians

Although custodian banks owe fiduciary duties to their client funds, institutional investors may have little recourse if their custodian fails to notify them of a settlement. Basically, the institution would be out of luck.

Institutional Investors Need to Actively Monitor Custodian Banks

While relying upon custodian banks to collect settlement payments has its risks, at the very least, institutions using custodians for this purpose need to engage in routine monitoring activities to ensure that the custodians are doing their jobs—either through periodic audits or by hiring an independent, third-party with experience to monitor. Not only will this maximize the institution's collections from class action settlements, but also it may protect the institution's trustees and management from liability.

EDUARD KORSINSKY

Managing Partner, Co-Founder
Levi & Korsinsky LLP / CORE Monitoring Systems LLC

Eduard Korsinsky is the Managing Partner and Co-Founder of Levi & Korsinsky LLP, a national securities firm that has recovered billions of dollars for investors since its formation in 2003. For more than 24 years Mr. Korsinsky has represented investors and institutional shareholders in complex securities matters. He has achieved significant recoveries for stockholders, including a $79 million recovery for investors of E-Trade Financial Corporation and a payment ladder indemnifying investors of Google, Inc. up to $8 billion in losses on a ground-breaking corporate governance case. His firm serves as lead counsel in some of the largest securities matters involving Tesla, US Steel, Kraft Heinz and others. He has been named a New York "Super Lawyer" by Thomson Reuters and is recognized as one of the country's leading practitioners in class action and derivative matters.

Mr. Korsinsky is also a founder of CORE Monitoring Systems LLC, a technology platform designed to assist institutional clients more effectively monitor their investment portfolios and maximize recoveries on securities litigation.

Mr. Korsinsky received his LL.M. Master of Law(s) from New York University School of Law in 1997 and his J.D. from Brooklyn Law School in 1995.

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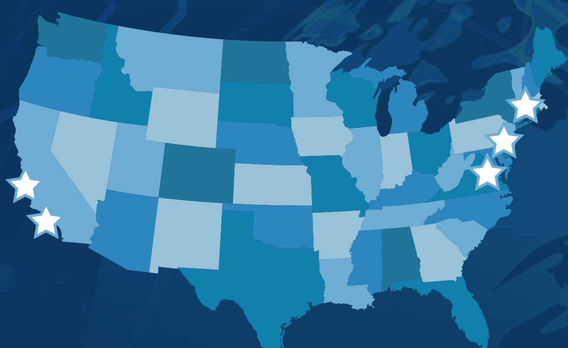

OFFICES

New York
Connecticut
Washington, D.C.
California

CONTACT

Doug Borths
Director of Institutional Client Services & Marketing

dborths@zlk.com or 407-965-5748

Adam T. Savett
Director of Communications & Institutional Research

atsavett@zlk.com or 212-363-7500

Levi & Korsinsky LLP
CORE Monitoring Systems LLC

@MergerAlerts
@COREClassAction