

# Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions

Elliott J. Weiss<sup>†</sup> and John S. Beckerman<sup>††</sup>

## CONTENTS

I. INTRODUCTION .....	2054
II. THE DYNAMICS OF SECURITIES CLASS ACTION LITIGATION .....	2058
III. AGENCY-COST CONCERNS .....	2064
A. <i>The Absence of Effective Monitoring</i> .....	2064
1. <i>Judicial Review of Settlements</i> .....	2066
2. <i>Judicial Awards of Fees to Plaintiffs' Attorneys</i> .....	2071
B. <i>Direct Evidence of Attorneys' Opportunistic Behavior</i> .....	2074
C. <i>Other Concerns Relating to Settlements</i> .....	2079
1. <i>Do the Merits Matter when Class Actions Are Settled?</i> .....	2080
2. <i>"Strike Suits"</i> .....	2084
IV. INSTITUTIONAL AND INDIVIDUAL INVESTORS' STAKES IN CLASS ACTIONS ..	2088
V. HOW PROCEDURAL RULES AND PRACTICES DETER MONITORING .....	2095
A. <i>Procedures Applicable to Class Action Plaintiffs</i> .....	2097
B. <i>Procedural Obstacles to Institutions Becoming Named Plaintiffs</i> .....	2098
1. <i>Procedures for Appointment of Lead Counsel</i> .....	2098
2. <i>Lack of Timely Notice</i> .....	2100

---

<sup>†</sup> Charles E. Ares Professor, University of Arizona College of Law. Thanks to Mark Ascher for patient tutoring on trust law and Brian Carter, Kyra Padden, and David Reid for valuable research assistance.

<sup>††</sup> Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. Thanks to Brian Lieberman and Jonathan Henes for valuable research assistance.

An earlier version of this Article was presented at a conference on The Law and Economics of Litigation Reform, sponsored by the John M. Olin Program in Law and Economics, at Georgetown University Law Center on October 28, 1994. The authors thank Lynn Stout, Warren F. Schwartz, and other participants in the conference, as well as Charles Ares, William Bratton, Lawrence Cunningham, Josh Sarnoff, Jeanne Schroeder, and Charles Yablon, for constructive comments and criticisms.

3. <i>Discovery Concerning Typicality and Adequacy</i> . . . . .	2101
C. <i>Procedural Obstacles to Secondary Participation</i> . . . . .	2103
1. <i>Intervention</i> . . . . .	2103
2. <i>Objection</i> . . . . .	2104
VI. PROPOSED CHANGES IN CLASS ACTION PROCEDURES . . . . .	2105
A. <i>Appoint as Lead Counsel the Attorney of the "Most Adequate Plaintiff"</i> . . . . .	2105
B. <i>Provide Early Notice to Class Members with Large Claims</i> . . . . .	2108
C. <i>Regulate Discovery Directed at Typicality, Adequacy, and Reliance</i> . . . . .	2109
VII. WILL INSTITUTIONS ACT AS LITIGATION MONITORS? . . . . .	2109
A. <i>Fiduciary Obligations</i> . . . . .	2112
1. <i>Trustee's Duty of Care</i> . . . . .	2113
2. <i>Trustee's Duty of Loyalty</i> . . . . .	2117
B. <i>Balancing Costs and Benefits</i> . . . . .	2120
1. <i>The Potential Benefits of Institutional Activism</i> . . . . .	2121
2. <i>The Potential Costs</i> . . . . .	2124
3. <i>Concerns About Liability for Breach of Fiduciary Duty</i> . . . . .	2125
VIII. CONCLUSION . . . . .	2126

## I. INTRODUCTION

Controversy abounds about securities class actions,<sup>1</sup> centering on the fact that attorneys operating on a contingent fee basis initiate most such suits in the names of "figurehead" plaintiffs with little at stake. Some critics charge that class actions are mostly "strike suits" that avaricious plaintiffs' lawyers file with a view to coercing settlements from innocent defendants unwilling to incur the high costs of litigation. Other critics focus on the agency costs

---

1. Hereinafter we use the term "class actions" to mean class action suits brought under the federal securities laws. Such actions generally fall within one of four categories: (1) suits under § 11 of the Securities Act of 1933, brought on behalf of persons who purchased securities in a public offering; (2) suits under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, brought on behalf of persons who purchased securities from defendants who misrepresented material facts relating to those securities; (3) suits under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, brought on behalf of persons who purchased or sold securities at prices influenced by material misrepresentations made by defendants who neither purchased nor sold those securities; and (4) suits under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, brought on behalf of persons who purchased or sold securities from defendants who possessed material, nonpublic information relating to those securities. Suits in subcategory (3) are commonly referred to as fraud-on-the-market (FOM) suits.

Class and derivative actions brought under state corporate law involve issues similar to those involved in securities class actions. *See, e.g.,* Kahn v. Sullivan, 594 A.2d 48 (Del. 1991) (approving settlement between corporation and shareholder who filed second derivative suit challenging corporate gift over objection of shareholder who filed first derivative suit challenging gift). However, state law actions involve unique procedural issues that are beyond the scope of this Article.

inherent in class actions initiated and maintained by attorneys who operate without meaningful client supervision. They claim that when class actions are settled, as most are, plaintiffs' attorneys often shortchange the plaintiff class.

Plaintiffs' attorneys respond to these criticisms by arguing that they perform a public service and protect innocent investors. Class actions, they claim, constitute a necessary supplement to the efforts of the Securities and Exchange Commission (SEC) to deter securities fraud and provide the only effective mechanism for compensating investors injured by securities fraud.<sup>2</sup> Plaintiffs' attorneys also assert that Rule 23 of the Federal Rules of Civil Procedure requires that courts approve class action settlements and awards of attorneys' fees<sup>3</sup> and assures that class members' interests are "scrupulously protected."<sup>4</sup>

Committees in both houses of the 103d Congress held hearings on whether new legislation was needed to control class action "abuses"<sup>5</sup> but reached no conclusions and recommended no legislation. The 104th Congress has already begun to revisit these questions.<sup>6</sup> Arthur Levitt, Chairman of the SEC, has argued consistently that "[p]rivate actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws."<sup>7</sup> He has opposed legislation that would decimate the effectiveness of class actions, while supporting other changes in the rules governing such actions, "because private litigation imposes substantial unnecessary costs when it is abused by private plaintiffs or their attorneys."<sup>8</sup>

The agency-cost literature, with its emphasis on the absence of effective protection for class members' interests, first sparked our interest in class

---

2. See, e.g., *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 141, 145 (1993) [hereinafter *Senate Hearings*] (testimony of William S. Lerach).

3. See FED. R. CIV. P. 23.

4. *Senate Hearings*, supra note 2, at 143.

5. *Id.* at 1; see *Prepared Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Before the House Subcommittee on Telecommunications and Finance, Committee on Commerce*, FED. NEWS SERV., Feb. 10, 1995, available in LEXIS, News Library, Curnws File [hereinafter *Levitt 1995 testimony*]; *Prepared Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Litigation Under TI-IF, Federal Securities Laws, Before the House Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce*, FED. NEWS SERV., July 22, 1994, available in LEXIS, News Library, Curnws File [hereinafter *Levitt 1994 testimony*].

6. See *Securities Litigation Reform Topic of Separate House, Senate Legislation*, 27 Sec. Reg. & L. Rep. (BNA) No. 3, at 116 (Jan. 20, 1995). On March 8, 1995, the House passed H.R. 1058, the Securities Litigation Reform Act, which would make significant amendments in both the procedures and the substantive rules governing securities class actions, almost all of which would make it more difficult to maintain such actions. The Senate appears inclined to adopt a more balanced reform measure. See *Senators, Witnesses Call for Balance in Securities Law Reform*, 27 Sec. Reg. & L. Rep. (BNA) No. 9, at 335 (Mar. 3, 1995).

7. Levitt 1995 testimony, supra note 5. Mr. Levitt also pointed out that "[o]ur markets are the envy of the world precisely because they operate fairly and efficiently under a system in which full disclosure, not inside advantage, is the rule." *Id.*

8. *Id.*

actions. We knew that institutional investors own a majority of the stock of publicly held corporations<sup>9</sup> and account for a significantly larger portion of securities trading.<sup>10</sup> It therefore seemed likely that institutional investors had similarly large stakes in most class actions. If so, it also seemed likely that institutions, acting individually or collectively, might be well situated to monitor the conduct of plaintiffs' attorneys as proxies for all members of plaintiff classes.

We found that institutional investors' stakes in class actions were even larger than we thought. The fifty largest claimants in a large sample of class actions accounted for more than 57% of the dollar value of all claims filed.<sup>11</sup> More significant, the ten largest claimants in twenty class actions for which we were able to obtain detailed claims data accounted, on average, for 40.5% of the dollar value of the claims filed.<sup>12</sup> The largest claimant, on average, accounted for 13.1% and the second largest for 6.7%.<sup>13</sup> Data we gathered from a small group of institutions tended to corroborate these findings. The two largest recoveries received by the State of Wisconsin Investment Board in one recent year represented roughly 13.7% and 20.2% of all amounts recovered by class members in those actions. The California Public Employees Retirement System had recoveries, over a twenty-one month period, that equaled roughly 14.2%, 10.0%, and 6.2% of the amounts recovered by class members in three class actions.<sup>14</sup> Three other large institutions had comparably large recoveries. Moreover, there are substantial differences, often amounting to millions of dollars, between the allowable losses claimed by institutions in class actions and the amounts they actually recovered.<sup>15</sup> This further suggests that institutions could realize substantial benefits by serving as litigation monitors.

Of course, institutions would likely find such service worthwhile only if, as many commentators claim, excessive agency costs pervade class action litigation. To examine this claim, one must first understand the dynamics of class action litigation and how they relate to the criticisms frequently directed at such litigation. Part II describes the characteristics of class actions that have become the focus of most critics' concerns. Plaintiffs' attorneys, not investors,

---

9. In 1990, institutions were estimated to own 53% of public and private equity. Carolyn K. Brancato & Patrick A. Gaughan, *Institutional Investors and Capital Markets: 1991 Update 8* (Columbia Institutional Investor Project, Ctr. for Law and Economic Studies, Columbia Univ. Sch. of Law, Sept. 1991).

10. See *Supplementary Information to Securities Transactions Settlement*, 58 Fed. Reg. 52,891, 52,896 (1993) (estimating that "[d]uring 1992, institutions accounted for two-thirds, and perhaps more, of daily share volume on the NYSE"); James A. White, *Nasdaq Posts a Blistering 56.8% Surge for 1991 as More Big Investors Pile On*, WALL ST. J., Jan. 2, 1992, at 15 (discussing institutions' increasing purchases of stock in small companies that trade over the counter).

11. See *infra* text accompanying note 197.

12. See *infra* tbl. 2 accompanying note 200.

13. See *infra* tbl. 2 accompanying note 200.

14. See *infra* text accompanying note 207.

15. See *infra* tbl. 2 accompanying note 200.

initiate most class actions. We explain the dynamic that leads plaintiffs' attorneys to file class actions quickly, often within days of the events giving rise to such litigation, and note that virtually all class actions that survive motions to dismiss and motions for summary judgment are settled.

Part III addresses agency-cost issues. Commentators point out that plaintiffs' attorneys invariably face a choice between maximizing their own income and maximizing the benefits realized by the plaintiff class and suggest that plaintiffs' attorneys often place their own interests first.<sup>16</sup> Moreover, both courts and commentators are skeptical whether courts use their power to approve proposed settlements and award attorneys' fees effectively to constrain attorneys' self-serving behavior.<sup>17</sup>

We describe two cases that exemplify the problems involved in judicial review of settlement terms and awards of attorneys' fees. Then we highlight three recent cases in which plaintiffs' attorneys agreed to a settlement term that is highly prejudicial to class members whose claims probably represent, in dollar values, more than seventy percent of the claims of the plaintiff classes. Finally, we discuss two criticisms of class actions that relate to these agency-cost issues: Janet Cooper Alexander's claim that virtually all class actions are settled on a formulaic basis that takes no account of the merits of the parties' positions;<sup>18</sup> and assertions, made mostly by representatives of companies in industries that have been frequent targets of class actions, that most class actions are non-meritorious "strike suits." We show that the evidence on which Professor Alexander relies does not support her conclusion. We conclude that the strike suit claim probably has some merit and involves agency-cost issues.

Part IV addresses the commonly held assumption that no class member has a large enough stake in the typical class action to justify service as a litigation monitor. Our data, referred to above,<sup>19</sup> demonstrate the size of the stakes that institutional investors have had in numerous class actions, and also show that individual investors with small losses recover a very minor portion of the amounts paid out in class action settlements.

Part V points out that an institutional investor would find it worthwhile to serve as a litigation monitor if it were "lead plaintiff," that is, the class

---

16. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 534-48 (1991); John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 887-88 (1987) [hereinafter Coffee, *Regulation*]; John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 685-86 (1986) [hereinafter Coffee, *Economic Theory*]; Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 17-18 (1991).

17. See, e.g., *Bell Atl. Corp. v. Bolger*, 2 F.3d 1304, 1309-10 (3d Cir. 1993); *Alleghany Corp. v. Kirby*, 333 F.2d 327, 346-48 (2d Cir. 1964) (Friendly, J., dissenting), *aff'd per curiam*, 340 F.2d 311 (2d Cir. 1965) (en banc), *cert. dismissed*, 384 U.S. 28 (1966); Alexander, *supra* note 16, at 566; Macey & Miller, *supra* note 16, at 45-47.

18. Alexander, *supra* note 16, at 566-68.

19. See *supra* text accompanying notes 11-15.

member whose lawyer is designated lead counsel for the class. We describe how judicial practices and interpretation of rules governing selection of lead counsel, provision of notice to class members, and discovery directed at plaintiffs currently make it difficult and unattractive for an institutional investor to act as a lead plaintiff, and how other procedural rules discourage institutions from intervening in class actions and filing objections to proposed settlements.

Part VI proposes new practices, consistent with current procedural rules, that courts could adopt to encourage institutional investors to become lead plaintiffs. These practices would allow market forces, not courts, to play a dominant role in determining who served as plaintiffs' lead counsel in class actions, how lead counsel would be compensated, and the settlement terms that counsel for the plaintiff class would be inclined to propose.

Part VII discusses whether institutional investors are likely to participate actively in class actions if courts begin to interpret procedural rules as we suggest. We submit that creation of a litigation environment more conducive to active institutional participation, appreciation of the benefits that might be realized by acting as lead plaintiff, and concerns about liability for breach of fiduciary duty are likely to lead at least some institutions to begin to play a more active role.

Part VIII concludes by noting that constructive institutional participation also has the potential to alleviate many current concerns about the legitimacy of class action litigation, and thus might increase significantly the extent to which such litigation advances the disclosure policies of the federal securities laws.

## II. THE DYNAMICS OF SECURITIES CLASS ACTION LITIGATION

Securities class actions serve a socially beneficial function: promoting investor confidence in the integrity of the securities markets. The SEC has "consistently stressed the importance of private actions under the antifraud provisions of the federal securities laws,"<sup>20</sup> because such actions "ensure that investors have a meaningful right to seek recovery against those who defraud them"<sup>21</sup> and provide "deterrence against securities law violations" that supplements "the Commission's own enforcement activities."<sup>22</sup> In *Basic Inc. v. Levinson*, the Supreme Court endorsed class actions as necessary to implement "the congressional policy embodied in the [Securities and Exchange Act of] 1934."<sup>23</sup> More specifically, the Court created a presumption that "an

---

20. Levitt 1994 testimony, *supra* note 5.

21. *Id.*

22. *Id.*; *Senate Hearings*, *supra* note 2, at 111 (testimony of William R. McLucas, Director, SEC Division of Enforcement); *see also id.* at 600 (letter from Richard C. Breeden, Chairman, SEC, to Sen. Peter Domenici, Aug. 12, 1992).

23. 485 U.S. 224, 245 (1988).

investor's reliance on any public material misrepresentations . . . may be presumed for purposes of a[n SEC] Rule 10b-5 action"<sup>24</sup> because otherwise the predominance of individual issues would preclude maintenance of class actions to enforce Rule 10b-5.<sup>25</sup>

Courts sometimes refer to plaintiffs as private attorneys general enforcing compliance with policies Congress has adopted,<sup>26</sup> but it is plaintiffs' attorneys, not aggrieved investors, who initiate and control most class actions. As the Seventh Circuit recently observed:

Securities actions, like many suits under Rule 23, are lawyers' vehicles. . . . When defendants' counsel took [plaintiff's] deposition and learned that she knew little about either the Fund or the case and had given counsel free reign, they learned only that this case fits the norm. . . . Counsel to whom [plaintiff] entrusted the litigation—perhaps more accurately, who found [plaintiff] to wage the litigation—is a specialist in the field . . . .<sup>27</sup>

Attorneys typically have much more to gain from these class actions than do the investors who serve as named plaintiffs.<sup>28</sup> If they settle the case or prevail on the merits, the court generally will award the attorneys for the plaintiff class a fee in the range of twenty to thirty percent of the fund their efforts have created.<sup>29</sup> The allure of such awards makes plaintiffs' attorneys willing

24. *Id.* at 247.

25. See FED. R. CIV. P. 23(b)(3). The district court relied upon, and the Supreme Court endorsed, this pragmatic rationale to support the presumption of reliance. See 485 U.S. at 228.

26. See *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 723 F.2d 155, 168 (1st Cir. 1983) ("[A]n investor . . . who brings an action under the securities laws serves the public interest by policing the securities market . . . ."), *aff'd in part and rev'd in part*, 473 U.S. 614 (1985).

27. *Kamen v. Kemper Fin. Servs.*, 908 F.2d 1338, 1349 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991); see also *In re Telesphere Int'l Sec. Litig.*, 753 F. Supp. 716, 719 n.6 (N.D. Ill. 1990) (observing that class action lawsuits in securities field most often either begin with lawyer or derive main impetus from lawyer).

28. Some firms repeatedly initiate class actions in the names of "professional" plaintiffs who have widely dispersed and thinly spread stock holdings. Harry Lewis, a retired attorney, is reputed to have been lead plaintiff in 300 to 400 suits. Andrew Leigh, *Being a Plaintiff Sometimes Amounts to a Profession*, INVESTOR'S BUS. DAILY, Nov. 1, 1991, at 8. One court described another plaintiff who had appeared in 38 class actions as "one of the unluckiest and most victimized investors in the history of the securities business . . . who spends a good deal of his time being a plaintiff in class action securities fraud suits." *In re Urcarco Sec. Litig.*, 148 F.R.D. 561, 563 & n.1 (N.D. Tex. 1993), *aff'd sub nom. Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994); see also *Citron v. E.I. DuPont de Nemours & Co.*, No. 83-6219, 1983 WL 18002, at \*2 (Del. Ch. May 18, 1983) (describing plaintiff whose attorneys monitored her securities portfolio, consisting of more than 250 separate issues and having total value exceeding \$500,000, for possible violations of federal securities laws.)

29. *Central R.R. & Banking Co. v. Pettus*, 113 U.S. 116 (1885), recognized the principle that attorneys had a legitimate claim to fees payable from a common fund that their efforts had created. Fees in class actions often amount to 20 to 30% of the gross amount recovered from defendants. See Court Awarded Attorney Fees, Report of the Third Circuit Task Force, 108 F.R.D. 237, 247 n.32 (Oct. 8, 1985) [hereinafter Report of the Third Circuit Task Force]; see also *Paul, Johnson, Alston & Hunt v. Graulty*, 886 F.2d 268, 272 (9th Cir. 1989). *But see* 13 CLASS ACTION REP. 258-471, 526-57 (1990) (reviewing in detail fee awards in securities class actions prior to 1990 and calculating that fees and costs averaged 15.2% of recoveries).

to “bear a substantial amount of the litigation risk . . . [so long as they can] exercise nearly plenary control over all important [litigation] decisions.”<sup>30</sup>

Thus, although occasionally a stockholder who suspects a securities law violation may ask a lawyer to conduct an investigation and bring a class action if it is warranted,<sup>31</sup> the usual pattern is for a lawyer who specializes in representing plaintiffs to take the initiative. The lawyer typically becomes aware of a significant move in the price of a company’s stock following disclosure of worse-than-expected earnings or other significant, unexpected information. She then conducts a brief investigation, generates a class action complaint, finds someone to serve as a “representative” plaintiff, and files the complaint, often within a few days of the disclosure at issue.<sup>32</sup>

The portrait of the typical named plaintiff that emerges from the case law demonstrates that plaintiffs’ attorneys recruit most of the investors in whose names they initiate class actions. In a large number of class actions, plaintiffs are poorly informed about the theories of their cases, are totally ignorant of the facts, or are illiterate concerning financial matters.<sup>33</sup> In many others, the named plaintiff has a close relationship to the plaintiff’s lawyer or her firm.<sup>34</sup>

30. Macey & Miller, *supra* note 16, at 3. Courts have acknowledged plaintiffs’ attorneys’ dominant role by allowing them, in appropriate circumstances, to seek judicial approval of class action settlements to which their ostensible clients have objected. *See Saylor v. Lindsley*, 456 F.2d 896, 899–900 (2d Cir. 1972).

31. *E.g.*, *Lewis v. Curtis*, 671 F.2d 779, 781 (3d Cir.) (plaintiff testified he called lawyer and asked him to investigate settlement agreement between Hammermill Paper Company and Carl Icahn), *cert. denied*, 459 U.S. 880 (1982).

32. Melvyn I. Weiss, senior partner in a prominent plaintiffs’ securities law firm, submitted data to the Senate Securities Subcommittee on 229 securities class actions that his firm filed from 1990 to 1993. Of these, 157—68.6% of the total—were filed within 10 days of the disclosures that gave rise to plaintiffs’ claims. *Senate Hearings, supra* note 2, at 465–70, 472–502, 538–46 (letter from Melvyn I. Weiss to Sen. Donald W. Riegle, Jr., Chairman, Senate Comm. on Banking, Housing, and Urban Affairs, and exhibits 1 and 5 thereto) (percentage calculated by authors); *see also* Milt Policzer, *They’ve Cornered the Market: A Few Firms Dominate the Derivative-Suit Arena*, NAT’L L.J., Apr. 27, 1992, at 1, 34 (of 46 class actions studied, 12 were filed within one day and another 30 were filed within one week of publication of unfavorable news about defendant corporation).

33. *See, e.g.*, *Rand v. Monsanto Co.*, 926 F.2d 596, 598–99 (7th Cir. 1991) (named plaintiff did not know he was named plaintiff and thought he could recover \$100,000 when his stock fell less than \$1,000 on bad news); *Rolex Employees Retirement Trust v. Mentor Graphics Corp.*, 136 F.R.D. 658, 666 (D. Or. 1991) (plaintiff unfamiliar with basic elements of case became involved after groundwork of suit had been laid); *Kelley v. Mid-America Racing Stables, Inc.*, 139 F.R.D. 405, 409–10 (W.D. Okla. 1990) (plaintiffs largely unfamiliar with facts of case and what they did know appeared to come entirely from counsel); *Koenig v. Benson*, 117 F.R.D. 330, 337–38 (E.D.N.Y. 1987) (plaintiff who read, wrote, and spoke only Yiddish had son explain to him important parts of complaint and did not meet with attorney until well after basic preparation for suit had been completed).

34. *See, e.g.*, *In re Greenwich Pharmaceuticals Sec. Litig.*, Civ. A. No. 92-3071, 1993 WL 436031, at \*2 (E.D. Pa. Oct. 25, 1993) (mem.) (plaintiff was father of attorney in firm representing class); *Shields v. Washington Bancorporation*, No. 90-11-1, 1991 U.S. Dist. LEXIS 14373, at \*5–7 (D.D.C. Oct. 10, 1991) (mem.) (repeat plaintiff had been co-counsel with attorney and split fees in past). The repetition and continuity of the attorney-client relationship in such instances free the lawyers from concern with in-person solicitation prohibited by Rule 7.3(a) of the ABA Model Rules of Professional Conduct and DR 2-103 of the ABA Code of Professional Responsibility. As one plaintiffs’ attorney has stated, “‘You’re not allowed to solicit someone who’s not your client. . . . But there’s nothing unethical about telling [a client] he’s got a cause of action. . . . Someone who’s contacted you, you can call in advance [of a suit].’” *The Professional Plaintiffs*, AM. LAW., Dec. 1989, at 70 (first ellipsis added, other alterations in original).



The most common recruitment practice followed by plaintiffs' attorneys apparently is to maintain a list of potential plaintiffs and their stockholdings.<sup>35</sup>

Plaintiffs' attorneys' practice of recruiting investors to serve as named plaintiffs has become the focus of much recent criticism of class actions. This may reflect long-standing concerns about lawyers soliciting business and stirring up litigation. The traditional prohibition on solicitation has eroded considerably, however.<sup>36</sup> This practice can best be understood not as an effort to stir up unnecessary litigation, but as the product of a dynamic involving modern information-processing technology, judicial practices, and attorney self-interest.

For private litigation to supplement the SEC's enforcement efforts effectively, attorneys who specialize in representing plaintiffs must participate in the identification of situations in which suits should be brought. Modern information-processing technology largely places all plaintiffs' attorneys on an equal plane with respect to this search function. Any lawyer with access to a computer and financial databases can monitor the securities markets and wire services for major stock price moves tied to significant corporate announcements or events that may signal potential securities law claims. Upon discovering such a situation, an attorney can quickly download all of the subject company's public statements relevant to that announcement or event, together with additional information pertinent to a possible claim of securities

---

35. See, e.g., *Greenfield v. U.S. Healthcare, Inc.*, 146 F.R.D. 118, 120 & n.1 (E.D. Pa. 1993), *aff'd*, 22 F.3d 1274 (3d Cir. 1994) (discussing attorney's selection of plaintiff from list of potential plaintiffs maintained by his firm). Some plaintiffs' attorneys freely admit that maintaining lists of potential plaintiffs "makes life easier." Jonathan M. Moses, *Lawyer Given to Filing Shareholder Lawsuits Comes Under Scrutiny*, WALL ST. J., Oct. 28, 1992, at A1, A13 (quoting Richard D. Greenfield). Others deny that they follow this practice and assert that potential plaintiffs seek them out. William S. Lerach, of Milberg Weiss Bershad Hynes & Lerach, insists that he does not keep a list of client stock holdings from which to find plaintiffs, but that clients come to him quickly enough to file suits within 24 hours of the announcement of bad news. Policzer, *supra* note 32, at 1, 34. These denials may be accurate, but when a law firm consistently files class actions within a few days of corporate announcements, it seems likely that if it does not maintain lists of potential plaintiffs, it has some surrogate doing so or uses a functionally equivalent device for finding plaintiffs, such as friendly stockbrokers maintaining lists of investors who might be willing to serve as plaintiffs. Mr. Lerach's partner Melvyn Weiss has testified: "Most of the calls we get are from brokers, from other lawyers, from institutional investors—they come from all over—and from big law firms who have friends and clients, and they can't bring the actions themselves, and they say, 'Bring that action.'" *Senate Hearings*, *supra* note 2, at 328; see also *In re Marion Merrell Dow Inc. Sec. Litig.*, [1994–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,356 (W.D. Mo. July 18, 1994) (plaintiff's affidavits stated that broker "referred" named plaintiff to counsel, who had brief conversation with plaintiff on same day complaint was filed and obtained authorization to sue on plaintiff's behalf).

36. *Shapiro v. Kentucky Bar Ass'n*, 486 U.S. 466 (1988), held that states could not categorically prohibit lawyers from sending truthful and nondeceptive direct mail solicitation letters targeted to potential clients. One district court recently responded to defendants' "clamor about counsel generating this suit rather than the clients" by reflecting:

In truth, class actions are inevitably the child of the lawyer rather than the client when the client's recovery is going to be small in relation to the costs of prosecuting the case. . . . There are cases in which lawyers find clients and precipitate cases where perhaps no one client would ever come forward to complain. I suppose lawyers going out to find clients is not the bad thing it was once thought to be. Legal policy has changed. Perhaps acceptance of class actions made this inevitable.

*Williams v. Balcro Pension Investors*, 150 F.R.D. 109, 118 (N.D. Ill. 1993) (footnote omitted).

fraud, such as whether the company made a public offering or whether insiders bought or sold stock during the period in which the firm may have suppressed or misrepresented material information.<sup>37</sup> If the attorney decides there are grounds on which to file a complaint, she or her staff can use computers to incorporate quickly all such information into a complaint alleging securities fraud.<sup>38</sup>

Any attorney who goes through this process will be aware that lawyers at rival firms probably will have engaged in similar searches and may well have reached similar conclusions. Those firms also will then be in a position to file class action complaints relating to the announcement or event in question. The attorney also will know that all such complaints are likely to be transferred to one district, if necessary, and consolidated in a single action.<sup>39</sup> The court then will appoint one or more of the attorneys who have filed complaints as lead or co-lead counsel.

Plaintiffs' attorneys prize such appointments. The lead counsel effectively controls the conduct of a class action, including assignment of work among all lawyers who represent putative class action plaintiffs. If the lead counsel chooses to do much of the work herself, she will be able to claim the lion's share of any fees awarded.<sup>40</sup>

Courts most often appoint as lead counsel the lawyer who files the first complaint.<sup>41</sup> Thus, plaintiffs' lawyers "race to the courthouse."<sup>42</sup> Some courts follow a different procedure, allowing all lawyers who have filed suits containing the same or similar claims to decide which of their number the court should appoint as lead counsel.<sup>43</sup> This procedure, too, rewards lawyers

---

37. See *Senate Hearings*, *supra* note 2, at 80 (testimony of William S. Lerach).

38. See *id.* Sometimes this process goes awry. See Junda Woo, *Judges Show Growing Skepticism in Class-Action Securities Cases*, WALL ST. J., Jan. 11, 1995, at B8 (noting that two complaints, filed on the date Philip Morris made unexpected announcement and on next business day, contained "identical allegations" that Philip Morris "had engaged in conduct 'to create and prolong the illusion of (Philip Morris') success in the toy industry'").

39. See 28 U.S.C. § 1407(a) (1988) (authorizing consolidation of "actions involving one or more common questions of fact" pending in different districts).

40. See, e.g., *Garr v. U.S. Healthcare, Inc.*, 22 F.3d 1274, 1277 (3d Cir. 1994) ("The lead attorney position is coveted as it is likely to bring its occupant the largest share of the fees generated by the litigation.").

41. See *Senate Hearings*, *supra* note 2, at 80 (testimony of William S. Lerach) (explaining that "courts historically have rewarded the first filed case with control of the case as lead counsel"); Jeffrey Marshall, *He Gains from Banks' Pains*, U.S. BANKER, June 1993, at 12 ("[T]he primary reason you want to get to the courthouse first is to be able to run the case." (quoting Richard Greenfield)); Policzer, *supra* note 32, at 34 ("The general rule is the first to file is generally given some priority in terms of handling the case." (quoting Ernest T. Kaufman)).

42. See *Senate Hearings*, *supra* note 2, at 80 (testimony of William S. Lerach) (noting that plaintiffs' attorneys "are competitive" and "want to be first to file so that we can control the case").

43. According to the *Manual for Complex Litigation*, courts should independently assess the functions, identities, and organization of designated counsel, and should also consider the lawyers' views. Although these need not be adopted, "[j]udges naturally and properly prefer to give special consideration to the suggestions of counsel in such matters." MANUAL FOR COMPLEX LITIGATION (SECOND) § 20.224 (1986); see also *Majeski v. Balcor Entertainment Co.*, 134 F.R.D. 240, 250 (E.D. Wis. 1991) (counsel in consolidated actions directed to inform court whether they could work out suitable arrangements pertaining

who file early.<sup>44</sup> To promote their efforts to be named lead counsel, plaintiffs' attorneys, in addition to seeking to be the first to file, sometimes share copies of their complaints with other plaintiffs' lawyers who will support their election as lead counsel.<sup>45</sup> Within a short time, these other lawyers typically file additional class action complaints that are identical to the complaints filed by the first attorney except for the plaintiffs' names and number of shares.<sup>46</sup> If the court then decides to have all plaintiffs' attorneys determine who will be lead counsel, the lawyers who filed "copycat" complaints support the appointment of the attorney whose work product they have shared.<sup>47</sup>

A plaintiffs' attorney who is aware of a potential securities fraud claim thus faces a practical problem. She cannot initiate a class action in her own name.<sup>48</sup> If she waits until she is approached by an aggrieved investor to file a complaint, she likely will find that complaints already have been filed by other attorneys. To have a reasonable chance of being named lead counsel, at least in a high-visibility case, she needs to file quickly and thus will resort to one of the plaintiff-recruitment practices described above.

Of course, being the first to file (or being named lead counsel for a plaintiff class) does not ensure that a plaintiffs' attorney will receive a fee. The courts recognize that securities class actions pose "the threat of extensive discovery and disruption of normal business activities"<sup>49</sup> and thus may have potential settlement value for the plaintiff class far out of proportion to their

---

to representation of plaintiff class).

44. In addition, an attorney cannot be sure, at the time she files her complaint, which procedure the court will use. Consequently, speed in filing will always seem important.

45. *Garr v. U.S. Healthcare, Inc.*, 22 F.3d 1274, 1277 (3d Cir. 1994) (defense counsel explaining that "in class actions additional complaints are generated so that the original attorney will have allies when a vote is taken to determine the lead attorney").

46. *See id.* at 1276 ("On November 6, 1992, Levin and Sklar filed [a] complaint which replicated the *Greenfield* and *Strunk* complaints except that the names of the plaintiffs and the number of shares they owned were changed."). Multiple filings, and involvement by numerous firms, also allow plaintiffs' lawyers to share the financing of class actions and to spread the risks involved. *See Coffee, Economic Theory, supra* note 16, at 705. In addition, if multiple plaintiffs file complaints, it is more likely that at least one putative class representative will be found suitable.

47. Courts sometimes consider competing lawyers' reputations in deciding who should be appointed lead counsel, in order to ensure that she is capable of representing the class adequately. *See, e.g., Wetzell v. Liberty Mut. Ins. Co.*, 508 F.2d 239, 247 (3d Cir.) (noting that plaintiff's attorney "must be qualified, experienced, and generally able to conduct the proposed litigation"), *cert. denied*, 421 U.S. 1011 (1975). However, most members of the securities plaintiffs' bar are well known to the courts, *see In re Activision Sec. Litig.*, 723 F. Supp. 1373, 1374 (N.D. Cal. 1989) (referring to "number of well-recognized lawyers who specialize in plaintiffs' securities litigation"), and can support their applications for appointment as lead counsel with transcripts from previous class actions that include laudatory judicial characterizations of their past performance. *But see In re Oracle Sec. Litig.*, 136 F.R.D. 639, 649 (N.D. Cal. 1991) (attributing plethora of laudatory remarks about class counsel in fee orders and paucity of other observations to courts' delight with clearing their dockets of complex cases).

48. *Cf. Pope v. City of Clearwater*, 138 F.R.D. 141, 144-45 (M.D. Fla. 1991) (disqualifying law firm from representing class where named plaintiff was partner in same firm); L. Stuart Ditzen, *Richard Greenfield Is Barred by U.S. Court for One Year*, PHILA. INQUIRER, Dec. 23, 1993, at C1 (reporting that Richard D. Greenfield was suspended from practice for one year for attempting to deceive court concerning his personal interest in plaintiff corporation on whose behalf he initiated class action).

49. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 742-43 (1975).

merit. They have reacted to this possibility by becoming sensitive to the judicial "interest in deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding . . . extensive discovery costs."<sup>50</sup> In particular, courts have begun to rely increasingly on Rule 9(b)'s requirement that fraud be pleaded with particularity to screen out non-meritorious and inadequately researched class action complaints.<sup>51</sup> In recent years, they have dismissed on motion something on the order of forty percent of all securities class actions.<sup>52</sup>

If a class action survives motions to dismiss and motions for summary judgment, though, it is practically certain to result in a fee award to the attorneys for the plaintiff class. Defendants have "exceptionally strong incentives to settle" any class action in which they are unable to obtain a judgment on the merits prior to trial.<sup>53</sup> Plaintiffs' attorneys have similar incentives.<sup>54</sup> Consequently, virtually all class actions not dismissed on motion are settled.

### III. AGENCY-COST CONCERNS

#### A. *The Absence of Effective Monitoring*

Concerns about class actions relate largely to the possibility that plaintiffs' attorneys seek to advance their own financial interests, rather than the interests of the investors they purport to represent, not only by taking the initiative in filing class actions, but by the manner in which they conduct and agree to settle such litigation.<sup>55</sup> No one disputes that a named plaintiff who has only a nominal financial interest in a class action, especially a plaintiff that an attorney has "recruited," is unlikely to monitor effectively her attorney's prosecution of the action or the terms on which her attorney recommends that

---

50. *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1397 (1994).

51. *See* 9 F.3d at 268 (requiring plaintiffs to plead facts giving rise to "strong inference of fraudulent intent"); *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1548 (9th Cir. 1994) (en banc) (rejecting Second Circuit approach but requiring complaint to allege "with particularity the circumstances constituting fraud").

52. *See* Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438, 445-46 (1994).

53. Alexander, *supra* note 16, at 566. Alexander explains these incentives in detail. *See id.* at 528-34, 548-68. They include the potentially catastrophic liability that would result from a judgment for plaintiffs; the risk aversion of individual defendants, who often control the corporate defendant; individual defendants' ability to settle cases using "other people's money," *id.* at 566, as a result of the provisions of insurance policies and rules governing indemnification of corporate officers and directors; and insurers' concern about the possibility that they will be held liable in excess of policy limits if they reject settlements proposed by the parties.

54. Plaintiffs' attorneys receive a more certain return on their investment in a case by settling rather than proceeding to trial. *See id.* at 543-48; Coffee, *Economic Theory*, *supra* note 16, at 716-18.

55. Other commentators have questioned whether private enforcement of various securities law provisions should be maintained. *See* Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1995), and Congress, as we write, is considering legislation that would severely restrict or abolish most securities class actions. *See supra* note 6 and accompanying text.

the action be settled. Indeed, attorneys generally can influence strongly, if not control, the terms on which their clients agree to settle suits other than class actions because an attorney's knowledge about the law and how it applies to the facts almost always is superior to that of her client.<sup>56</sup> In other kinds of litigation, however, a lawyer's ability to succeed often will depend to some degree on her client's cooperation.<sup>57</sup> Moreover, the client, in principle if not in fact, retains the power to accept or reject any settlement her lawyer recommends.<sup>58</sup> The client also has the power to bargain with her lawyer, in advance, about the terms on which the lawyer will be compensated.<sup>59</sup>

None of these constraints is present when class actions are settled. Plaintiffs' attorneys typically do not rely on named plaintiffs for vital testimony, do not bargain with named plaintiffs over the fees they will be paid,<sup>60</sup> and do not require named plaintiffs' approval of the terms on which they propose to settle class actions.<sup>61</sup> The only constraints on plaintiffs' attorneys are the rules of professional responsibility, attorneys' personal sense of duty, and Rule 23's requirement that a court (i) approve any settlement and (ii) determine what constitutes a reasonable fee for the attorney's efforts.

The rules governing attorneys' professional conduct, which bar an attorney from allowing her own interests, financial or otherwise, to influence how she serves her client's interests,<sup>62</sup> do not effectively constrain plaintiffs' attorneys in class actions.<sup>63</sup> The conflicts of interest inherent in such actions lead some plaintiffs' attorneys—critics would say most<sup>64</sup>—to give considerable weight to their interest in maximizing their fee income when deciding on what terms to settle class actions.<sup>65</sup> The extent of that influence depends on two factors.

---

56. See Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUD. 189, 214 (1987).

57. See Saul Levmore, *Commissions and Conflicts in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters, and Other Agents' Rewards*, 36 J.L. & ECON. 503, 520-21 (1993)

58. See Miller, *supra* note 56, at 213.

59. The Model Rules of Professional Conduct bar only unreasonably high contingency fees. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5 (1989).

60. Other than agreeing that the client will owe no fee if the action is unsuccessful.

61. See *supra* note 30.

62. See MODEL RULES OF PROFESSIONAL CONDUCT Rules 1.2(a), 1.7(b), 2.1 (1989); MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 5-101(A) (1981).

63. Proving that an attorney has violated these ethical prohibitions almost always is problematic. In addition, the collective action and free-rider problems that discourage class members from actively monitoring their attorney's conduct of a class action also serve to discourage efforts to prove that an attorney has violated the governing ethical rules. See CHARLES W. WOLFRAM, *MODERN LEGAL ETHICS* § 8-14 (1986). *But cf.* Jonathan M. Moses, *Firm's Trustee Sues Holders' Attorneys*, WALL ST. J., Dec. 1, 1992, at B6 (reporting on suit by bankruptcy trustee claiming that plaintiffs' attorneys in shareholder derivative action "rushed to settle to get millions of dollars in fees rather than adequately pursue the claims they were asserting").

64. See Mary Kay Kane, *Of Carrots and Sticks: Evaluating the Role of the Class Action Lawyer*, 66 TEX. L. REV. 385, 395-96 (1987); Charles W. Wolfram, *The Second Set of Players: Lawyers, Fee Shifting, and the Limits of Professional Discipline*, LAW & CONTEMP. PROBS., Winter 1984, at 293, 295.

65. One study of 104 class actions found that plaintiffs' attorneys earned a statistically significant "settlement premium" in cases that were settled compared to the fees earned by attorneys in actions litigated to judgment. Andrew Rosenfield, *An Empirical Test of Class-Action Settlement*, 5 J. LEGAL STUD. 113, 116-17 (1976).

One, which no doubt varies considerably among attorneys, is the individual attorney's personal sense of right and wrong.<sup>66</sup> The other is the attorney's awareness that a court must approve any settlement to which the attorney agrees and must decide what constitutes a reasonable fee for the service the attorney has rendered to the class.

### 1. *Judicial Review of Settlements*

The requirement that a court approve any settlement of a class action provides only modestly more protection to class members than do the rules of professional responsibility,<sup>67</sup> largely because settlement hearings typically are not adversarial in character. Objectors are rare, and often are only "straw objectors" represented by disgruntled attorneys who have been frozen out of participation in a case. Judge Henry Friendly pointed out many years ago: "Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork . . ."<sup>68</sup> The same holds true today. Professors Macey and Miller describe settlement hearings as "pep rallies jointly orchestrated by plaintiffs' counsel and defense counsel."<sup>69</sup>

Trial judges are not well situated to evaluate the parties' joint presentation at settlement hearings critically, nor are they often inclined to do so. First, the judge usually has not reviewed the relevant evidence in any detail and thus is not in a good position to evaluate independently to what extent it supports plaintiffs' claims or defendants' defenses. She has even less information as to how diligently and effectively plaintiffs' attorneys have prosecuted the action. Plaintiffs' and defendants' counsel, when describing the evidence and their

---

66. For an example of diligent prosecution of a class action, see *In re Software Toolworks Inc.*, 38 F.3d 1078, 1082 (9th Cir. 1994) (plaintiffs' attorneys appeal dismissal of claims against underwriters and accountants despite having secured recovery of \$26.5 million—approximately \$6.90 per share—from issuer and officers in connection with \$71 million offering), *amended*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 98630 (9th Cir. Mar. 13, 1995); see also *In re Crazy Eddie Sec. Litig.*, 824 F. Supp. 320, 323, 326–27 (E.D.N.Y. 1993) (reporting that plaintiffs' attorneys assisted government in locating and recovering substantial assets secreted by principal perpetrator of securities fraud, which assets were not part of settlement fund); Letter from Richard B. Dannenberg to Hon. Arthur Levitt, Chairman, SEC 13 (Feb. 2, 1994) (on file with authors) (noting that certain plaintiffs' attorneys "who are not publicity conscious" have recovered large amounts that investors lost due to "egregious frauds which are not high profile [and] which are not the subject of Commission enforcement action"); John C. Coffee, Jr., *Claims Made Settlement: An Ethical Critique*, N.Y. L.J., July 15, 1993, at 5 (commending settlement in *In re Zenith Lab. Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,617 (D.N.J. Feb. 11, 1993)).

67. See, e.g., *Bell Atl. Corp. v. Bolger*, 2 F.3d 1304, 1309–10 (3d Cir. 1993); *Alleghany Corp. v. Kirby*, 333 F.2d 327, 346–48 (2d Cir. 1964) (Friendly, J., dissenting), *aff'd per curiam*, 340 F.2d 311 (2d Cir. 1965) (en banc), *cert. dismissed*, 384 U.S. 28 (1966); Alexander, *supra* note 16, at 566; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 26–27 [hereinafter Coffee, *Champion*]; Macey & Miller, *supra* note 16, at 45 ("[J]udicial approval appears to be highly imperfect as a protection for the plaintiffs' interests, for several reasons.").

68. *Alleghany*, 333 F.2d at 347 (Friendly, J., dissenting); see also *Bell*, 2 F.3d at 1310.

69. Macey & Miller, *supra* note 16, at 46.

efforts to the court, will be inclined "to spotlight the . . . [proposed settlement's] strengths and slight its defects."<sup>70</sup>

Second, judges generally feel pressured to move their dockets and have an interest in approving settlements. Judge John Keenan expressed this sentiment in *In re Warner Communications Securities Litigation* when he remarked: "[T]he court starts from the familiar axiom that a bad settlement is almost always better than a good trial."<sup>71</sup> Janet Cooper Alexander notes that judges "typically display a strong interest in seeing large, complex cases such as securities class actions settle rather than go to trial and often take an active role in promoting settlement."<sup>72</sup> Lacking any incentive to probe deeply, and lacking the time and information necessary to do so, it is not surprising that courts tend to approve almost all class action settlements.<sup>73</sup>

*In re Warner Communications Securities Litigation* illustrates the extremes to which courts go to approve class action settlements.<sup>74</sup> This litigation arose after Warner announced on December 8, 1982, that the sales of its subsidiary, Atari, and Warner's earnings for 1982, would be significantly below projections Warner previously had issued. The next day the price of Warner stock dropped by more than one-third. Several securities class actions were filed shortly thereafter. Plaintiffs alleged that between May 3, 1982,<sup>75</sup> and December 8, 1982, Warner had knowingly or recklessly issued false and misleading reports and projections and that various Warner officers and directors had sold more than \$30 million in Warner stock, including \$20 million in stock that Steven Ross, Warner's high-profile CEO,<sup>76</sup> had sold between August and October. Warner shareholders also filed "piggyback" derivative actions in federal district court and Delaware Chancery Court, alleging that Warner's directors had violated their fiduciary duties by participating in, permitting, or not preventing these unlawful, and potentially costly, actions.

Following certification of a plaintiff class and extensive discovery, the parties agreed to a settlement that called for \$17.54 million to be paid to a settlement fund in the federal securities action (\$11.25 million by Warner, \$6

---

70. *Bell*, 2 F.3d at 1310.

71. 618 F. Supp. 735, 740 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986).

72. Alexander, *supra* note 16, at 566.

73. This is not to say that the requirement that a court approve a class action settlement is meaningless. It undoubtedly imposes at least a weak constraint on plaintiffs' attorneys. See Kane, *supra* note 64, at 403 ("[T]he rule protects the parties only against the most egregious and blatant abuses."). In certain kinds of class actions (and in shareholder derivative actions) the parties often are able to structure settlements that require defendants to commit to largely cosmetic, "corrective" activities and provide for payment of a substantial fee to plaintiffs' attorneys. See Coffee, *Champion*, *supra* note 67, at 24-25. Settlements of securities class actions are less vulnerable to this sort of manipulation. They almost always involve payment of some financial consideration by defendants to the plaintiff class.

74. *Warner*, 618 F. Supp. at 735. Elliott Weiss, a coauthor of this Article, was counsel of record for the Objector in this action. This account draws on his personal experience in that capacity and reflects his point of view about that litigation.

75. The date Warner issued its quarterly report for the first quarter of 1982.

76. See generally CONNIE BRUCK, *MASTER OF THE GAME* (1994) (chronicling career of Steven Ross).

million by insurance carriers, and \$290,000 disgorged in an SEC enforcement action by two officers who sold Warner stock just before Warner's December announcement) and \$2 million to be paid to Warner, by its directors and officers (D&O) insurer, to settle the derivative action. The agreement did not call for any payment by Ross or other payments from the other Warner officers charged with insider trading. The agreement further provided that the settlement of the consolidated securities class actions and state derivative actions filed in federal court was contingent on the Delaware Chancery Court approving the settlement of the derivative actions filed in that court, and vice versa.<sup>77</sup>

A Warner shareholder who was also a member of the plaintiff class filed objections to the settlement in both courts.<sup>78</sup> He claimed that if the disclosure claim against Warner had sufficient merit to lead Warner (and its insurer) to settle for \$17.25 million, the insider trading claim against Ross almost surely also had substantial merit. Consequently, either class plaintiffs' counsel had relinquished a meritorious claim against Ross for no consideration or (more likely) some portion of the amount Warner was paying to settle the disclosure claims represented a payment to settle the claims against Ross.<sup>79</sup> If the first were the case, the district court should not approve dismissal of the insider trading claims against Ross. If the second were true, neither court should approve the settlements of the derivative actions.<sup>80</sup>

The Stipulation of Settlement explained that plaintiffs had decided not to pursue the insider trading claims against Ross because he had sold Warner stock to raise funds to pay a substantial federal income tax liability that arose as a consequence of his exercise early in 1982 of soon-to-expire options to purchase Warner stock. Objector initially took the position that, even were that so, Ross' sales still would have constituted unlawful insider trading had he known about Atari's difficulties when he sold his stock.<sup>81</sup>

---

77. See *In re Warner Communications Sec. Litig.*, 798 F.2d 35, 36 (2d Cir. 1986); *Stepak v. Ross*, 11 DEL. J. CORP. L. 1011, 1016 (Del. Ch. Sept. 5, 1985).

78. The objection was filed by Stephen Gross, a federal administrative law judge, who had purchased 10 shares of Warner stock as custodian for his son Andrew Gross. Judge Gross is the brother-in-law of Professor Weiss.

79. If the FOM and insider trading claims together had a settlement value of \$17.25 million (plus the amount previously disgorged), plaintiffs' counsel, and the class they represented, would be indifferent as to whether the \$17.25 million was paid by Warner, the D&O insurer, or Ross and the other executives charged with insider trading.

80. Warner's D&O insurance policy provided coverage for claims relating to Warner's allegedly misleading disclosures and directors' failure to prevent such disclosures, but not for claims relating to insider trading. From the point of view of Warner's shareholders, it did not matter whether the D&O insurer paid \$8 million toward the \$17.25 million settlement of the securities class action, see *supra* note 79, or, as the parties had agreed, \$6 million toward that settlement and \$2 million to Warner to settle the derivative claims. In either event, Warner would be out of pocket \$9.25 million. However, the settlement structured by the parties purported to provide Warner with a \$2 million recovery in the derivative action, which served to justify derivative plaintiffs' agreement to dismiss that action and Warner's agreement to pay derivative plaintiffs' attorneys' fees.

81. *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir.), cert. denied, 114 S. Ct. 467 (1993), recently confirmed that evidence that an insider traded while in possession of material, nonpublic information is



The first settlement hearing, in Delaware Chancery Court, involved only the derivative claim. Objector asked the court to defer any decision until the federal district court, which had before it the settlements of both the federal securities claims and state derivative claims, had ruled on his objection.

At the federal hearing, Objector pointed out that the evidentiary record amassed by plaintiffs' counsel made clear that Warner officials first became aware that Atari was not performing up to expectations early in 1982 and that in August—shortly before Ross' first sale of Warner stock—two of Ross' senior lieutenants conducted an intensive review of Atari and learned that its sales had slowed substantially, its inventories of unsold video games had ballooned, and its efforts to develop and produce its own line of personal computers were close to collapse. While there was no "smoking gun" evidence proving that these executives had reported to Ross, it seemed likely that Ross was aware of the problems at Atari before he sold his stock.

Plaintiffs did not depose Ross until after they agreed with defendants on settlement terms. Ross, in his deposition, denied all knowledge of the problems at Atari. He characterized his role as CEO as that of a "dreamer," focusing on strategic and creative concepts, not business operations. Ross also explained, in line with the already-negotiated Stipulation of Settlement, that he had sold \$20 million in Warner stock in order to raise the funds he needed to pay taxes due as a consequence of his exercise early in 1982 of soon-to-expire stock options.<sup>82</sup>

Plaintiffs' counsel had made no effort to challenge this aspect of Ross' deposition testimony. Objector directed the court's attention to tables in Warner's proxy statements for 1979 through 1982, which established that Ross (i) had not held any stock options that expired early in 1982 and (ii) had not exercised any stock options during 1982.<sup>83</sup>

Ross' attorney conceded that Objector's factual assertions concerning Ross' stock options were correct but then offered an alternative justification, for which there was no support in the record, for Ross' sale of \$20 million in Warner stock.<sup>84</sup> Ross' attorney, Warner's counsel, and plaintiffs' attorneys in the class and derivative actions all continued to urge the court to approve the proposed settlement, notwithstanding their concession that the stated factual predicate for their agreement to dismiss the insider trading claims against Ross

---

sufficient to sustain an insider trading conviction.

82. See Deposition of Steven J. Ross at 142, 147, *In re Warner Communications Sec. Litig.*, 618 F. Supp. 735 (S.D.N.Y. 1985) (No. 82 Civ. 8288) (on file with authors).

83. See Affidavit of Elliott J. Weiss, dated July 31, 1985, ¶ 10, *Warner* (No. 82 Civ. 8288) (on file with authors). Ross had certain exercised stock options in 1981, but his tax liability in connection with those options, if any, would not arise until he sold the stock that he had purchased. See Objector's Reply Memorandum of Law at 18 n.\*, *Warner* (No. 82 Civ. 8288) (on file with authors).

84. See Affidavit of Elliott J. Weiss, *supra* note 83, Exhibit I (letter from Arthur Liman to Elliott J. Weiss (July 29, 1985)).

was untrue.<sup>85</sup> Objector urged the court to disapprove the settlement as collusive and unfair or, at a minimum, to allow Objector to conduct additional discovery, including deposing Ross and those involved in negotiating the settlement.

The court approved the settlement, finding that it was fair to the class. Concerning plaintiffs' claim that Ross had engaged in unlawful insider trading, the court reported:

Defendant Ross testified that he had decided in late 1981 to sell a large enough number of shares of his Warner stock to be able to realize \$18,000,000, thus allowing him to reduce his liabilities resulting from his exercise of a class of Warner stock options which were expiring in early 1982.<sup>86</sup>

The court then rejected Objector's claim as "factually without foundation and legally without merit,"<sup>87</sup> stating: "[Objector] . . . fails to counter Ross' sworn contention that he had to sell his Warner stock, in accordance with a pre-existing publicly announced financial plan, in order to exercise soon-to-expire stock options and pay the taxes due thereon."<sup>88</sup> Finally, even though the notice of settlement hearing stated that the federal hearing would consider the fairness of the proposed settlement of both the securities class actions and pendent state derivative claims that plaintiffs had filed in the federal action, the court concluded by advising Objector:

If [Objector] believes that the settlement is unfair to Warner he should pursue his objection in the Delaware Chancery Court which is considering the fairness of the derivative settlement and arrangements between Warner and its management and has the obvious expertise to do so. This Court is concerned solely with the fairness of the settlement to the class . . . .<sup>89</sup>

---

85. Plaintiffs' counsel at no point in the litigation attempted to explain why they had failed to discover, or to take account of, the facts about Ross' stock options that Objector's attorney found in Warner's proxy statements.

86. *Warner*, 618 F. Supp. at 742.

87. *Id.* at 751.

88. *Id.* at 752.

89. *Id.* at 753. Objector had informed the district court that the Delaware Chancery Court had already held its settlement hearing and that he had informed the chancery court that he intended to press his objection to the derivative settlement in the federal hearing. Objector had not asked the chancery court to leave the record open, and consequently that court did not have in its record the information concerning Ross' nonexistent stock options that Objector had filed in federal court. Lacking that evidence, and perhaps relying on the district court's assertion that no such evidence had been produced, the chancery court approved the derivative settlement two weeks later. *See Stepak v. Ross*, 11 DEL. J. CORP. L. 1011, 1016 (Del. Ch. Sept. 5, 1985). Coffee points out that as a result of this settlement, "the parties most responsible for the violation of Rule 10b-5 (and the only parties able to profit from the entire set of events) still profited and escaped the bulk of the financial sanction." Coffee, *Economic Theory*, *supra* note 16, at 719 n.134.

Objector appealed, primarily on the ground that he had demonstrated, and the proponents of the settlement had conceded, that the factual basis on which the district court approved dismissal of the insider trading claims against Ross was false. The court of appeals, affirming, did not discuss the facts. Instead, it noted the chancery court's approval of the settlement in the state derivative action (which the chancery court's opinion made clear did not collaterally estop objector from attacking the settlement of the derivative claims filed in the federal action and was not *res judicata* as to those claims) and held that "because the issue of apportionment . . . has been resolved in another appropriate forum, appellant *has had his day in court on this issue.*"<sup>90</sup>

## 2. *Judicial Awards of Fees to Plaintiffs' Attorneys*

Courts tend to scrutinize plaintiffs' attorneys' fee requests considerably more closely than they do settlement terms. Perhaps this is because settlements at least appear to be the product of an adversarial process while, once a settlement has been approved, no one but plaintiffs' attorneys has much reason to be concerned with how much of the settlement fund is paid out as attorneys' fees. Well-represented objectors rarely appear,<sup>91</sup> so only the court is in a position to protect absent class members from overreaching by plaintiffs' attorneys.<sup>92</sup>

Courts use one of two methods to determine what constitutes a reasonable attorneys' fee: lodestar or percentage-of-recovery.<sup>93</sup> The lodestar method requires the court first to review the attorneys' records to determine how many hours they devoted to the action and whether that level of effort was reasonably necessary. Then the court decides whether the quality of the attorneys' work or other circumstances justify awarding them some multiple of their ordinary hourly compensation. The percentage-of-recovery method demands less of the court's time. The judge simply reviews the quality of plaintiffs' attorneys' efforts, taking into account the difficulty of the case and

---

90. *In re Warner Communications Sec. Litig.*, 798 F.2d 35, 36 (2d Cir. 1986) (emphasis added). Insofar as Objector's goal was to raise an issue of principle, he achieved a small measure of success. Judge Newman wrote a brief concurring opinion stating that in a similar situation, where the issue of apportionment of liability between corporate and individual defendants was "appropriately" before a court, the court should consider that issue before approving the settlement. *Id.* at 38 (Newman, J., concurring). Some courts have since followed that course. See *Lewis v. Hirsch*, No. CIV.A.12,532, 1994 WL 263551 (Del. Ch. June 1, 1994) (withholding approval of settlement because derivative-action plaintiff had not adequately investigated insider trading claims against corporate executives before agreeing to settlement that released those executives from all liability for insider trading); *SEC v. Shah*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,374 (S.D.N.Y. July 26, 1994) (holding that it would create impermissible windfall to allow company president to offset amount he had paid to settle FOM claim against his obligation to disgorge insider trading profits).

91. Collective action and free-rider problems serve to deter objections from class members. See *infra* text accompanying notes 251-53.

92. See *Hensley v. Eckerhart*, 461 U.S. 424, 437 (1983).

93. See Report of the Third Circuit Task Force, *supra* note 29.

the result they have achieved, and then awards a fee equal to some percentage of the fund the attorneys have recovered.

Despite the greater scrutiny, neither method provides investors with much more in the way of actual protection than does the requirement that a court review a class action settlement to ensure that it is fair. First, as John Coffee has explained in detail, neither method fully succeeds in aligning the interests of plaintiffs' attorneys with the interests of the plaintiff class.<sup>94</sup> Second, both methods require courts to make a crucial judgment—what percentage of the recovery or multiplier of the lodestar the attorneys should receive—after the fact and on the basis of imperfect information.<sup>95</sup> Consequently, the decision the court makes is most unlikely to achieve its goal, which is to approximate the fee that a fully informed client, acting on behalf of the class, would have agreed to pay the attorney *before* authorizing her to initiate the litigation.<sup>96</sup>

Third, judges have been reluctant to leave plaintiffs' attorneys empty-handed, even when they conclude that those attorneys have provided nothing of value to the class. *In re Oracle Securities Litigation*<sup>97</sup> illustrates this judicial reticence, and is particularly striking because the judge involved, Vaughn Walker, demonstrated a sophisticated grasp of agency-cost issues when he employed a competitive bidding process to appoint lead counsel in the securities class action portion of that litigation.<sup>98</sup>

In *Oracle*, as in *Warner*, a "piggyback" derivative action was filed by another law firm seeking to hold certain Oracle officers and directors liable for subjecting Oracle to litigation expenses and potential liability in the securities class action and for a minor amount of alleged insider trading. Also as in *Warner*, the *Oracle* class and derivative actions were consolidated and the parties eventually negotiated a linked settlement. Oracle agreed to pay \$23.25 million and Arthur Andersen & Co., Oracle's auditor, agreed to pay \$1.75 million to a settlement fund in the securities class action. Class counsel's fee, \$4.8 million plus expenses, was established by its winning bid. The derivative plaintiffs dismissed their claims that Oracle's management had breached its fiduciary duties and that Oracle should sue Arthur Andersen, receiving in consideration for their dismissal only Oracle's acknowledgment that it had made

---

94. Coffee, *Economic Theory*, *supra* note 16, at 684–91. Coffee argues that the percentage-of-recovery method does a better job of aligning interests than the lodestar method. *Id.* at 691; *accord* Kirchoff v. Flynn, 786 F.2d 320, 324–26 (7th Cir. 1986); Macey & Miller, *supra* note 16, at 50–61.

95. As is the case with settlement terms, the court must depend on plaintiffs' attorneys and defendants for information relating to the merits of plaintiffs' case and the strength of defendants' defenses. *See supra* text accompanying note 70.

96. *See Kirchoff*, 786 F.2d at 326 (holding that court should refer to private market practices in setting attorneys' fees).

97. 852 F. Supp. 1437 (N.D. Cal. 1994).

98. *See In re Oracle Sec. Litig.*, 131 F.R.D. 688 (N.D. Cal. 1990) (establishing bidding procedure); 132 F.R.D. 538 (N.D. Cal. 1990) (appointing lead counsel); 136 F.R.D. 639 (N.D. Cal. 1991) (denying reconsideration of order appointing lead counsel).

certain changes in its insider trading and revenue recognition policies. Oracle also agreed to pay derivative plaintiffs' counsel a fee of up to \$750,000.<sup>99</sup>

In his first opinion evaluating the settlement, Judge Walker pointed out that "[t]he sole benefit which the derivative settlement confers upon Oracle's current shareholders is a termination of the expenses associated with [the consolidated class and derivative actions],"<sup>100</sup> in exchange for which derivative plaintiffs' counsel was requesting a fee of \$750,000. The judge had no problem with the notion that the derivative claims should be dismissed, agreeing with the parties that they were "virtually meritless,"<sup>101</sup> but questioned whether counsel was entitled to the requested fee. He also directed Oracle to retain independent counsel to advise its board as to whether the settlement was in Oracle's best interests.<sup>102</sup>

Oracle dutifully appointed two disinterested directors to a special litigation committee (SLC) and retained Latham & Watkins as independent counsel to the SLC.<sup>103</sup> The SLC conducted an investigation and prepared a sixty-seven-page report (at an undisclosed cost) concluding that the settlement proposed by the parties was in Oracle's best interests.<sup>104</sup>

The SLC considered and rejected the strategy of causing Oracle to move to terminate the derivative action entirely, reasoning that although such a motion was very likely to succeed, Oracle probably would have to spend about as much on litigating the motion as the court was likely to order it to pay to plaintiffs' counsel. The court agreed.<sup>105</sup> The court also agreed with the SLC's decision to grant a release to Arthur Andersen, finding that there was insufficient evidence to support a claim that Arthur Andersen had been negligent.<sup>106</sup>

The court then turned to the question of what fee should be awarded to derivative plaintiffs' attorneys, noting that they were entitled to a fee only if the claim they had asserted was "meritorious" and they had provided Oracle with a substantial benefit. Despite his earlier endorsement of the SLC's conclusion that there was virtually no evidentiary support for either the derivative claim or a claim by Oracle against Arthur Andersen, Judge Walker characterized the derivative complaint as "meritorious," asserting that plaintiffs had a "reasonable hope" of proving that the defendants in the derivative action had engaged in intentional or reckless mismanagement.<sup>107</sup>

Judge Walker next considered whether derivative plaintiffs had provided

---

99. *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1178 (N.D. Cal. 1993).

100. *Id.* at 1184.

101. *Id.* at 1185.

102. *Id.* at 1190. The judge also noted that if the parties to the class action agreed to sever the tie between the two settlements, he was prepared to approve the class action settlement. The parties did not avail themselves of that opportunity.

103. *See In re Oracle Sec. Litig.*, 852 F. Supp. 1437, 1440 (N.D. Cal. 1994).

104. *Id.*

105. *Id.* at 1444.

106. *Id.*

107. *Id.* at 1445.

Oracle with a substantial benefit. Their agreement to drop their prosecution of an action with no apparent merit—which the court’s earlier decision had characterized as the “sole benefit” of the derivative settlement—clearly did not provide the requisite benefit. Nor did Oracle’s changes in accounting and insider trading policies, “most or all” of which, Judge Walker found, “appear to have resulted from SEC pressure.”<sup>108</sup> That left Arthur Andersen’s \$1.75 million contribution to the class action settlement fund.

Judge Walker had already taken that payment into account when he calculated the fee payable to plaintiffs’ attorneys in the class action. He also observed that it was “at least somewhat doubtful”<sup>109</sup> that any portion of Arthur Andersen’s contribution was attributable to the efforts of derivative plaintiffs. Nonetheless, Judge Walker concluded that “it is fair to give derivative counsel the benefit of the doubt and *ascribe the [entire] Arthur Andersen contribution to the derivative litigation*”<sup>110</sup> and awarded derivative counsel a \$525,000 fee and \$69,384.76 in expenses.<sup>111</sup> In short, he allowed this aspect of the derivative and class action game to be played as it traditionally has been played.<sup>112</sup>

### B. *Direct Evidence of Attorneys’ Opportunistic Behavior*

We do not contend that plaintiffs’ attorneys derive most of their income from class actions through opportunistic behavior. Many class actions have merit and many plaintiffs’ attorneys diligently prosecute such actions and thereby perform a socially beneficial function.<sup>113</sup> But the potential for opportunism in class actions is so pervasive, and evidence that plaintiffs’ attorneys sometimes act opportunistically so substantial, that it seems clear plaintiffs’ attorneys often do not act as investors’ “faithful champion.”<sup>114</sup>

---

108. *Id.* at 1448.

109. *Id.*

110. *Id.* (emphasis added).

111. *Id.* at 1451.

112. A court that elects to disregard that “tradition” may bear a substantial burden. *See* *BTZ, Inc. v. Great N. Nekoosa Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,607 (1st Cir. Feb. 16, 1995) (confirming denial of attorneys’ fees to lawyers who claimed they forced corporation to capitulate to hostile takeover bid). The victorious bidding corporation had agreed to pay a fee of up to \$2 million, as awarded by the court, in exchange for the lawyers’ voluntary discontinuance of their suit challenging the target’s takeover defense and entry into a “clear sailing agreement.” The trial court concluded that the lawyers had produced nothing of value for the target’s shareholders and denied their fee request. *See* *Georgia-Pacific Corp. v. Great N. Nekoosa Corp.*, 731 F. Supp. 38 (D. Me. 1990); *Georgia-Pacific Corp. v. Great N. Nekoosa Corp.*, 727 F. Supp. 31 (D. Me. 1989). The First Circuit reversed and remanded, directing the trial court to reconsider its decision. *Weinberger v. Great N. Nekoosa Corp.*, 925 F.2d 518 (1st Cir. 1991). In an exhaustive opinion, the trial court again denied the fee request. *Weinberger v. Great N. Nekoosa Corp.*, 801 F. Supp. 804 (D. Me. 1992). That decision was affirmed on appeal. *BTZ, Inc. v. Great N. Nekoosa Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,607 (1st Cir. Feb. 16, 1995)

113. *See supra* note 66.

114. Professor Coffee uses this term to describe the role plaintiffs’ attorneys ideally should play. *See* *Coffee, Champion*, *supra* note 67.

Plaintiffs' attorneys can respond to criticisms of specific settlements by arguing that the critic does not adequately appreciate the relevant facts, or that the criticism reflects no more than a difference of opinion about the adequacy of a settlement's terms. The same response is not available with regard to three recent class action settlements we identified, all of which involved settlement terms that we believe can be construed only as clearly prejudicial to the interests of much of the plaintiff classes.<sup>115</sup>

In all three cases, defendants agreed to pay an agreed-upon sum into a settlement fund. Class members were allowed to claim losses equal to a specified dollar amount for each share of stock they purchased during the class period. If valid claims exceeded the amount paid into the settlement fund, those claims would be paid on a pro rata basis, after deduction of plaintiffs' attorneys' fees and expenses. If valid claims (plus attorneys' fees and expenses) totaled less than the amount paid into the settlement fund, the remaining balance would be refunded to defendants.

The "kicker" was in how the parties defined valid claims. If a claimant with an otherwise valid claim had purchased more than a designated amount of the corporate defendant's stock, the settlement notices stated, defendants had a right to establish that that claimant "is not entitled to the presumption of reliance, as described by the United States Supreme Court in *Basic Inc. v. Levinson*, . . . and did not actually rely on the alleged misrepresentations or omissions in making the purchase decision."<sup>116</sup> The notices all stated that class members who filed claims in excess of these ceilings would be required to submit additional information to show that the claimant "actually relied on any alleged misrepresentation or omission with respect to [claimant's purchases of defendants' stock]."<sup>117</sup> Unless claimants elected to reduce their claims to the ceiling amounts, they would be required to provide this information within twenty days after it was requested, unless the claims administrator, for good cause shown, granted a claimant an extension.

---

115. Notice of Pendency of Action, Class Action Determination, Proposed Settlement, Settlement Hearing and Right To Share in Settlement or To Request Exclusion, *Trief v. Dun & Bradstreet Corp.*, No. 89 Civ. 1741 (S.D.N.Y. July 30, 1993) [hereinafter *D&B Notice*]; Notice of Class Certification and Pendency and Proposed Settlement of Class Action and Hearing, *In re TCBY Sec. Litig.*, No. LR-C-90-608 (E.D. Ark. June 8, 1992) [hereinafter *TCBY Notice*]; Notice of Pendency and Proposed Settlement of Class Action and Settlement Hearing, *In re Beverly Enters. Sec. Litig.*, No. CV 88-01189 RSWL (Tx) (C.D. Cal. Apr. 24, 1992) [hereinafter *Beverly Notice*].

Other recent class action settlements may well include provisions similar to those discussed in the text. We asked a number of institutional investors if they were aware of settlements that involved provisions similar to those discussed in the text, and were advised of no additional such settlements. We did not otherwise attempt a comprehensive survey of the terms of recent settlements.

116. *TCBY Notice*, *supra* note 115, ¶ 6(b); *see also Beverly Notice*, *supra* note 115, ¶ 6(b). The *D&B Notice* includes a similar provision. *See D&B Notice*, *supra* note 115, ¶ 15. The designated ceilings were \$43,750 and \$1250 for the two subclasses in the *Beverly Enterprises Securities Litigation*; \$12,750, \$12,250, and \$500 for the three subclasses in the *TCBY Securities Litigation*; and \$25,000 in *Trief v. Dun & Bradstreet*.

117. *TCBY Notice*, *supra* note 115, ¶ 6(b); *see also D&B Notice*, *supra* note 115, ¶ 14(b); *Beverly Notice*, *supra* note 115, ¶ 6(b).

Defendants, within twenty days of receipt of the requested information, had the right to serve on any claimant who provided such information a notice of challenge.<sup>118</sup> Unless the claimant then requested a hearing, the claims administrator would deny its claim. If a claimant requested a hearing, defendants were entitled to seek discovery relating to the claimant's reliance on the defendant's alleged misrepresentations. Notably, claimants were advised that they would be responsible for paying their own costs in connection with this procedure, including the cost of retaining counsel in connection with such discovery and the reliance hearing. "Class counsel [does not] have any obligation to act with respect to any such challenge . . . ."<sup>119</sup>

Claims data we have gathered relating to other class actions suggest that these reliance provisions probably applied to well over half the dollar value of all claims eligible to be filed in these actions.<sup>120</sup> From the perspective of the investors eligible to file those claims, these provisions are highly objectionable.<sup>121</sup> Initially, they represent what might most accurately be described as "defendants' strike suits"—assertion by defendants of a defense on which they have almost no chance of prevailing, accompanied by the threat that they will saddle class members with substantial costs and legal fees, for the purpose of coercing those class members into dropping or reducing meritorious claims. A brief review of the law of reliance makes clear why this is so.

*Basic Inc. v. Levinson* held that, because a stock's market price reflects all publicly available information, a court may presume that all members of the plaintiff class in suits based on alleged material misrepresentations relating to public companies had relied on those misrepresentations.<sup>122</sup> The Court further held that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the

---

118. The provisions in the *D&B* settlement were substantially less objectionable than those in *Beverly* and *TCBY*, in that the *D&B* settlement specifies that in no event will defendants receive a refund of more than \$5 million of the \$20 million paid into the settlement fund, *D&B Notice*, *supra* note 115, ¶ 12, and provides that defendants can only challenge claimants' reliance for "good cause," *id.* ¶ 15. The \$25,000 threshold limited the applicability of the reliance provision to claimants who had made investments of more than \$1 million. Letter from Edward Labaton, lead counsel for plaintiffs in *D&B*, to Elliott Weiss 1 (Jan. 12, 1995) (on file with authors). The good faith requirement resulted in defendants challenging only claimants who failed to supply any information. *Id.* Class counsel received copies of all challenges and wrote letters to claimants urging them to respond and offering to assist them in doing so. *Id.* Class counsel advised the authors that they were aware of no case in which a challenge was not withdrawn when a claimant supplied the specified data. *Id.* at 1–2.

119. *D&B Notice*, *supra* note 115, ¶ 15; *TCBY Notice*, *supra* note 115, ¶ 7; *Beverly Notice*, *supra* note 115, ¶ 7.

120. See *infra* text accompanying notes 197–98.

121. Notably, no investor has objected to these settlement provisions. That may be due to ignorance as to the holding of *Basic* or to the fact that most institutional investors delegate responsibility for handling settlement notices and completing proofs of claim to clerical personnel. Lawyers representing institutional investors with whom we have discussed these reliance provisions all have termed them highly objectionable.

122. 485 U.S. 224, 247 (1988).



presumption of reliance.”<sup>123</sup> *Basic* provided three examples of how a defendant in a fraud-on-the-market (FOM) suit could rebut this presumption. First, a defendant could prove that the plaintiffs were privy to the truth and thus had not been deceived by the defendant’s misrepresentations.<sup>124</sup> Second, if corrective or omitted information had dependably entered the market and dispelled the effects of defendant’s misrepresentations, those misstatements would not have distorted the price of the securities in question.<sup>125</sup> Third, defendants could prove that a claimant would have purchased or sold defendant’s securities, at the same price, even had she known that defendant’s statements were false or misleading.<sup>126</sup>

Justice White, dissenting, observed that these defenses were largely illusory, that “rebuttal is virtually impossible in all but the most extraordinary case.”<sup>127</sup> Analysis demonstrates that White’s observation was correct. The first defense, in essence, amounts to proof that a claimant traded on the basis of material, nonpublic information. Such cases rarely arise; when they do, defendants often will have difficulty marshaling proof of such insider trading. If the second defense pertains, plaintiffs will have suffered no damages and, in all likelihood, no suit will have been brought. The third defense applies only to irrational investors—those who, for idiosyncratic reasons, purchase securities without regard to whether they are overpriced or sell securities without regard to whether they are underpriced. All three represent null, or close to null, sets.<sup>128</sup> Defendants in FOM suits nonetheless clearly have a right to attempt to rebut the presumption of reliance. It does not follow, however, that it is reasonable for plaintiffs’ attorneys to agree to include reliance provisions in class action settlements.

Reliance provisions are also objectionable because class members with claims above the ceiling amounts, unless they are knowledgeable about *Basic*’s discussion of the presumption of reliance, are likely to read a reliance provision in a settlement notice as stating, in essence: “You had better reduce your claim to the ceiling amount unless you can prove that you actually relied on defendants’ alleged misrepresentations (which the settlement agreement does not describe and which defendants continue to maintain they did not make). Otherwise, your claim will be denied. Even if you can prove reliance, defendants are likely to force you to incur legal costs and expenses substan-

---

123. *Id.* at 248.

124. *Id.*

125. *Id.* at 248–49.

126. *Id.* at 249.

127. *Id.* at 256 n.7 (White, J., dissenting) (citation omitted).

128. In no reported post-*Basic* case has a defendant succeeded in rebutting the presumption of reliance, nor has any court allowed a defendant to use any defense other than the three listed by the Court to rebut that presumption. See *Fine v. American Solar King Corp.*, 919 F.2d 290, 299 (5th Cir. 1990), cert. dismissed, 502 U.S. 976 (1991); *Rand v. Cullinet Software, Inc.*, 847 F. Supp. 200, 205 (D. Mass. 1994); *In re Harcourt Brace Jovanovich, Inc. Sec. Litig.*, 838 F. Supp. 109, 113 (S.D.N.Y. 1993); *Guenther v. Pacific Telecom., Inc.*, 123 F.R.D. 333, 337 (D. Or. 1988).

tially in excess of any amount you are likely to recover from this action.”

Defendants' requests for additional information appear designed to produce similar inferences.<sup>129</sup> They include no explanation of the holding of *Basic*, much less of its import. They demand that the claimant state, for each purchase of defendants' stock during the class period, “the primary reasons why you purchased the stock at the time you purchased it and what you relied on in making your decision to purchase.”<sup>130</sup>

Many claimants entitled to file claims in excess of the ceiling no doubt reduced their claims from the start. Many more probably did so after receiving these requests. Some may have doubted that they could prove that they actually relied on defendants' alleged misrepresentations or omissions, even assuming that they could find out what those misrepresentations and omissions were. Many more may have questioned whether they could prove that defendants were responsible for those misrepresentations or omissions. Almost all were likely to conclude that, even if they could prove that they relied on material misrepresentations or omissions for which defendants were responsible, the costs of doing so almost surely would exceed the value of their claims. Few were likely to realize that, if they responded that they purchased defendants' stock in reliance on the integrity of its market price, defendants probably would have had no reasonable ground on which to challenge their claims.<sup>131</sup>

We find plaintiffs' attorneys' acquiescence to the inclusion of reliance provisions in these settlement agreements very troubling. Plaintiffs' attorneys' fiduciary duties run to all members of the plaintiff class. In these cases, however, plaintiffs' attorneys agreed to a settlement term that threatened to impose substantial litigation expenses on class members who almost certainly accounted for more than half the dollar value of class members' claims. There is no indication that defendants in these cases possessed any evidence suggesting that any class member was not entitled to the presumption of reliance.<sup>132</sup> Absent such evidence, inclusion of these provisions can only be

---

129. See Request for Additional Information, *Trief v. Dun & Bradstreet Corp.*, No. 89 Civ. 1741 (S.D.N.Y. Aug. 3, 1994); Request for Additional Information, *In re TCBY Sec. Litig.*, No. LR-C-90-608 (E.D. Ark. Oct. 14, 1992). We were advised that the request in *Beverly* was also much the same.

130. Request for Additional Information at 2, *Dun & Bradstreet*, No. 89 Civ. 1741; Request for Additional Information at 3, *TCBY*, No. LR-C-90-608.

131. An attorney at one institution advised us that, in the one instance in which that institution was faced with completing such a request, it had elected to reduce its claim because the institution had no way of proving that it had relied on the defendant's alleged misrepresentations. An attorney at another institution advised us that his institution took a different tack. In two cases in which the institution was asked for additional information, it objected directly to defendants' counsel. In one, where the institution remained a substantial shareholder, the defendant corporation withdrew the request. In the second, the institution agreed to reduce its claim, which was far above the ceiling, by five percent.

132. The notices of settlement make no reference even to allegations to this effect, nor do they indicate that defendants deposed any members of the plaintiff class. *D&B Notice*, *supra* note 115; *TCBY Notice*, *supra* note 115; *Beverly Notice*, *supra* note 115. Even if defendants had evidence suggesting they could rebut the presumption of reliance as to certain class members, plaintiffs' attorneys, at a minimum, should have insisted that the notice of settlement explain to class members the import of *Basic's* presumption and

explained as a concession that plaintiffs' attorneys made to defendants in order to secure their agreement to settle these cases. But if that is so, then plaintiffs' attorneys should not have requested fee awards based on the maximum payments by defendants into the settlement funds while assuming no responsibility for the legal expenses or costs that class members with the greatest part of the class' claims would have to incur to litigate reliance issues.

### C. *Other Concerns Relating to Settlements*

Two other criticisms of class actions deserve attention; both suggest that the most significant problem is not that cases are settled on unfair terms or for inadequate amounts, but that most class actions lack merit. Were that the case, the most appropriate strategy probably would be to abolish securities class actions or to reduce substantially the circumstances in which they can be brought. After all, class actions that lack merit do not serve any compensatory or deterrent function.<sup>133</sup> Their principal effect is to impose an unjustified "tax" on public corporations and indirectly on investors.<sup>134</sup> Non-meritorious claims that have settlement value also may discourage firms from voluntarily disclosing information of interest to investors<sup>135</sup> or from engaging in economically beneficial transactions. As SEC Chairman Arthur Levitt has noted, they also may "breed cynicism about the efficacy of private rights of action as a deterrent to wrongdoing"<sup>136</sup> and may "adversely affect the development of substantive securities law, as courts develop broad doctrines in an attempt to curb what they perceive to be vexatious litigation."<sup>137</sup>

Investors presumably would prefer to have abolished their right to bring non-meritorious claims. They would realize that while such action would eliminate the occasional payments that they now receive from class action

---

the grounds on which defendants would be entitled to question whether they were entitled to its benefit.

133. Recoveries realized from non-meritorious class actions provide investors with windfalls, not compensation for losses they have incurred as a consequence of defendants' wrongdoing. Settlements extracted without regard to whether defendants have violated the securities laws are not likely to deter such violations.

134. The analogy to a tax is particularly apt because most class action settlements are funded largely by D&O insurance policies, which virtually all public corporations purchase. Thus the costs associated with such litigation are spread among all public corporations and, indirectly, among all their shareholders.

135. See Udayan Gupta & Brent Bowers, *Small Fast-Growth Firms Feel Chill of Shareholder Suits*, WALL ST. J., Apr. 5, 1994, at B2.

136. STAFF OF SENATE SUBCOMM. ON SEC. OF THE COMM. ON BANKING, HOUS. AND URBAN AFFAIRS, 103D CONG., 1ST SESS., PRIVATE SECURITIES LITIGATION 59 (1994) [hereinafter STAFF REPORT] (prepared at direction of Sen. Christopher J. Dodd).

137. Levitt 1995 testimony, *supra* note 5. In his testimony before the committee in 1994, Chairman Levitt seemed to imply that the Supreme Court's decisions in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994), reflected such concerns. See Levitt 1994 testimony, *supra* note 5. Similar concerns may lie behind some courts' decisions to dismiss what appear to be clearly meritorious class actions. See, e.g., *Malone v. Microdyne Corp.*, 26 F.3d 471 (4th Cir. 1994) (reversing and remanding district court's dismissal of complaint alleging corporation had issued financial statements that substantially overstated sales in violation of generally accepted accounting principles).

settlements, viewed *ex ante* they are as likely to be on the losing as the winning side of any such settlements. They also would appreciate that the only real beneficiaries of non-meritorious class actions are lawyers—the plaintiffs' attorneys who initiate such suits and generally receive twenty to thirty percent of any amounts recovered, and defendants' attorneys, who most observers believe are paid roughly equivalent amounts.

### 1. *Do the Merits Matter when Class Actions Are Settled?*

In a noted law review article, Janet Cooper Alexander describes how plaintiffs' attorneys and courts act with respect to class action settlements in terms that comport well with our description. But Alexander goes on to make a much more ambitious claim—that most participants in class actions not only have strong incentives to settle, but customarily settle such actions on a formulaic basis that gives no weight to the merits of the parties' positions.<sup>138</sup> If this claim is true, it would seem to follow that most class actions lack merit. After all, if defendants are prepared to pay the same proportion of claimed damages to settle both meritorious and non-meritorious suits, one would expect plaintiffs' attorneys to bring many weak or non-meritorious suits. With recovery assured, it would not pay for them to take the time and effort necessary to sort out whether a suit had merit before filing a complaint.<sup>139</sup> Alexander rests her conclusion on analysis of settlements of eight class actions brought against computer-related companies that made initial public offerings (IPOs) in 1983. She found that six of the eight cases settled for "remarkably similar" percentages of the damages at stake and that the other two settled for lesser percentages for reasons unrelated to the merits.<sup>140</sup> She concludes that "the most likely explanation for the similarity of outcomes is that the merits *did not affect* the settlement amounts."<sup>141</sup>

Other commentators have pointed out that Alexander's conclusion is suspect because her sample was so small<sup>142</sup> and because other studies of

---

138. Alexander, *supra* note 16, at 566–68.

139. We should note that Alexander does not push her claim this far. She argues only that the merits do not matter when class actions are settled. *See id.* As explained in the text, however, the logical implication of her claim is that many class actions lack merit, and that is how some critics of class actions have interpreted her study. *See, e.g., In re Urcarco Sec. Litig.*, 148 F.R.D. 561, 566 (N.D. Tex. 1993), *aff'd sub nom. Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994). Alexander herself has elsewhere acknowledged that securities class actions have an important deterrent function, and that studies of settlement may understate the compensatory benefit of such actions. *See Janet Cooper Alexander, The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. REV. 17 (1993) [hereinafter Alexander, *Lawsuit Avoidance Theory*].

140. Alexander, *supra* note 16, at 507, 514–21. One of the outliers involved a company where the only source of recovery was the defendant's D&O insurance. In the other, market-related events made it clear that plaintiffs could not hope to recover a significant portion of their theoretical maximum damages. Alexander also noted a ninth case, which had not settled at the time she wrote her article.

141. *Id.* at 523 (emphasis added).

142. Seligman, *supra* note 52, at 453. It also is notable that in a more recent article, Alexander argues that a drop in the price of an IPO is not a sufficient condition to bring on a class action, but that plaintiffs

class actions have found significant correlations between the strength of plaintiffs' claims and the amounts plaintiffs have recovered.<sup>143</sup> We offer more direct criticism of Alexander's analysis.

Alexander concedes that the six defendant companies "were in the same or closely related industries," made relatively contemporaneous stock offerings "at similar stages of their development," and thus were "subject to similar product market, stock market, and economic forces."<sup>144</sup> But she asserts that it was improbable that plaintiffs' claims had similar merit in all six cases, because it seems unlikely that all defendants were responsible for misrepresentations of similar magnitude or that the evidence relating to all defendants' degree of culpability was the same.<sup>145</sup> Moreover, she opines, "it appears that some of the cases were stronger than others on the facts."<sup>146</sup>

Alexander's reasoning fails to consider critical features of plaintiffs' claims. Section 11 of the Securities Act of 1933,<sup>147</sup> which all plaintiffs invoked, provides that if a registration statement contains a single material misrepresentation, the issuer will be liable, regardless of fault.<sup>148</sup> Thus, if each of the six cases involved at least one material misrepresentation, the relative magnitude of those misrepresentations would not matter.<sup>149</sup>

Other features of § 11 also tend to produce relatively uniform outcomes in cases in which a material misrepresentation probably will be proved. The underwriters of each offering, certain of the issuer's officers, and the issuer's directors all are jointly and severally liable unless they are able to prove that they exercised due diligence in preparing the registration statement. The corporate and individual defendants' liability is set by law as the difference between the price at which the securities were sold in the IPO and the price at which they were trading on the date on which suit was brought.<sup>150</sup> Defendants, if liable, can reduce the amount of their liability only by proving

---

use a transaction cost/expected value analysis to decide whether to sue. Alexander, *Lawsuit Avoidance Theory*, *supra* note 139, at 28–29.

143. See Steven P. Marino & Renée D. Marino, *An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters*, 22 SEC. REG. L. REV. 115 (1994).

144. Alexander, *supra* note 16, at 509.

145. *Id.* at 514.

146. *Id.* at 523.

147. 15 U.S.C. § 77k (1988).

148. Alexander's comments about the differences in the strength of the six cases would be pertinent had she compared the settlements to the damages that plaintiffs theoretically could have recovered under Rule 10b-5. However, estimating Rule 10b-5 damages, which equal investors' "out-of-pocket" losses, see *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971), often is problematic. Consequently, Alexander compared the settlements to damages recoverable under § 11. Given that choice, § 11, not Rule 10b-5, provides the appropriate framework for evaluating the comparative strength of the plaintiffs' claims.

149. Of course, where no court has held that a material misrepresentation was made, the settlement value of a case would be affected by the number of misrepresentations a plaintiff believed a registration statement contained and how clear it was that those misrepresentations were material.

150. 15 U.S.C. § 77k(e).

negative causation—that all or part of any decline in the securities' value was due to other causes.<sup>151</sup>

Given this statutory framework, we consider it significant that, as Alexander notes, the six companies Alexander studied all made their IPOs during a boom period for computer industry IPOs, “at an earlier stage in their development than had previously been the rule,”<sup>152</sup> and “at ‘fantastically inflated prices.’”<sup>153</sup> However, Alexander gives these facts no weight. She also fails to mention a phenomenon that was so widespread during the period at issue that industry observers coined a new term, “vaporware,” to describe it: computer companies announcing, and then failing to bring to market, “hot” new products.<sup>154</sup>

In short, it seems highly plausible that all six defendant companies' registration statements contained at least one material misrepresentation relating to either the development of the company's products, the risks involved in bringing those products to market, the time at which those products would be brought to market, or the competition the company would face. Alexander's observation that the declines in the companies' stock prices were due to “unforeseen technical problems or stronger than anticipated competition”<sup>155</sup> renders the plausible probable. That plaintiffs' principal allegation in all cases was that the companies' offering documents “did not adequately disclose risks that would prevent the company from succeeding”<sup>156</sup> further increases the likelihood that all six cases involved claims of roughly equal merit, at least with regard to the issuer defendants.

Moreover, at least some of the other defendants in all six cases probably would have found it difficult to establish due diligence defenses, assuming that the companies' registration statements all contained at least one material misrepresentation.<sup>157</sup> In any event, if a defendant company had sufficient resources to pay any damages plaintiffs were likely to receive, the individual defendants' defenses would not have mattered much to plaintiffs.<sup>158</sup> Consequently, even if we accept Alexander's claim that the six cases settled

151. *Id.*

152. Alexander, *supra* note 16, at 507.

153. *Id.* at 508 n.28 (quoting *It's the Morning After for Venture Capitalists*, BUS. WK., Sept. 24, 1984, at 118).

154. See Tom Shea, *Developers Unveil “Vaporware”*, INFOWORLD, May 7, 1984, at 48 (new term describes products announced long before ready).

155. Alexander, *supra* note 16, at 508 (quoting Michael Blumstein, *New Issues: Market Slumps*, N.Y. TIMES, Sept. 19, 1984, at D1).

156. *Id.* at 509 n.36.

157. Unless such misrepresentations were due to the negligence of low-level employees, which seems unlikely, they almost certainly were the fault of one or more of the potential individual defendants. See Jim Bartimo, *Stoking the Micro Fire*, INFOWORLD, Dec. 3, 1984, at 47, 48 (attributing rush to go public of companies selling “vaporware” to pressure from venture capital firms to liquidate their investments in computer industry start-ups).

158. The defendant companies would have a stake in this issue because if those defendants could not establish due diligence defenses, they would be jointly and severally liable with the companies and could be made to contribute to any damage award. 15 U.S.C. § 77k(f) (1988).

for very similar percentages of the maximum damages available to plaintiffs, those results would not appear to be particularly "remarkable."<sup>159</sup>

But Alexander's analysis of the six cases ignores the possibility that all six defendants would have succeeded in proving negative causation—that the declines in the price of their stocks resulted from causes other than defendants' misrepresentations. Alexander states that so adjusting her computations "would open the door both to manipulation of the results and to taking the merits into account in determining the stakes."<sup>160</sup> It is not clear why that is so. Courts generally accept evidence of a decline in an index made up of stock issued by comparable companies as proof of negative causation.<sup>161</sup> The necessary calculations are largely mechanical once one has decided which index to use.

Alexander notes that the indices of high technology stocks were extremely volatile during the period relevant to the cases she studied.<sup>162</sup> One can recalculate the "maximum stake" involved in the six cases Alexander studied<sup>163</sup> to take account of changes in what we believe to be the most relevant such index, the Hambrecht and Quist High Technology Index (H&Q Index). The adjustment would reflect changes in the index between the dates on which the six companies offered stock to the public and the dates on which suits were brought.<sup>164</sup> A recalculation of the amounts for which the six cases settled as a percentage of those adjusted maximum stakes produces a picture dramatically different from the one that Alexander presents.<sup>165</sup>

---

159. See STAFF REPORT, *supra* note 136, at 152 n.371 (analyzing Alexander's claim in similar terms); see also Alexander, *supra* note 16, at 532–33 n.137 (acknowledging these characteristics of litigation under § 11).

160. Alexander, *supra* note 16, at 519 n.71.

161. See, e.g., *Beecher v. Able*, 435 F. Supp. 397, 407–09 (S.D.N.Y. 1977); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 586 (E.D.N.Y. 1971); cf. *Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342–43 (2d Cir. 1987) (holding that plaintiffs' unreliable statistics failed to suggest that stock decline actually resulted from misstatement). Alexander herself relies on evidence of negative causation to explain the result in one of her two outlier cases, pointing out that one company's stock price declined by nearly 30% immediately after the IPO and before any adverse information was disclosed. See Alexander, *supra* note 16, at 518.

162. Alexander, *supra* note 16, at 507, 508–09 (noting that Hambrecht & Quist High Technology Index (H&Q Index) declined 45% from June 1983 to November 1984).

163. *Id.* at 517 tbl. 4.

164. Alexander computed the maximum damages at stake by multiplying the difference between the price at which stock was offered and the price of that stock at the time suit was brought by the number of shares sold in the IPO. Princeton Ventures Research recalculated those stakes by determining the dates of the relevant IPOs and lawsuit filings and the value of the H&Q Index on those dates. It then adjusted the difference between the stock's price on those dates to reflect changes in the H&Q Index. Tables prepared by Princeton Ventures Research (n.d.) (on file with authors) [hereinafter Princeton Ventures Research Tables]. For example, Alexander reported that the maximum amount at stake in Activision was \$19 million, based on the sale of four million shares at \$12 and a closing price of \$7.25 on the day suit was brought. Alexander, *supra* note 16, at 517 tbl. 4. The H&Q Index declined from 871.09 on the date of Activision's offering to 790.01 on the date of suit—a decline of 9.3%. Princeton Ventures Research Tables, *supra*. Taking this decline into account, the maximum amount at stake in Activision was \$16.02 million.

165. The "Maximum Stakes," "Settlement," and "Settlement (% of Max. Stakes)" figures in Table 1 are from Alexander's Table 4. Alexander, *supra* note 16, at 517 tbl. 4. The "Adjusted Maximum Stake" and "Settlement (% of Adj. Max. Stake)" figures are from the Princeton Ventures Research Tables, *supra* note 164. Princeton Ventures Research made similar calculations for settlements of class actions against four other computer-related companies that, as with the companies Alexander studied, made IPOs in the

Company Name	Alexander's Maximum Stake (\$ million)	Adjusted Maximum Stake (\$ million)	Settlement (\$ million)	Settlement as % of Alexander's Maximum Stake	Settlement as % of Adjusted Maximum Stake
Diasonics	95.69	83.91	25.00	26.12	29.80
Fortune	48.75	51.92	12.00	24.62	23.11
Victor	48.38	43.51	13.00	26.87	29.88
Activision	19.00	16.02	4.75	25.00	29.64
Priam	32.73	8.46	6.75	20.60	79.77
Masstor	29.25	21.22	8.00	27.35	37.71

TABLE 1. *Settlements as a Percentage of Adjusted Stakes*

In sum, had the six cases Alexander studies gone to trial, defendants probably would have succeeded, to some relatively uniform degree, in using evidence of changes in the H&Q Index to prove negative causation. The impact of that evidence would have varied considerably between cases, though, because for some the H&Q Index changed very little between the date of the offering and the date suit was filed, while for others it changed dramatically. Taking changes in the Index into account, the six cases appear to have settled for widely varying percentages of the maximum damages that plaintiffs, had they prevailed on the merits, realistically could have hoped to recover. Alexander rests her claim that "the merits do not matter" entirely on what she terms the "remarkably similar" results reached in the six cases. In fact, the results reached in those six cases were quite dissimilar. Whether plaintiffs' attorneys allowed their personal interests to influence the terms on which they settled these cases, we cannot say. But in these six cases, and we assume in most others, it is likely that the merits influenced the attorneys' settlement calculations.

## 2. "Strike Suits"

Other critics make a similarly disturbing claim: that plaintiffs' attorneys automatically file frivolous class actions—which they term "strike suits"—whenever a public company's stock declines by more than ten percent during some brief period. This, they argue, has led to an "explosion" of frivolous class action litigation.<sup>166</sup> To support these claims, critics point to the frequent

---

first half of 1983. The companies, and the percentages of the adjusted amounts at stake for which they settled, were: Cook Data Services—51.06%; Automatix—38.64%; Televideo Systems—2.57%; and Avant-Garde—no adjusted loss, but \$4.2 million recovered. *Id.*

166. See *Senate Hearings*, *supra* note 2, at 12–13 (statement of Edward R. McCracken, President and



instances in which a number of plaintiffs' attorneys have filed class action complaints against a company within days after a sharp decline or increase in the price of its stock<sup>167</sup> and to a few instances in which plaintiff's attorneys, in their rush to the courthouse, have filed clearly inappropriate complaints.<sup>168</sup>

Plaintiffs' attorneys and others have refuted critics' more extreme assertions<sup>169</sup> but, as Joseph Grundfest notes, "carving back on these extreme assertions does not establish that the status quo is an appropriate equilibrium."<sup>170</sup> Strike suits still may be a serious problem. One study found that forty percent of class actions settled for less than \$2.5 million. Concluding that this amount "is less than the defendants' cost of taking one of these cases to trial,"<sup>171</sup> the authors asserted that such cases were "weak or without merit."<sup>172</sup> In contrast, the staff of the Senate Securities Subcommittee pointed out that low recoveries "may reflect a different problem in private securities litigation—class action counsel who settle cases to maximize their own fees rather than clients' recovery."<sup>173</sup>

To get a handle on the nature of the alleged "strike suit" problem, it is important first to define what one means by that term. We believe it is appropriate to describe a class action as a "strike suit" if a plaintiff's attorney initiates the action without reasonable grounds to believe it has merit or,

CEO, Silicon Graphics, Inc.); *id.* at 19 (statement of Thomas Dunlap, Jr., General Counsel, Intel Corp.) (referring to "10% rule").

167. *See supra* note 32.

168. *See Hershfang v. Citicorp*, 767 F. Supp. 1251, 1258 (S.D.N.Y. 1991) (admonishing counsel for filing complaint comprising patchwork of newspaper clippings downprinted from NEXIS devoid of facts giving rise to inference of guilty knowledge by defendants); Woo, *supra* note 38, at B8.

169. *See Seligman, supra* note 52, at 442–45. At the Senate Hearings, plaintiffs' attorneys produced data showing that in the period 1986–92, plaintiffs filed class actions against less than five percent of the public companies whose stock price experienced such a decline. *See Senate Hearings, supra* note 2, at 871 (letter from William Lerach) (based on report prepared by Princeton Ventures Research, Inc., *reprinted in id.* at 878–83); *see also* John C. Coffee, Jr., *Securities Class Actions: Myth, Reality and Reform*, N.Y. L.J., July 7, 1994, at 5 (crediting same study).

170. Grundfest, *supra* note 55, at 734.

171. *Senate Hearings, supra* note 2, at 48.

172. *Id.*; *see also* FREDERICK C. DUNBAR & VINITA M. JUNEJA, RECENT TRENDS II: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? (National Economic Research Assocs. 1993), *reprinted in Senate Hearings, supra* note 2, at 739–75. An experienced plaintiffs' attorney has questioned these findings. In a letter to the authors, Edward Labaton notes that in one case where investors had economic losses of \$60 million, which he settled for \$12 million, Ms. Juneja testified as an expert for defendants that plaintiffs' losses attributable to the alleged fraud were only \$6 million. Letter from Edward Labaton to Elliott Weiss, *supra* note 118, at 2–3.

173. STAFF REPORT, *supra* note 136, at 32. The Staff Report notes that the time value of money may also explain in part plaintiffs' willingness to settle for a recovery equal to only a small portion of their losses. *Id.* at 32 n.75 (citing Coffee, *Economic Theory, supra* note 16, at 703). The Staff Report also notes that O'Brien's study and others reaching similar conclusions can be criticized on methodological grounds and on grounds of bias. *Id.* app. A.

Joseph Grundfest argues that whether defendants settle cases for more or less than their avoidable litigation costs "is a critical signal of the defendants' own perception of the merits of plaintiffs' claims." Grundfest, *supra* note 55, at 741. If defendants pay more than avoidable litigation costs, they cannot "credibly claim that the plaintiffs' case was totally without merit." *Id.* Absent information as to defendants' estimates of their avoidable litigation costs, he claims, one cannot draw conclusions as to defendants' assessment of the merits of the claims they are defending.

having initiated an action reasonably believing it was meritorious, the attorney maintains the action after discovery makes clear the action lacks merit.<sup>174</sup> In either situation, the action apparently has a negative net present value, since the plaintiff has no prospect of prevailing on the merits and her attorney inevitably will incur additional costs by continuing the litigation. Consequently, the attorney's motive for initiating the action or continuing to litigate must be tactical—she must expect to extract a settlement from defendants and thus to generate an award of attorneys' fees.

Plaintiffs' attorneys are able to generate attorneys' fees by initiating or maintaining strike suits because in most class actions, defense costs are far larger than those of prosecution. As we have seen, plaintiffs' attorneys can research and prepare, at relatively modest cost, complaints alleging that corporations and their managers have engaged in securities fraud.<sup>175</sup> Plaintiffs' attorneys also can, at similarly modest cost, generate extensive requests for documents and interrogatories. Defendants almost always must incur much higher costs to respond.<sup>176</sup>

Moreover, even where plaintiffs' claims appear marginal or defendants produce documents that appear to establish that plaintiffs' claims lack merit, the malleable, fact-based standards courts use to determine whether information is material<sup>177</sup> and whether defendants have acted with scienter<sup>178</sup> make it difficult for defendants to persuade courts to dismiss complaints for failure to state a claim or to grant summary judgment motions. Plaintiffs often can exploit "the plasticity of legal rules that lie at the heart of modern discovery"<sup>179</sup> to pursue additional discovery, including seeking to depose numerous officials of the defendant corporation for the purpose of determining, for example,

---

174. Nevertheless, the pejorative label "strike suit" should not be applied merely because a court at some point determines a class action should be dismissed. Lawsuits that are dismissed, both class actions and others, often have been both initiated and maintained in good faith.

It is inevitable that some part of the time a judge or jury will ultimately disagree with a plaintiff about whether the facts support his right to a judgment, or that a plaintiff will change his mind about the strength of his case as he obtains better information through civil discovery.

STAFF REPORT, *supra* note 136, at 13.

175. See *supra* notes 37–38 and accompanying text.

176. "The costs that plaintiff and defendant will typically incur are asymmetric, with the defendant's costs being considerably greater than the plaintiff's." Coffee, *Champion*, *supra* note 67, at 17; see also Alexander, *supra* note 16, at 548. For one example of a burdensome document request served on defendants, see *Senate Hearings*, *supra* note 2, at 194–223 (reprinting plaintiffs' first request for production of documents in *Tolan v. Adler*, Civ. No. C-90-20710-WAI (PVT) (N.D. Cal. received Mar. 28, 1991), a securities class action). The 105 requests include, for the period January 1, 1989, to March 28, 1991, "All documents that discuss or refer to profit margins at Adaptec" (No. 103); "All documents contained in any of Adaptec's customer files" (No. 104); and "All purchase orders, sales orders, invoices, shipping records, payment records, return records and receiving records, for any Adaptec product or service" (No. 105).

177. See *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (fact "is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding" on course of action); see also *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (adopting *TSC Industries* standard for 10b-5 context).

178. See 2 THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* § 13.4 (practitioner's ed., 2d ed. 1990).

179. Frank H. Easterbrook, *Discovery as Abuse*, 69 B.U. L. REV. 635, 640 (1989).

whether their recollections of the events at issue square with the information disclosed in the documents that defendants have produced.<sup>180</sup> Courts have had little success in policing such exploitation of the rules governing discovery.<sup>181</sup>

*In re Time Warner, Inc. Securities Litigation*<sup>182</sup> illustrates the strike suit problem. The district court initially dismissed a complaint alleging that Time Warner had not disclosed certain information about its plans to issue stock in the hope that keeping that information secret for a time would allow it to sell that stock at a higher price than otherwise would have been the case. The Second Circuit reversed, holding that the information arguably was material and that Time Warner might have believed it could benefit by proceeding as alleged.<sup>183</sup> Several months later, the parties announced that they had agreed to settle the case for \$5.5 million, a pittance compared to the more than \$200 million in damages that the plaintiff class allegedly incurred. A lawyer familiar with the negotiations advised one of the authors that plaintiffs had agreed to settle only because it was clear the district judge was prepared to grant defendants' motion for summary judgment and plaintiffs did not think it likely they would prevail on a second appeal. When asked on what basis plaintiffs' attorneys could justify demanding a settlement, he replied: "Purely economics."<sup>184</sup>

Some portion of class actions surely meet our definition of strike suits, but whether the correct figure is four percent or forty percent we cannot say.<sup>185</sup> Neither can we identify to what extent strike suits are made possible by factors beyond the scope of this Article, such as the plasticity of discovery rules and the fact-based standards courts use to determine materiality and scienter.

We are confident, though, that the strike suit problem has an agency-cost dimension. When courts review proposed class action settlements, they tend to focus almost exclusively on whether the plaintiff class is receiving adequate compensation for the value of its claims. If those claims have little apparent merit or little evidentiary support and plaintiffs' attorneys have succeeded in securing a relatively substantial recovery for the class, courts also tend to reward those attorneys generously.<sup>186</sup> The prospect of such a reward provides

---

180. *See id.* ("Engineers and CEOs tied up in discovery are not contributing to useful products. Deposition costs are not measured in time and money alone.")

181. *Id.* at 639-40.

182. 9 F.3d 259 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1397 (1994).

183. 9 F.3d at 267-71. Judge Ralph Winter, dissenting, argued persuasively that it was inconceivable that defendants could have expected to benefit in the manner suggested by the court. *See id.* at 272.

184. Interview with confidential source, at John M. Olin Conference on the Law and Economics of Procedural Reform, Georgetown University Law Center, in Washington, D.C. (Oct. 29, 1994).

185. It seems unlikely that the figure exceeds 40%. *See supra* notes 171-72 and accompanying text.

186. *See In re Cenco Inc. Sec. Litig.*, 519 F. Supp. 322, 326-27 (N.D. Ill. 1981) (awarding fee equal to four times lodestar where contingency factor was "very high"); *Galdi Sec. Corp. v. Propp*, 87 F.R.D. 6, 14 (S.D.N.Y. 1979) ("The lower the probability of success, the higher the bonus should be.").

plaintiffs' attorneys with the incentive to initiate and pursue weak claims of securities fraud until they extract a settlement offer from defendants.<sup>187</sup>

#### IV. INSTITUTIONAL AND INDIVIDUAL INVESTORS' STAKES IN CLASS ACTIONS

Most critiques of class actions assume that substantial agency costs are unavoidable because no class member has a stake in the litigation large enough to justify monitoring the attorneys who represent the class.<sup>188</sup> This assumption underlies Professors Macey and Miller's proposal that courts dispense with plaintiffs in class actions and simply auction off claims to the attorney willing to pay the most for them,<sup>189</sup> as well as Judge Walker's decision to auction off the lead counsel position in *Oracle*.<sup>190</sup> Similarly, the Third Circuit recently observed that "[g]enerally, the costs of monitoring will exceed the *pro rata* benefit to any single shareholder even though they may be lower than the benefits to all."<sup>191</sup>

We began our research suspecting that institutional investors account for a substantial portion of the interests represented by plaintiffs' counsel in most class actions.<sup>192</sup> Data on institutions' stock holdings and share of trading fueled these suspicions. In addition, Professor Alexander had noted that in one class action involving an initial public offering, the top ten claimants accounted for 23.5% of total approved claims of \$11.7 million, the top five accounted for 16%, and the highest claim was for a loss of \$1.7 million.<sup>193</sup> In another such action, the top five claimants accounted for 32.7% of \$33 million in claimed losses and the top 1% of claimants (twenty-three claims) accounted for 54%

---

187. Cf. *In re "Agent Orange" Prod. Liab. Litig.*, 611 F. Supp. 1296, 1311 (E.D.N.Y. 1985) ("Rewarding the filing and prosecution of large, complex lawsuits with poor prospects for success arguably risks fueling the growth of 'nuisance' or 'strike' litigation, in which settlement becomes the main object and attorney fee awards an overpowering motivating force."), *rev'd in part on other grounds and aff'd in part*, 818 F.2d 226 (2d Cir. 1987).

188. Coffee, *Economic Theory*, *supra* note 16, at 677-78; Coffee, *Regulation*, *supra* note 16, at 894-95 ("[T]he plaintiff with the largest expected recovery may still have an inadequate incentive to monitor . . ."); Macey & Miller, *supra* note 16, at 20 ("[T]he small size of the individual claims creates enormous free-rider effects: no rational plaintiff would take on the role of litigation monitor because she would incur all the costs of doing so but would realize only her *pro rata* share of the benefits.")

189. Macey & Miller, *supra* note 16, at 108.

190. Judge Walker was attempting to replicate the fee arrangement that a knowledgeable client would have negotiated. *In re Oracle Sec. Litig.*, 131 F.R.D. 688, 692-93 (N.D. Cal. 1990). It would seem to follow that, had the court believed the class included a knowledgeable investor with a suitably large stake in the litigation, the court's preference would have been to involve that class member in the fee negotiation.

191. *Bell Atl. Corp. v. Bolger*, 2 F.3d 1304, 1309 n.9 (3d Cir. 1993). *Bell Atlantic* was a derivative action, but the authority the court cited on this point largely relates to class actions. See also *Eisenberg v. Gagnon*, 766 F.2d 770, 785 (3d Cir.), *cert. denied*, 474 U.S. 946 (1985); *Green v. Wolf Corp.*, 406 F.2d 291, 296 (2d Cir. 1968) (explaining that in typical class action, "no one person may have been damaged to a degree which would have induced him to institute litigation solely on his own behalf"), *cert. denied*, 395 U.S. 977 (1969); *Deutschman v. Beneficial Corp.*, 132 F.R.D. 359, 374 (D. Del. 1990).

192. See *supra* text accompanying notes 9-10.

193. Alexander, *supra* note 16, at 575.

of claimed losses.<sup>194</sup> A comment in *The Wall Street Journal* concerning class actions reported that in one such case, five institutional claimants, out of a total of 302 claimants, accounted for 36% of claimed losses; in a second case, 1% of 4952 claimants accounted for 52% of claimed losses; and in a third, one claimant of 1531 accounted for more than 16% of claimed losses.<sup>195</sup>

We analyzed data that Gilardi & Co., a leading claims administrator, had submitted to the Senate Securities Subcommittee and developed a more comprehensive picture of the extent of the stakes institutional investors and other large claimants have in class actions.<sup>196</sup> We found that the fifty largest claimants in eighty-two actions accounted for a median of 57.8% and an average of 57.5% of all allowed losses, even though they represented only a median of 1.7% and an average of 3.5% of all claims filed.<sup>197</sup> The fifty largest claimants' average loss was \$597,000 in the eighty-two actions for which all necessary data were reported; their median loss was \$267,927. In fifteen of those actions, the fifty largest claimants' average allowed loss exceeded \$1 million. Moreover, these figures appeared to understate the size of large claimants' stakes because Gilardi treats as separate claims all claims filed by associated institutions, such as mutual funds under common management or pension funds split between different managers.<sup>198</sup>

We then analyzed claims reports for twenty settled class actions as summarized in Table 2. These reports further document that institutional investors account for almost all the largest claims made in class actions and that some institutions have very large amounts at stake in most such actions. They also suggest that class members recover low percentages of their recognized losses in class actions,<sup>199</sup> which makes it likely that the institutions with the largest amounts at stake might well be able to generate substantial net benefits by acting as litigation monitors.

---

194. *Id.* at 576.

195. Vincent E. O'Brien, *The Class-Action Shakedown Racket*, WALL ST. J., Sept. 10, 1991, at A20; see also Vincent E. O'Brien & Richard W. Hodges, A Study of Class Action Securities Fraud Cases 1988-1993, at III-3 (1993) (unpublished manuscript, on file with authors) (reporting that in five securities class actions, top five claims accounted for average of 25% of all allowed claims, top 10 accounted for 34.49%, and top 1% (an average of 31 claims) accounted for 39.60%).

196. *Senate Hearings*, *supra* note 2, at 783-92. The data were provided by Gilardi & Co. Incomplete data were provided on a number of other class actions.

197. The institutional investors among the top 50 claimants (the number of which was not supplied) accounted for a median of 45.4% and an average of 45.9% of all allowed losses. *Id.*

198. This statement is based on our examination of settlement distribution reports we received from Gilardi & Co. See *infra* note 200.

199. Data on the extent to which class actions compensate investors for their losses are subject to considerable interpretation. We assume that the parties who settle class actions define "allowed losses" as equivalent to investors' losses caused by defendants' alleged frauds. But that is not necessarily so. Allowed losses might reflect investors' market losses in the securities in question, which generally will be much larger than their losses attributable to defendants' frauds. Compare *Senate Hearings*, *supra* note 2, at 75, 77 (testimony of Edward J. Radetich that recoveries average 13.5455% of investors' losses) with *id.* at 141, 143 (testimony of William S. Lerach that "claimants receive about 60 percent of their recoverable damages").

Corporate Defendant	Total Recognized Losses	Ten Largest Claimants (% of total)	Largest Claimant (% of total)	Second Largest Claimant (% of total)	Percent of Recognized Losses Recovered
Altos Computer	\$12,200,484	\$9,806,588 (80.4%)	\$4,151,241 (34.0%)	\$1,824,532 (15.0%)	19.7%
American Continental	\$89,809,874	\$12,361,759 (13.8%)	\$3,995,210 (4.4%)	\$2,472,628 (2.8%)	N.A.
Amre	\$45,197,866	\$27,674,518 (61.2%)	\$11,507,506 (25.5%)	\$5,349,022 (11.8%)	24.5%
Avon Products	\$39,554,879	\$15,351,069 (38.8%)	\$3,077,816 (7.8%)	\$2,806,815 (7.1%)	10.8%
Cetus	\$78,326,437	\$25,618,609 (32.7%)	\$7,430,658 (9.5%)	\$4,355,625 (5.6%)	10.1%
Columbia S&L	\$127,876,063	\$46,085,801 (36.0%)	\$14,070,068 (11.0%)	\$12,008,274 (9.4%)	N.A.
Daisy Systems	\$46,317,178	\$18,391,867 (39.7%)	\$8,565,645 (18.5%)	\$2,252,970 (4.9%)	N.A.
DeLaurentiis	\$30,776,512	\$11,437,466 (37.2%)	\$2,772,693 (9.0%)	\$1,665,936 (5.4%)	N.A.
Fidelity Financial	\$6,707,789	\$1,900,932 (28.3%)	\$463,105 (6.9%)	\$430,396 (6.4%)	23.2%
Floating Point	\$55,776,823	\$21,808,307 (39.1%)	\$4,654,111 (8.3%)	\$2,931,517 (5.3%)	15.3%
Newport Pharmaceutical	\$16,810,872	\$5,183,897 (30.8%)	\$1,421,071 (8.5%)	\$814,510 (4.8%)	23.6%
Odetics	\$1,473,690	\$791,360 (53.7%)	\$479,900 (32.6%)	\$131,685 (8.9%)	N.A.
Pyramid Technology	\$8,625,369	\$5,191,557 (60.2%)	\$728,410 (8.4%)	\$716,928 (8.3%)	24.9%
Qintex	\$19,591,108	\$3,806,643 (19.4%)	\$615,080 (3.1%)	\$506,032 (2.6%)	14.2%
Rykoff-Sexton	\$26,100,286	\$11,641,214 (44.6%)	\$5,670,994 (21.7%)	\$1,069,353 (4.1%)	22.0%
Symbol Technology	\$84,178,415	\$35,215,275 (41.8%)	\$13,620,518 (16.2%)	\$4,884,592 (5.8%)	11.4%
Todd Shipyards	\$55,209,505	\$23,947,446 (43.4%)	\$3,892,640 (7.1%)	\$3,390,641 (6.1%)	17.5%
Vidmark	\$6,288,956	\$2,132,382 (33.9%)	\$450,000 (7.2%)	\$363,630 (5.8%)	41.7%
VLSI Technology	\$7,230,678	\$3,477,430 (48.1%)	\$1,047,833 (14.5%)	\$614,643 (8.5%)	N.A.
Western Health Plans	\$7,517,880	\$1,989,909 (26.5%)	\$626,374 (8.3%)	\$338,492 (4.5%)	13.0%
Mean (%)	—	40.5%	13.1%	6.7%	—
Median (%)	—	39.0%	8.8%	5.8%	—

TABLE 2. *Large Claimants' Share of Losses*<sup>200</sup>

200. Two law firms provided us with the settlement reports for a total of the five most recent class action settlements they had administered. A third law firm provided us with reports for 15 class actions that

All but twenty-six of the claimants who filed the ten largest claims in these cases and all but four of the claimants who filed the two largest claims appear to be institutional investors.<sup>201</sup> These institutional claimants include mutual fund groups, bank trust departments, insurance companies, professional money managers, and pension funds.<sup>202</sup> Only ten of the claimants who filed the ten largest claims appear to have been foreign entities. One of these foreign claimants filed the largest claim in the Avon Products litigation and three were among the ten largest claimants in Western Health Plans.

The percentages in Table 2 probably overstate large claimants' stakes as a percentage of the losses suffered by class members; not all class members file claims. Investors with small claims no doubt file less often, because at some point the costs involved in filing a proof of claim will exceed the amount an investor is likely to recover. In contrast, it seems likely that institutional investors with sizable losses almost always file.<sup>203</sup> In any event, it is the absolute size of institutions' claims that we find significant. Those losses define what institutions have at stake in class actions.

We also gathered data from the State of Wisconsin Investment Board (SWIB), the California Public Employees Retirement System (CalPERS), the State of New Jersey pension fund, a large private pension fund, and a large mutual fund group that further confirm that institutional investors often have large stakes in class actions. For each of these institutions, where the data were

---

it had settled in recent years. While these reports do not constitute a random sample, we have no reason to believe they are not representative. The data in them are consistent with the data for the larger universe of settlements included in the *Senate Hearings*, *supra* note 2; *see supra* text accompanying notes 196–98. In addition, when we requested these reports, we did not inform the law firms involved of the focus of our inquiry.

Our examination of these settlement reports made clear that several associated or affiliated investors often file claims in the same class action—for example, several mutual funds or pension funds managed by the same advisor. We treat as single claims all claims that, based on data such as common names and addresses, we concluded had been submitted by entities under common management.

The reports for three actions included the total amount paid to class members, which we used to compute "Percent of Recognized Losses Recovered." For the others, we looked first to the *Senate Hearings*, *supra* note 2, at 263–64, 784–92, for data on total claims paid in the named class actions. If such data were not included in the Hearings, we next reviewed judicial decisions approving settlements of class actions against the companies in question. Where no such decision was reported, we reviewed *The Wall Street Journal* and the NEXIS News/Cumwvs, News/Arcnws, and Compny/Allnws files for reports of settlements. Where such reports included the amount of the settlement, but no statement or estimate of attorneys' fees and costs, we assumed that 75% of the settlement fund was paid to the class.

201. Individuals filed the largest claim in Fidelity Financial and the second largest claims in Columbia S&L, Quintex, and Vidmark. Individuals filed three of the ten largest claims in American Continental, seven of the ten largest in Fidelity Financial, and six of the ten largest in Quintex.

202. Most of these reports were made available to us on the condition that we not identify claimants, so as to preserve their privacy.

203. No reliable estimates of the extent of nonfiling are available. Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1449 (1994), reviews studies that seem to indicate that "perhaps 40% or more [of eligible shares] do not file claims." Alexander later notes, however, that the proportional trading model that plaintiffs' damage experts use, which provides the basis for these estimates, "systematically overstates damages by assuming that all shares are equally likely to trade. . . . [Thus, t]hese studies . . . understate the effectiveness of securities litigation." *Id.* at 1463.

supplied,<sup>204</sup> we computed total recoveries from class actions for each year, the two largest recoveries, and all other recoveries in excess of \$200,000.<sup>205</sup> We also calculated the percentage of total recoveries in the relevant actions that these recoveries represented.<sup>206</sup> We report below, for each of these institutions, total annual recoveries, data concerning the two largest recoveries, and data concerning additional large recoveries that represented in excess of five percent of the total recovered by the plaintiff class.

SWIB recovered \$5,625,386 from class actions in fiscal 1994. Its two largest recoveries, \$1,712,795 from a suit against C.R. Bard<sup>207</sup> and \$1,160,639 from a suit against Rykoff-Sexton, represented 13.7% and 20.2%, respectively, of the totals paid to the plaintiff class in those actions. SWIB had recoveries in excess of \$200,000 from five other class actions during this period. The \$305,186 it recovered from a suit against TCBY represented 15.1% of the total paid to the class in that action,

CalPERS recovered \$3,104,956 from class actions in 1993 and \$2,775,434 in the first nine months of 1994. Its two largest recoveries during this period, \$1,445,321 from a suit against RJR-Nabisco and \$828,592 from a suit against Tenneco, represented 2.7% and 2.2%, respectively, of the totals paid to the plaintiff class in those actions. CalPERS had recoveries in excess of \$200,000 from seven other class actions during this period. The \$245,444 it recovered from a suit against Micropolis represented 14.2% of the total paid to the class in that action; the \$467,840 it recovered from a suit against Digital Communications represented 10.0% of the total paid to the class in that action; and the \$795,578 it recovered from a suit against Raychem represented 6.2% of the total paid to the class in that action.

The New Jersey pension fund recovered \$2,059,636 in 1991, \$563,640 in 1992, and \$322,065 in 1993 from class actions. Its two largest recoveries during this period, \$810,358 from a suit against Bergen Brunswick and \$749,167 from a suit against Continental Illinois, represented 27.0% and 1.9%, respectively, of the totals paid to the plaintiff class in those actions. The New Jersey fund had recoveries in excess of \$200,000 from four other class actions during this period. The \$535,215 it recovered from a suit against Lymphomed represented 5.6% of the total paid to the plaintiff class in that action.

---

204. All but the mutual fund group provided details of all recoveries in one or more recent years.

205. Estimates vary widely as to the extent to which recoveries in class actions compensate class members for their compensable losses. We treat as potentially significant all recoveries in excess of \$200,000 because we view that figure as a reasonable proxy for cases in which an institutional investor's arguably compensable losses exceed \$1 million.

206. We used the same method to compute the totals paid to class members as we did to compute the percentage of recognized loss recovered in Table 2. *See supra* note 200.

207. We use the name of the corporation involved to identify all class actions discussed in this Part. However, other defendants probably were named in these actions and they or their insurers may have contributed toward these settlements.



The large private pension fund recovered \$3,659,821 from class actions through September 19, 1994, \$4,307,223 in 1993, and \$2,872,204 in 1992. Its two largest recoveries, \$1,525,167 from a suit against Whittaker and \$811,434 for a suit against MGM/UA, represented 14.3% and 3.1%, respectively, of the totals paid to the plaintiff class in those actions.<sup>208</sup> The fund had recoveries in excess of \$200,000 from eleven other class actions during this period. The \$602,600 the fund recovered from a suit against On-Line Software represented 19.6% of the total paid to the plaintiff class in that action; the \$236,514 it recovered from a suit against FHP International represented 6.1% of the total paid to the plaintiff class in that action.

The mutual fund group recovered \$18.3 million in 1993.<sup>209</sup> Its two largest recoveries, \$2.1 million from a suit against Tenneco and \$1.7 million from a suit against Chiquita Brands, represented 5.6% and 22.7%, respectively, of the totals paid to the plaintiff class in those actions.

Finally, we analyzed the data Gilardi & Co. supplied to the Senate Securities Subcommittee and the claims distribution reports to determine what share of settlements goes to what one might call "average individual investors," who often are said to be the principal beneficiaries of securities class actions.<sup>210</sup> We found that they receive a very minor share of the sums paid to investors as a consequence of such suits. From the Gilardi & Co. data for eighty-two cases, we computed that all claimants other than those who filed the fifty largest claims had median losses of \$590 and average losses of \$868.<sup>211</sup>

We then used claims distribution reports for fourteen settlements<sup>212</sup> to compute the percentage of valid claims filed and the percentage of losses claimed by investors with allowable losses of less than or equal to \$1000 and less than or equal to \$5000.<sup>213</sup>

---

208. The fund also recovered \$1,197,078 from a suit involving the acquisition of Wagon-Lits N.V. that was decided by a Belgian court. See *Accor Shares Lower in Paris as Wagon-Lits Takeover Cost Rises*, AFX News, June 24, 1994, available in LEXIS, World Library, Extafx File (conversion from Belgian francs by authors). We included this recovery in the funds' total recoveries during 1994.

209. Telephone Interview with associate general counsel, fund group (Oct. 3, 1994).

210. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1577 (9th Cir. 1990) (Congress intends through securities laws "'to protect the public, particularly unsophisticated investors'" (quoting *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980))), cert. denied, 499 U.S. 976 (1991); *Free World Foreign Cars, Inc. v. Alfa Romeo*, 55 F.R.D. 26, 30 (S.D.N.Y. 1972) (Rule 23 "intended to benefit the small consumer or investor who otherwise would have no means of redress"); *Senate Hearings*, supra note 2, at 141 (prepared statement of William S. Lerach) ("victims of fraud" are "[t]ens of thousands of people, many of them retirees").

211. This calculation excludes the Lincoln Savings litigation, which involved few institutional claimants. If it is included, the mean recovery of claimants other than the top 50 is \$951.

212. Six other settlement reports did not contain data that allowed us to extract easily information about claims of modest size.

213. The "less than \$5000" category includes investors with losses of less than \$1000.

Corporate Defendant	Claims ≤\$1000 (% of Total Valid Claims)	Claims ≤\$1000 (% of Total Allowed Losses)	Claims ≤\$5000 (% of Total Valid Claims)	Claims ≤\$5000 (% of Total Allowed Losses)
Altos Computer	48.41	.89	77.80	3.59
American Continental	4.37	.29	61.38	18.71
Cetus	42.81	1.73	81.22	9.29
Columbia S&L	19.30	.60	66.64	7.36
Daisy Systems	23.14	.54	68.02	4.36
DeLaurentiis	16.90	.67	61.92	10.46
Fidelity Financial	42.51	3.39	80.46	18.33
Newport Pharmaceutical	37.87	2.67	78.75	15.22
Pyramid Technology	35.36	.40	62.36	2.29
Qintex	37.73	2.65	76.50	15.79
Rykoff-Sexton	20.93	.52	62.20	5.40
Vidmark	23.49	1.41	71.39	16.79
VLSI Technology	42.67	2.37	83.17	13.25
Western Health	23.54	1.79	74.24	18.47
Mean	29.93	1.42	71.86	11.38
Median	29.45	1.15	72.82	11.86

TABLE 3. *Small Claimants' Share of Claims and Losses*

If one makes the reasonable assumption that investors' "allowable losses" average roughly ten percent of the amounts they paid for securities, allowable losses of \$1000 and \$5000 correspond to individual investments of roughly \$10,000 and \$50,000, respectively. The latter figure strikes us as more than what most people assume the "average individual investor" typically invests in a given security. But even if one treats all claims up to \$5000 as having been made by "average individual investors," it is apparent that such investors receive only a very minor share of the amounts recovered in securities class actions.

## V. HOW PROCEDURAL RULES AND PRACTICES DETER MONITORING

Institutional investors with large stakes in class actions surely are more capable than typical figurehead plaintiffs of effectively monitoring how plaintiffs' attorneys conduct such litigation. Institutions' large stakes give them an incentive to monitor, and institutions have or readily could develop the expertise necessary to assess whether plaintiffs' attorneys are acting as faithful champions for the plaintiff class. Until very recently,<sup>214</sup> however, institutions have not sought to play that monitoring role. They have sat on the sidelines, allowed plaintiffs' attorneys to proceed as they see fit, and become involved in class actions only to the extent of filling out proof-of-claim forms once settlements are negotiated and approved.<sup>215</sup>

Institutions' passivity does not signal that institutions always are pleased with the job plaintiffs' attorneys do. Representatives of institutional investors with whom we spoke reflected a variety of attitudes. Most saw class actions and the associated threat of liability as an important component of the mandatory disclosure system. Some noted that institutions, as large shareholders with diversified portfolios, bear most of the costs of class action litigation as well as reap most of the benefits. Several voiced suspicions about plaintiffs' attorneys' motivations and questioned the terms on which some class actions have been settled. Maryellen F. Andersen, Treasurer of the Council of Institutional Investors, recently expressed similar sentiments to the Senate Committee on Banking, Housing, and Urban Affairs. She noted that institutions "are the ones who are hurt if the system does not work right, or effectively, or efficiently, and we are the ones who stand to benefit when it does."<sup>216</sup> She added: "[T]here is reason to believe the [class action litigation] system is not yet working right."<sup>217</sup>

---

214. See *infra* note 273.

215. This is how lawyers representing a range of institutions have described to us the roles that those institutions typically play in class actions. The principal exception is that some mutual funds monitor the progress of class actions more closely so that they can (a) review the adequacy of proposed settlements and (b) take account of expected recoveries from pending class actions, as appropriate, when computing their net asset value.

An attorney who has monitored and participated in securities litigation for several institutional investors confirmed to us that institutions most often have gotten involved as plaintiffs, either prosecuting their own claims or suing on behalf of a class, in suits involving purchases of debt securities, which often are sold to only a small number of investors. He also stated that on a few occasions, institutions that were pursuing claims on their own behalf against issuers have recovered a portion of their attorneys' fees from class action settlement funds created in actions against the same issuers, where the institutions have worked closely with class plaintiff's counsel and have provided substantial assistance to class counsel. Finally, the attorney noted that it normally will not make economic sense for an institution (or institutions) to initiate direct claims against an issuer unless it (or they) has claims of at least \$10 million. Telephone Interviews with confidential source (Oct. 4-5, 1994).

216. *Senate Hearings, supra* note 2, at 323 (testimony of Maryellen F. Andersen).

217. *Id.* Ms. Andersen also testified that institutions are unsure of the nature or dimensions of problems with class action litigation. *Id.* at 324.

We do not believe that institutional investors have been passive because they have been concerned about having to pay large fees to plaintiffs' attorneys. Many attorneys who now represent plaintiffs in class actions, and probably other attorneys as well, presumably would be as prepared to litigate class actions on a contingent fee basis for institutional investor clients as they have been to represent figurehead plaintiffs.<sup>218</sup> Moreover, from an institutional investor's point of view, the most advantageous position in which to monitor a class action is that of "lead plaintiff," by which we mean the named plaintiff whose attorney serves as lead counsel and thus controls how the action will be prosecuted. As lead plaintiff, an institution would bear no larger share of plaintiffs' attorneys' fees than it would as a passive member of the plaintiff class, but it would be far better situated to monitor and influence lead counsel's conduct. An institution that preferred to participate secondarily, by intervening in the action or objecting to a settlement once it was reached, would have less influence over plaintiffs' attorneys and would probably have to pay both its own attorneys' fees and its share of any fees awarded to the attorneys who represent the class.<sup>219</sup>

---

218. Attorneys who now find it worthwhile to represent nominal plaintiffs in class actions on a contingent fee basis should find it attractive to represent institutional investors on a similar basis unless they generate a substantial portion of their income through opportunistic behavior. While substantial agency costs appear to be associated with class actions as currently prosecuted, *see supra* parts II–III, it also is clear that many plaintiffs' attorneys are reputable lawyers who generate income from class actions largely through skillful representation of investors' interests. Some of those lawyers might prefer to represent institutional investor clients, particularly if by doing so they could avoid having to participate in the current "race to the courthouse." Richard Dannenberg, senior partner at Lowey Dannenberg Bemporad & Selinger, notes:

The real perceived abuse that needs to be remedied is the immediate multiple filing of actions with the purpose of seeking to be appointed lead counsel. . . . Were the courts to establish criteria for the appointment of lead counsel, which exclude the consideration of the first to file, most, if not all, of the perceived abuses would disappear.

Letter from Richard B. Dannenberg to Arthur Levitt, *supra* note 66, at 3 n.3.

In addition, some firms that now represent clients largely on a fee-for-service basis and thus have not represented plaintiffs in class actions might find it attractive to represent institutional investor plaintiffs in class actions on a contingent fee basis. After all, as established a firm as Cravath, Swaine & Moore elected to represent the Federal Deposit Insurance Corporation and the Resolution Trust Corporation partly on a contingent fee basis. Marianne Lavelle, *FDIC Legal Program Criticized*, NAT'L L.J., Nov. 25, 1991, at 3; Scot J. Paltrow, *FDIC Seeks \$6.8-Billion Damages from Drexel*, L.A. TIMES, Nov. 15, 1990, at A1, A19; *see also* Kirchoff v. Flynn, 786 F.2d 320, 323–28 (7th Cir. 1986) (discussing circumstances in which contingency fee arrangement is more rational for clients and lawyers).

On the other hand, some firms that now represent class action plaintiffs might face substantial conflict-of-interest issues were they to seek to represent institutional investors, many of which are part of multiservice financial organizations that those attorneys have sued. In addition, some plaintiffs' attorneys may prefer to represent figurehead plaintiffs, who are not likely to pose any conflict problems and are not likely to have sufficient financial interest in the litigation to want to monitor or to have the knowledge or ability to do so. *See* Margaret A. Jacobs, *Lawyers and Clients:irate Investors Keep Sharp Eye on Attorneys in Smith Barney Suit*, WALL ST. J., Sept. 30, 1994, at B8 (describing how committee of well-educated, affluent investors has been monitoring securities class action and noting that plaintiffs' lawyers refer to committee as "the Committee from Hell").

219. While FED. R. CIV. P. 23(c)(2)(C) permits non-opt-outs to appear through counsel, it is almost unheard of for absentee class members to appear through counsel other than to object to a proposed settlement or award of attorneys' fees. Intervenor not serving in any representative capacity are "entitled to no fee out of any fund obtained by the class members except to the extent that their work benefits the class as a whole." *County of Suffolk v. Long Island Lighting Co.*, 710 F. Supp. 1407, 1422 (E.D.N.Y.

It seems much more likely that institutions' passivity is attributable, to a substantial degree, to obstacles that arise as a consequence of the procedures courts employ in class action litigation. The significance of those obstacles can best be appreciated if one first understands the procedural steps confronting class action plaintiffs.

#### A. *Procedures Applicable to Class Action Plaintiffs*

A class action begins when one or more attorneys file complaints on behalf of named plaintiffs who purport to sue on behalf of a class of investors.<sup>220</sup> If more than one complaint relating to the same transaction or event is filed, all such complaints generally are transferred to one district, if necessary, and consolidated in a single action.

The judge to whom the case is assigned uses status conferences to organize pretrial proceedings. If several plaintiffs' lawyers are contending for the position of lead counsel for the class, the court typically designates or announces a procedure for designating lead counsel. The court also sets a discovery schedule.

Discovery usually follows rapidly on the filing of a class action complaint. Defendants seek evidence to rebut plaintiffs' assertions that they have met Rule 23's requirements for maintaining a class action. In particular, defendants seek ammunition (also relevant to the merits) that putative representative plaintiffs are subject to unique defenses that make them atypical class members, or cannot adequately represent the class because their interests conflict with those of the class. Rule 23(c)(1) also requires the court, "[a]s soon as practicable" after a class action is commenced,<sup>221</sup> to determine whether the suit can be maintained as a class action. The Rule also requires notice of the pendency of the action to be provided to all class members.<sup>222</sup>

---

1989), *aff'd*, 907 F.2d 1295 (2d Cir. 1990). Intervenor's claims, even if large, rarely are large enough to justify payment of attorneys' fees at ordinary hourly rates.

220. These allegations assert that plaintiff is suing on behalf of a defined class of similarly situated persons, for example, all persons who purchased stock in ABC Corporation between x date and y date, excluding any defendant or member of any defendant's family.

Lawsuits that include claims for violations of the provisions of the Securities Exchange Act of 1934 must be brought in U.S. District Courts, which have exclusive jurisdiction over such claims. Lawsuits for violations of the Securities Act of 1933 (but not of the Securities Exchange Act) may be brought in either federal or state courts, which have concurrent jurisdiction. Claims under state law may be filed in either state or federal courts.

221. FED. R. CIV. P. 23(c)(1) provides in relevant part: "As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained." In fact, "[a]s soon as practicable" may be several years.

222. FED. R. CIV. P. 23(c)(2) provides:

In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude the member from the class if the member so requests by a specified date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if the

Defendants' and plaintiffs' attorneys agree to settle virtually all class actions that survive motions to dismiss and motions for summary judgment. Counsel for the parties then ask the court to approve the settlement provisionally. If it does, the court sets a date for a settlement hearing and orders that notice be sent informing class members of the basic terms of the settlement, their right to object, and procedures for doing so.

At the settlement hearing, the court, after reviewing any objections, usually approves the proposed settlement as fair and adequate. It then passes on plaintiffs' attorneys' application for fees and reimbursement of expenses. All fees and expenses awarded are paid off the top of the settlement fund. The remainder of the fund then is distributed, in accordance with procedures agreed upon in the stipulation of settlement, to class members who have filed valid claims.

### B. *Procedural Obstacles to Institutions Becoming Named Plaintiffs*

The practices courts employ to select lead counsel for the class, to provide notice to class members, and to determine whether putative plaintiffs are adequate class representatives with typical claims produce the three principal procedural obstacles to institutional investors becoming lead plaintiffs in class actions.

#### 1. *Procedures for Appointment of Lead Counsel*

The processes courts use to designate lead counsel create the most significant obstacle. As discussed above, courts generally appoint as lead counsel either the lawyer who files the first complaint or a lawyer elected by all the lawyers who have filed complaints.<sup>223</sup>

Lawyers representing institutional investors are unlikely to win the "race to the courthouse" or even to be among the early filers. Regardless of whether an institution becomes aware of a potential claim on its own or is made aware of that claim by a plaintiffs' attorney, the institution presumably will want to evaluate carefully whether the potential claim has merit before deciding whether to file suit. An institution that proceeds in such a deliberative fashion, however, will face a steeply uphill battle if it decides that the case is strong enough, and its stake is large enough, to justify an effort to become lead plaintiff.

Despite authority that where more than one complaint is filed in a class action, the court should select as plaintiffs' lead counsel the lawyer who will

---

member desires, enter an appearance through counsel.  
223. See *supra* text accompanying notes 41-47.

best represent the interests of the class,<sup>224</sup> courts virtually never consider the possibility that one aspiring lead plaintiff is more likely than another to monitor her lawyer's conduct of the litigation. In fact, courts often state that a lead plaintiff need not be the best available class representative,<sup>225</sup> but merely one who is likely to pursue the case in the interests of the class.<sup>226</sup> Courts require nothing more by way of proof of adequacy than that an aspiring plaintiff have sustained losses akin to those incurred by other class members, be represented by competent counsel, and have no interest antagonistic to the interests of the class.<sup>227</sup> In essence, courts erroneously equate adequacy of representation with constitutional standing<sup>228</sup> and assume that no potential lead plaintiff is capable of contributing any more than her willingness to be named.<sup>229</sup>

An institutional investor inclined to monitor a class action actively who has not participated in the race to the courthouse thus is unlikely to secure the appointment as lead counsel of the lawyers it believes will most faithfully and diligently represent its interests and those of the plaintiff class. Similarly, plaintiffs' attorneys who become aware of a potential class action claim have

---

224. See *In re* "Agent Orange" Prod. Liab. Litig., 818 F.2d 179, 187 (2d Cir. 1987) (court's selection of lead counsel should be guided by best interests of class), *cert. denied*, 487 U.S. 1234 (1988); *Summit Office Park v. United States Steel Corp.*, 639 F.2d 1278, 1287 (5th Cir. 1981) (Wisdom, J., dissenting) ("[I]f a district court finds it advisable to appoint lead counsel, the selection should not be based on who filed suit first, but on the ability of the counsel to represent the class.").

225. See *Avagliano v. Sumitomo Shoji Am.*, 103 F.R.D. 562, 583 (S.D.N.Y. 1984); *Wolfson v. Riley*, 94 F.R.D. 243, 245 (N.D. Ohio 1981); *Apanewicz v. General Motors Corp.*, 80 F.R.D. 672, 677 (E.D. Pa. 1978); 7A CHARLES A. WRIGHT ET AL., *FEDERAL PRACTICE & PROCEDURE* § 1765 (1986 & Supp. 1994) (citing cases).

226. They reason that if class members think the chosen representative inadequate, they are free to opt out. See *Ockerman v. May Zima & Co.*, [1996-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,068, at 95,324-26 (M.D. Tenn. Dec. 22, 1986). In cases with a large volume of small claims, opting out is hardly a rational economic choice, since the small size of an opt-out's claim would by definition not warrant independent litigation.

227. See *Lewis v. Curtis*, 671 F.2d 779, 788 (3d Cir.) (plaintiff adequately represented class where plaintiff's attorney was qualified and plaintiff did not have interests antagonistic to class), *cert. denied*, 459 U.S. 880 (1982); *Susman v. Lincoln Am. Corp.*, 561 F.2d 86, 90 (7th Cir. 1977) (trial court did not abuse discretion in finding that plaintiffs did not adequately represent class because of potential conflict of interest arising from relationship between plaintiffs and counsel).

228. Constitutional standing and fairness and adequacy of representation, while related in that both deal with the propriety of a person's asserting claims in litigation, are distinguishable. The standing inquiry asks whether one can assert a claim for oneself; the adequacy inquiry should ask whether one is the proper person to assert a claim on behalf of others. *Hassine v. Jeffes*, 846 F.2d 169, 175-76 (3d Cir. 1988). The fact that plaintiffs themselves have standing to sue because they suffered injury or incurred loss should not automatically render them adequate representatives of the interests of other persons who are not before the court. *Cosgrove v. Bowen*, No. 85 Civ. 4472, 1988 WL 253323, at \*1 (S.D.N.Y. Nov. 1, 1988) (substantial difference between standing to sue and propriety, similarities, and adequacy of representation); 1 HERBERT B. NEWBERG, *NEWBERG ON CLASS ACTIONS* § 2.09 (2d ed. 1985).

229. See, e.g., *In re Adobe Sys., Inc. Sec. Litig.*, 139 F.R.D. 150, 156 (N.D. Cal. 1991):

The reality of complex cases of this type is that clients must defer a great amount of discretion to their lawyers. . . . [T]he test for adequacy of representation is merely whether or not plaintiffs have demonstrated a willingness and vigor to prosecute the action, whether they have any disabling conflicts going to the heart of the controversy, and whether they have qualified counsel.

no incentive to seek out an institutional investor as a client rather than file suit in the name of a figurehead plaintiff.<sup>230</sup>

## 2. *Lack of Timely Notice*

Lack of notice of the pendency and details of securities class actions complicates institutional investors' problems. As noted, plaintiffs' lawyers have no incentive to inform institutional investors of potential securities law claims with a view to enlisting them as clients. Neither are institutions likely to learn of such suits from corporate defendants. A corporation has no obligation to issue a press release disclosing that it has been sued unless the suit is likely to have a material effect on the corporation's financial condition. Moreover, corporations generally are averse to publicizing class actions,<sup>231</sup> perhaps fearing that doing so will stimulate the filing of additional claims.

Despite Rule 23's requirements, class members rarely receive notice of the pendency of a class action soon after the action is filed. In many cases, the parties agree, with the court's concurrence, to defer for months or even years the resolution of class certification issues. The parties may be concerned about the costs of notice, which can be substantial. Plaintiffs (or their counsel) initially are responsible for those costs, but defendants eventually bear them whenever a class action suit is settled.<sup>232</sup> Consequently, the parties may attempt first to resolve whether plaintiffs' complaint states a claim on which relief can be granted or whether it does so with the specificity Rule 9(b) requires. If the complaint survives a motion to dismiss, the parties may decide to proceed with discovery and attempt to negotiate a settlement. Then they can reduce litigation-related costs by sending a single notice informing class members of the pendency of the class action, the settlement, the hearing on the fairness of the settlement, and class members' rights to object to or share in the settlement or to opt out of the plaintiff class.<sup>233</sup>

Lack of timely notice makes it difficult for institutional investors to participate in class actions. An institution may be aware that it has sustained a large loss in the value of a particular security, and may even be able to link that loss to some public disclosure. But institutional investors do not have the expertise of plaintiffs' lawyers to perceive whether a claim of securities fraud

---

230. Absent incentives, plaintiffs' attorneys may prefer the freedom from monitoring that they enjoy when representing figurehead plaintiffs. See Jacobs, *supra* note 218, at B8.

231. WILLIAM L. CARY & MELVIN ARON EISENBERG, CORPORATIONS 1087 (6th ed. 1988).

232. In settled cases, defendants agree to pay the cost of notice either directly or indirectly through the settlement fund.

233. CARY & EISENBERG, *supra* note 231, at 1086-87; see also *D&B Notice*, *supra* note 115 (class certified on September 22, 1992; "Notice of Pendency of Action, Class Action Determination, Proposed Settlement, Settlement Hearing, and Right to Share in Settlement or to Request Exclusion" sent during August 1993, following execution of stipulation of settlement at end of June).



is likely to lie, or those lawyers' incentive to devote substantial resources to investigating potential claims.<sup>234</sup>

Thus, as the general counsel of one large institution makes clear, lack of notice hinders institutional participation in class actions: "We are often the largest shareholder of the plaintiff 'class.' Yet, seldom do we get much detail about the claims filed or progress of settlement discussions until a deal has already been struck."<sup>235</sup>

### 3. *Discovery Concerning Typicality and Adequacy*

To maintain a class action, a named plaintiff must be able to represent the class adequately and must have claims typical of the class. In part, this means that courts will refuse to certify purported classes if named plaintiffs are subject to unique defenses. Such plaintiffs' claims are deemed to be atypical, which renders the plaintiffs unsuitable to represent a class.

Adequacy and typicality requirements are designed to safeguard the interests of absentee class members, but courts generally assume that absentees probably will not appear to challenge the credentials of putative named plaintiffs. Consequently, courts permit defendants, as the best available surrogates, to mount such challenges. Defendants, however, are not interested in ensuring that class members are represented adequately by a named plaintiff with claims typical of the class, but in preventing class members from being represented by any named plaintiff at all.<sup>236</sup> Consequently, defendants use the threat of discovery to deter plaintiffs from coming forward and discovery itself to develop information that will convince a court to deny plaintiffs' request for class certification.

Rarely if ever, though, will discovery about typicality be relevant to class certification issues, at least in FOM suits. All members of purported plaintiff classes in such suits have the same interest in establishing that defendants made material misstatements and acted with scienter. Under the presumption of reliance established by *Basic*, all class members will be presumed to have

---

234. Nor does the financial press adequately inform institutional investors about class actions. Not all filings are reported, and press reports typically do not include details about the particulars of the claims asserted or the alleged class period.

235. Letter from Kurt N. Schacht, General Counsel, SWIB, to Sen. Pete V. Dominici 2 (Sept. 27, 1993) (on file with authors). Although we have focused on the possibility that institutions would find it beneficial to act as class representatives, it is also possible that an institutional investor falling within the class definition of a purported class action complaint would oppose the bringing of the class action. In such circumstances, early notice of the pendency of class actions would permit large investors who opposed particular class actions to take action to discourage their maintenance or to assist in their defense. See, e.g., Karen Donovan, *Pension Managers Speaking Up*, NAT'L L.J., Mar. 13, 1995, at A6-A7; Mark Walsh, *Big Investors Speaking Out on Securities Suits*, RECORDER, Feb. 23, 1995, at 3 (describing how CalPERS and three other pension funds wrote letter urging dismissal of suits against Intel Corp. following disclosure of flaws in Pentium chip). It is not clear whether such an investor would have standing to appear or intervene in the action.

236. Macey & Miller, *supra* note 16, at 63-66.

purchased or sold a security in the belief that its market price reflected all publicly available information, unless the defendant demonstrates that a class member acted on the basis of material inside information or purchased the security for reasons unrelated to its merit as an investment.<sup>237</sup> Investors who trade in violation of the prohibition against insider trading are not likely to subject themselves to scrutiny by becoming class action plaintiffs. Rational investors do not purchase securities at prices they believe are inflated by fraud, nor do they sell securities at prices they believe are depressed by fraud. Thus, a defendant is likely to be able to rebut the presumption of reliance only where someone has purchased securities with a view to becoming a class action plaintiff.

While a motion for class certification is not an appropriate point at which to litigate the merits of plaintiff's claim,<sup>238</sup> defendants can question whether an aspiring representative plaintiff is atypical because she is subject to, and is likely to be preoccupied with, defenses unique to her.<sup>239</sup> *In re Harcourt Brace Jovanovich, Inc. Securities Litigation*,<sup>240</sup> for example, upheld requests that two named plaintiffs produce the complaint and the transcript of any deposition given in any other securities class action or corporate derivative litigation to which either had been a party, as well as brokerage statements for all their securities trading activities during a two-year period. Other courts have upheld similar requests.<sup>241</sup>

Although these rulings may be reasonable in cases where defendants have some basis for alleging that a repeat plaintiff purchased stock in a troubled company, without regard to price, for the purpose of qualifying as a representative plaintiff,<sup>242</sup> they are troublesome to the extent that they open

---

237. See *supra* text accompanying notes 122–28; see also *Hoexter v. Simmons*, 140 F.R.D. 416, 419–20 (D. Ariz. 1991) (rejecting defendants' contention that named plaintiff's claims were not typical of those that would be made by institutional investors, sophisticated individual investors, and arbitrageurs).

238. See *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177–78 (1974); *Hanon v. Dataproducts Corp.* 976 F.2d 497, 508–09 (9th Cir. 1992).

239. *Hanon*, 976 F.2d at 508; *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 176, 180 (2d Cir. 1990), *cert. denied*, 498 U.S. 1025 (1991).

240. 838 F. Supp. 109, 113–14 (S.D.N.Y. 1993).

241. See *In re ML-Lee Acquisition Fund II, L.P. Sec. Litig.*, 149 F.R.D. 506 (D. Del. 1993); *Feldman v. Motorola, Inc.*, No. 90 C 5887, 1992 WL 137163 (N.D. Ill. June 10, 1992). *But see* *Burstein v. Applied Extrusion Technologies*, 153 F.R.D. 488 (D. Mass. 1994) (documents concerning plaintiffs' investment histories irrelevant to typicality determination).

242. See, e.g., *Welling v. Alexy*, 155 F.R.D. 654 (N.D. Cal. 1994) (holding that shareholder who appeared in 13 other securities class actions and who was unfamiliar with instant litigation failed typicality requirement); *In re Urcarco Sec. Litig.*, 148 F.R.D. 561, 563 n.1 (N.D. Tex. 1993), *aff'd sub nom. Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994); *Shields v. Smith*, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,449 (N.D. Cal. Nov. 4, 1991) (“The consistent pattern of purchasing a few shares in troubled companies, Plaintiff's involvement in over two dozen lawsuits, and his purchase of ABI shares after the company's disclosures of some short-term problems, supports an interpretation that Plaintiff's motive in purchasing two shares in ABI was to pursue a lawsuit.” (footnote omitted)). *But cf.* *Wells v. HBO & Co.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,009 (N.D. Ga. Apr. 24, 1991) (concluding that fact that proposed class representative served as class representative on other cases made her good candidate for position).

the door to similar “boxcar discovery” absent evidence suggesting a given named plaintiff was so motivated. The risk that they might be required to comply with similar discovery requests deters institutional investors from seeking to become lead plaintiffs in class actions. The cost of producing all documents concerning an institution’s investment philosophy and trading over several years would be substantial. An institution also might be concerned about disclosure of proprietary information, although use of confidentiality stipulations and protective orders could alleviate most such concerns.<sup>243</sup>

### C. *Procedural Obstacles to Secondary Participation*

#### 1. *Intervention*

Lack of notice that a class action is pending and of information about the progress of a pending case makes it difficult for class members to determine whether intervention is necessary to protect their interests. Moreover, courts are unlikely to grant applications to intervene in class actions because they require courts to reverse themselves in two respects. First, when a court certifies a class, it implicitly finds that a class action is superior to intervention by putative class members.<sup>244</sup> Second, notice of a pending class action is never given to putative class members prior to certification, so would-be intervenors almost never appear until after a court also has found that named plaintiffs will represent the interests of the class fairly and adequately. Under Rule 24(a), a person seeking to intervene as of right must show that her interest is not adequately represented by the existing parties.<sup>245</sup> Thus she must persuade the court to reverse both its superiority determination and its decision that the named plaintiff will adequately represent class members’ interests.<sup>246</sup>

---

243. The parties to class actions usually stipulate that they will treat as confidential all proprietary information produced in discovery and use it only in the litigation. There is no obvious reason why such stipulations should not protect information produced by a named plaintiff.

244. See *Brown v. Cameron-Brown Co.*, 92 F.R.D. 32, 50 (E.D. Va. 1981); see also FED. R. CIV. P. 23(b)(3).

245. FED. R. CIV. P. 24(a) requires a person seeking to intervene as of right to show that the applicant claims an interest relating to the property or transaction which is the subject of the action and the applicant is so situated that the disposition of the action may as a practical matter impair or impede the applicant’s ability to protect that interest, unless the applicant’s interest is adequately represented by existing parties.

246. See *County of Suffolk v. Long Island Lighting Co.*, 710 F. Supp. 1406, 1421 (E.D.N.Y. 1988) (denying intervention as of right where court already concluded plaintiffs could fairly and adequately represent interests of class), *aff’d*, 907 F.2d 1295 (2d Cir. 1990); *Fielding v. Allen*, 9 F.R.D. 106, 106–07 (S.D.N.Y. 1949) (denying application to intervene in derivative action absent evidence that representation by existing plaintiff would be inadequate).

As concerns permissive intervention,<sup>247</sup> courts have broad discretion. Their primary concern is whether intervention will “unduly delay or prejudice the adjudication of the rights of the original parties.”<sup>248</sup> The possibility that intervention might derail or inhibit settlement discussions is sufficient ground for denying permissive intervention.<sup>249</sup> Again, lack of notice makes it unlikely that an institution’s application to intervene will be timely.

## 2. *Objection*

An institution inclined to object to a settlement faces two obstacles, one informational, the other economic. As the general counsel to SWIB has pointed out:

[S]eldom do we get much detail about the claims filed or progress of settlement discussions until a deal has already been struck. If we want to object, we must retain separate counsel, opt out of a settlement and pursue a completely separate case or battle the company *and* class counsel in opposing a settlement. Given the relatively short time period in which decisions must be made, plaintiffs are almost never in a position to risk challenging a settlement. It is difficult to determine whether this results in companies being able to obtain more favorable settlements (foreclosing larger claims) than would be the case if real plaintiffs were more involved.<sup>250</sup>

Objecting to settlements also has been a low-percentage proposition. Courts can award attorneys’ fees to objectors who improve the terms of settlements,<sup>251</sup> but courts rarely are receptive to objectors’ claims<sup>252</sup> and usually force objectors to bear their own attorneys’ fees. Whether courts would react similarly to objections filed by institutional investors with significant

---

247. Permissive intervention requires only that the applicant have a conditional right to intervene conferred by statute, or that “an applicant’s claim or defense and the main action have a question of law or fact in common.” FED. R. CIV. P. 24(b).

248. FED. R. CIV. P. 24(b); *see also* *Fleming v. Lind-Waldock & Co.*, 922 F.2d 20 (1st Cir. 1990) (affirming denial of intervention).

249. *Long Island Lighting Co.*, 710 F. Supp. at 1422.

250. Letter from Kurt N. Schacht to Sen. Pete V. Dominici, *supra* note 235, at 2. Court-approved notices of settlement leave much to be desired. They disclose the size and source of the settlement fund, but not the damages originally sought or the percentage of allowable losses class members are likely to receive.

Obtaining information also can be a problem. Courts have discretion to grant or deny objectors’ requests to take discovery, *City of Detroit v. Grinnell Corp.*, 495 F.2d 448, 464 (2d Cir. 1974), and if the record in the case is comprehensive, as it often is by the time a case is settled, objectors find it difficult to demonstrate a need for additional discovery, *Weinberger v. Kendrick*, 698 F.2d 61, 79 (2d Cir. 1982), *cert. denied*, 464 U.S. 818 (1983).

251. *See, e.g.*, *White v. Auerbach*, 500 F.2d 822, 828 (2d Cir. 1974); *Gaines v. Sears, Roebuck & Co.*, [1979–1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,376 (N.D. Ill. 1980).

252. *See, e.g.*, *supra* text accompanying notes 71–90.

stakes in class actions is not clear,<sup>253</sup> but risk-averse institutions have been notably reluctant to test the waters.

## VI. PROPOSED CHANGES IN CLASS ACTION PROCEDURES

Courts would benefit were institutional investors with large stakes in class actions to serve as lead plaintiffs. Institutional investor plaintiffs would not usurp the courts' functions, for judicial approval of settlements and attorney fee awards still would be required. But institutional investors, by acting as litigation monitors, should make it easier for courts to perform their tasks. Institutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus, courts could be more confident that settlements negotiated under the supervision of institutional plaintiffs were "fair and reasonable" than is the case with settlements negotiated by unsupervised plaintiffs' attorneys. Similarly, a court might well feel confident in assuming that a fee arrangement an institutional investor had negotiated with its lawyers before initiating a class action maximized those lawyers' incentives to represent diligently the class' interests, reflected the deal a fully informed client would negotiate, and thus presumptively was reasonable.

To create a procedural environment that facilitates service by institutional investors as lead plaintiffs, courts must remove the existing obstacles to institutional participation. Courts readily could do so. All that is required are changes in courts' current approach to appointing lead counsel, providing notice, and regulating discovery directed at typicality and reliance.

### A. *Appoint as Lead Counsel the Attorney of the "Most Adequate Plaintiff"*

The key change relates to designation of lead counsel for the plaintiff class. In any class action in which more than one class member seeks to serve as lead plaintiff, a court should interpret Rule 23's requirement that a named plaintiff be able to represent the class "adequately" to mean that it should select as lead plaintiff the named plaintiff capable of "most adequately" representing class members' interests. Further, because the named plaintiff or group of plaintiffs with the largest financial stake in the outcome of an action has the greatest economic incentive to monitor class counsel's performance effectively, courts should adopt a presumption that that plaintiff or group will "most adequately" represent class members' interests.<sup>254</sup> Courts should

---

253. CalPERS has objected to settlements of corporate derivative suits, but has met with little reported success. See, e.g., *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991); see also *In re Pacific Enters. Sec. Litig.*, No. 94-55935, 1995 WL 49484, at \*3 (9th Cir. Feb. 9, 1995) (reporting that Wells Fargo Bank, GE Investments, IDS, Continental Trust, and Connecticut General Life Insurance objected to combined class action and derivative settlement, which district court approved).

254. This practice would not conflict with *Surowitz v. Hilton Hotels*, 383 U.S. 363 (1966), often cited inaccurately to support arguments that plaintiffs with little understanding of the facts or theories of their

provide other putative plaintiffs with an opportunity to rebut this presumption, but should allow them to do so only by demonstrating that the presumptively "most adequate" plaintiff has a significant disqualifying conflict of interest or is subject to unique defenses that would render it incapable of adequately representing the class.<sup>255</sup>

By so interpreting Rule 23, courts would alter dramatically the dynamics of class action litigation. Market forces would be brought into play. A plaintiffs' attorney who became aware of facts suggesting the existence of a meritorious securities fraud claim would no longer find it necessary to race to the courthouse. Rather, she probably first would investigate further to determine whether other publicly available information supported the apparently meritorious claim. Then she might attempt to ascertain which investors had the largest stakes in the class for which the proposed action could be brought and canvass those investors (who in most cases would be institutions) to see if one or more of them would be interested in directing her to initiate the proposed suit. Alternatively, she might file a well-researched complaint in the name of a figurehead plaintiff in the hope that a class member with a large claim would retain her to pursue the action.

Since facts suggesting the existence of securities fraud claims usually are widely known, plaintiffs' attorneys frequently would find themselves competing to be retained by institutional investors. That members of the plaintiffs' bar, and perhaps other attorneys as well, would be attempting to enlist institutional investors as potential lead plaintiffs should not be disturbing. Plaintiffs' attorneys currently engage in functionally identical conduct with regard to figurehead plaintiffs. Institutions, as experienced and sophisticated consumers of legal services, are in little danger of succumbing to the kind of pressure or influence at which the ethical proscription of in-person solicitation is directed. Moreover, well-established law firms nowadays regularly engage in genteel, but nonetheless aggressive, solicitation of institutional investors and other clients.

We do not believe that it would be fruitful to try to predict exactly how relationships between plaintiffs' attorneys and institutional investors are likely

---

claims and little incentive or ability to monitor the litigation can nonetheless be adequate class representatives. That case dealt with the validity of Mrs. Surowitz's verification of a complaint filed in her name, not class certification. Named plaintiffs with small stakes in an action still could qualify as adequate. If no aspiring lead plaintiff in a given action had more than a claim of nominal value, the court might want to select the lead plaintiff on some basis other than that we suggest.

255. Implicit in this proposal is the notion that only other class members, not defendants, should be allowed to challenge whether a particular plaintiff can adequately represent the class. Under current interpretations of the rules, courts have allowed defendants to contest a given plaintiff's adequacy and typicality because other class members did not have sufficient incentives to incur the costs of litigating those issues. Defendants, however, are interested in eliminating (or harassing) all class representatives, not in protecting the interests of absent class members. *See supra* text accompanying note 236. Under the proposed interpretation of Rule 23, these flawed proxies would no longer be allowed to question a given plaintiff's adequacy or typicality.

to evolve. One possibility is that many institutions, over time, will develop continuing relationships with one or more plaintiffs' attorneys. Whatever the pattern, plaintiffs' attorneys' reputations as effective advocates of investors' interests will become increasingly important. That, in turn, should reduce significantly the resources that institutions will need to devote to monitoring their attorneys' prosecution of class actions in which they are involved.

The change we propose also will place institutional investors in a position to negotiate fee arrangements with plaintiffs' lawyers before class actions are initiated. Again, it is not feasible to predict exactly what those arrangements will be. However, it may well be that they will differ substantially from the fee structures that courts currently employ—generally awarding fees equal to a declining percentage of whatever the plaintiff class recovers. An institution might attempt to discourage its attorneys from pursuing strike suits by stipulating that they will receive only a nominal fee if they settle for no more than some minimum percentage (e.g., ten percent) of the damages initially sought. To encourage its attorneys to pursue strong cases more vigorously, an institution might agree to pay them an increasing portion of any recovery in excess of some stipulated threshold (e.g., forty percent of the damages initially sought).<sup>256</sup>

Our market-based proposal has clear advantages over two alternative approaches others have proposed: Professors Macey and Miller's suggestion that class members' claims be auctioned to the highest bidder<sup>257</sup> and Melvyn Weiss' suggestion for a "case organization period" in class actions where multiple complaints have been filed.<sup>258</sup> Auctions will do little to eliminate strike suits, and, because of informational problems, are unlikely to provide class members with adequate compensation when their claims are meritorious.<sup>259</sup>

Mr. Weiss' proposal is that courts establish a case organization or "cooling off" period whenever duplicative class action complaints have been filed. "[D]uring the Case Organization Period, counsel for plaintiffs in each action . . . [would] confer among themselves about organization of counsel for prosecuting the multiple actions . . . ."<sup>260</sup> This procedure might slow the race

---

256. Such an approach also would differ from that followed by Judge Walker in *In re Oracle Securities Litigation*, 132 F.R.D. 538, 541, 548 (N.D. Cal. 1990), in which the court found that the most reasonable fee structure was one providing for class counsel to receive a declining percentage of any recovery.

257. See Macey & Miller, *supra* note 16, at 105–16; see also *In re Oracle Sec. Litig.*, 131 F.R.D. 688, 690 (N.D. Cal. 1990) (requiring plaintiffs' attorneys to bid for lead counsel position).

258. Letter from Melvyn I. Weiss, Partner, Milberg Weiss Bershad Hynes & Lerach, to Richard M. Samans, Competitiveness Policy Council (May 31, 1994) (on file with authors).

259. See Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 NW. U. L. REV. 423, 424–25 (1993). Auctions also do not "address the basic structural problems that divorce settlements from the merits." Alexander, *supra* note 16, at 590.

260. Weiss Cooling-Off Period Recommendations: Special Procedure for Managing Securities Class Actions § 2(e), in Letter from Melvyn I. Weiss to Richard M. Samans, *supra* note 258.

to the courthouse somewhat, but would do little to ensure more effective monitoring of plaintiffs' attorneys. Nor would it relieve courts of the task of deciding, on an *ex post* basis, how to compensate plaintiffs' attorneys for their efforts.

B. *Provide Early Notice to Class Members with Large Claims*

Rule 23 gives courts broad authority to "make appropriate orders . . . for the protection of . . . the class."<sup>261</sup> Our second proposal is that courts use this authority to require that early notice of the pendency of a putative class action be provided to prospective class members with potentially large claims. Specifically, shortly after any class action is filed, the court should order the issuer whose securities are involved to prepare a list identifying the 100 investors who purchased or sold (as the case may warrant) the largest accumulations of the relevant class of that issuer's securities during the class period alleged in the complaint, together with the mailing addresses of those investors or their nominees.<sup>262</sup> The court should require the issuer to furnish that list to the first-filing lawyer or lawyers, who should be required (a) to reimburse the issuer for its reasonable expenses in preparing the list; (b) to prepare a notice advising class members of the pendency of the action and the claims asserted; (c) to mail the notice to the investors on the list and to any investor service organization that has registered with the SEC and made a bona fide representation that it will circulate such information to its members or subscribers;<sup>263</sup> and (d) to publish the notice in *The Wall Street Journal* or a comparable publication.

Such notice would give institutional and other investors with substantial stakes in pending class actions an opportunity to decide whether they were interested in participating in those actions, alone or with other investors, as lead plaintiffs. If an institution decided to get involved, it could retain either the lawyer who filed the action or some other attorney. Similarly, if several institutions were interested in becoming involved, they could either compete to become lead plaintiff or agree to work together.

Allowing the first-filing lawyer to send the notice to the 100 largest prospective class members would provide that attorney an incentive—an increased chance of employment—designed to counter any hesitation she might have about doing the pre-filing investigation and other work necessary to prepare a complaint. Moreover, if the first-filing attorney is not retained by the

---

261. FED. R. CIV. P. 23(d)(2).

262. We assume that issuers will be able to use procedures similar to those they now employ to determine to whom notice of a pending class action shall be sent.

263. For example, the Council of Institutional Investors, Institutional Shareholder Services, or the Investor Responsibility Research Center.



lead plaintiff, the court should award her a reasonable fee for her efforts whenever the case results in a recovery for the plaintiff class.<sup>264</sup>

### C. *Regulate Discovery Directed at Typicality, Adequacy, and Reliance*

Our third proposal deals with discovery directed at typicality and reliance. In class actions in which institutional investors serve as lead plaintiffs, questions relating to typicality rarely should arise. As with questions concerning whether a given institution is the “most adequate” plaintiff,<sup>265</sup> we believe the right to conduct discovery relating to typicality and adequacy should be limited to other members of the plaintiff class, so as to keep it from becoming an expensive and abusive sideshow, intended to deter institutional investors from prosecuting class actions. Moreover, other class members should be allowed discovery concerning typicality and adequacy only where they can demonstrate some reasonable basis for believing that a presumptively adequate plaintiff would not be capable of representing the class effectively.

As to merits discovery relating to the presumption of reliance, courts should balance defendants’ legitimate need for discovery against the potential for abuse. The best solution might be for courts to defer defendants’ discovery on this point to a remedy phase of the litigation.<sup>266</sup> Courts should also allow institutional investor plaintiffs liberal use of confidentiality stipulations and protective orders.<sup>267</sup>

## VII. WILL INSTITUTIONS ACT AS LITIGATION MONITORS?

If courts modify procedural rules and practices to create a litigation environment more conducive to institutional investors serving as lead plaintiffs in class actions, are institutions likely to do so? Given the agency costs now associated with class actions and the large amount of potential damages one

---

264. *See* *Gottlieb v. Barry*, 43 F.3d 474, 488–89 (10th Cir. 1993) (reversing district court’s decision denying award of fee to attorneys who first filed class action, prosecuted action for 16 months, but were not named lead counsel when class was certified and remanding with instructions to award fee). Appointing as lead counsel the attorney selected by the “most adequate” plaintiff and providing early notice to investors with potentially large claims should largely moot the need for secondary participation through intervention and objection. Other class members with large claims will have meaningfully waived their opportunity to participate and, in any event, should have fewer doubts about whether their interests are being represented adequately.

265. *See supra* note 255.

266. We are not aware of any class action, conducted in the name of a figurehead plaintiff, in which defendants have attempted to take discovery from other members of the plaintiff class. Thus, deferring discovery on reliance as we suggest would not deprive defendants of rights they now exercise. Moreover, except in the rare case in which defendants have reason to believe an institution was trading on the basis of inside information, defendants’ pursuit of nonreliance claims amounts to little more than a “defendants strike suit.” *See supra* text accompanying notes 122–28.

267. *See* FED. R. CIV. P. 26(c).

or more institutions have at stake in almost every class action, one might assume that institutions will be sure to step forward. We do not.

Procedural obstacles no doubt have discouraged institutional investors from participating actively in class actions, but procedural obstacles alone almost certainly do not explain institutions' passivity. The absence of any demand by institutions for procedural changes itself suggests that institutions have been content to remain passive. One can view the history of institutional investor involvement in other corporate governance issues as supporting the same conclusion. As Robert Pozen, general counsel of Fidelity Investments, recently noted, not many institutions have elected to become more than "reluctant activists."<sup>268</sup>

As concerns class actions, though, the factors that have impeded institutional activism on other corporate governance issues are largely irrelevant. When dealing with other governance issues, institutions are limited largely to acting through the corporate electoral process.<sup>269</sup> They must deal with (a) collective action problems that make it difficult for them to prevail; (b) free-rider problems that have similar effects; (c) concerns relating to pressure from clients and, in the case of multibusiness institutions, customers; (d) potential securities law liabilities; and (e) lack of access to corporations' proxy statements.<sup>270</sup>

The dynamics of institutional investor activism with regard to class actions would differ dramatically. An institution interested in becoming lead plaintiff in a class action in which it had a large financial stake would not need the support or cooperation of any other institution. Collective action and free-rider issues thus would be irrelevant. So would concerns relating to securities law liabilities and access to corporate proxy statements. Were courts to adopt practices designed to encourage institutional investors to become lead plaintiffs, only concerns about client and customer pressure would remain.

Those concerns are not inconsequential; indeed, they may account for much of institutional investors' past passivity. But they should be much less of a constraint with respect to participation in class actions than they are with

---

268. Robert Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.-Feb. 1994, at 140.

269. Some institutions have tried to influence corporate managers through "quiet negotiations." See James A. White, *Giant California Pension Fund Softens Approach to Influencing Corporations*, WALL ST. J., Oct. 7, 1991, at C9. At least one, CalPERS, has concluded that corporate managers are likely to take it seriously only when it adopts a more confrontational strategy. See Susan Pulliam, *Calpers Goes Over CEOs' Heads in Its Quest for Higher Returns*, WALL ST. J., Jan. 22, 1993, at C1.

270. See Alfred F. Conard, *Fiduciary Obligation of the Asset Manager*, in PROXY VOTING OF PENSION PLAN EQUITY SECURITIES 86, 104 (Dan M. McGill ed., 1989). See generally John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (arguing that regulations should encourage institutional monitoring); John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 851-52 (1994) [hereinafter Coffee, *Report*]; Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991) (discussing collective action problems and agency costs in institutional shareholder activism).

respect to other governance issues.<sup>271</sup> The important point again is that an institution interested in becoming lead plaintiff in a class action would not need other institutions' support or cooperation. If a handful of institutions decided they were interested in serving as lead plaintiffs in class actions in which they had substantial claims, other institutions' passivity would enhance, not limit, the prospect that they would succeed.<sup>272</sup> Consequently, class actions could prove to be a particularly attractive forum for activism by public pension funds and other institutions that have demonstrated a willingness to assume a disproportionately large share of the costs of activism on other corporate governance issues.<sup>273</sup>

Institutions that have the largest stakes in class actions also are likely to conclude that they could realize disproportionately large benefits by becoming lead plaintiffs. In general, institutional investors are more inclined to become active on corporate governance issues where they can improve their comparative performance.<sup>274</sup> If an institution is the largest member of a plaintiff class, its losses due to the defendants' alleged fraud generally will be larger than those of other institutions; the institution then will stand to gain

---

271. In conversations and correspondence with the authors, some plaintiffs' lawyers have disagreed. One commented: "I do not believe your article adequately takes into account the difficult position with which many—perhaps most—institutional investors are faced. They typically have a close relationship with public companies and with investment bankers . . . [and] generally do not want to be perceived as hostile to corporate management." Letter from Edward Labaton to Elliott Weiss, *supra* note 118, at 3–4.

272. The dynamic would be much the same as that which discourages individual shareholders (or their attorneys) from waging proxy contests while encouraging them to initiate shareholder derivative suits. See Elliott J. Weiss, *Disclosure and Corporate Accountability*, 34 BUS. LAW. 575, 586 (1979).

273. A number of institutions signaled an interest in becoming more involved in class actions during the time this Article was in preparation. Perhaps most significant, the Council of Institutional Investors circulated a request for proposals (RFP) asking private law firms to suggest terms on which they would be prepared to represent the Council and its members in screening and participating in class action litigation. COUNCIL OF INSTITUTIONAL INVESTORS, REQUEST FOR PROPOSAL, SECURITIES LITIGATION COUNSEL (submissions due March 10, 1995). The RFP solicits "suggestions and proposals as to how [the Council] or its members might play a more constructive and active role in the litigation process as a litigation monitor/lead plaintiff or otherwise." *Id.* at 1. It notes that as fiduciaries, Council members "have a duty to evaluate litigation to the extent it is necessary and prudent to rectify injury suffered by the pension funds we manage." *Id.* The Council expressed an interest in "speeding the dismissal process of nonmeritorious cases or . . . achieving higher awards in meritorious cases." *Id.*; see also Donovan, *supra* note 235, at A6–A7.

In addition, on February 22, 1995, Professor Joseph Grundfest, acting on behalf of CalPERS, CREF, Stanford Management Company, and Wells Fargo Institutional Trust Company, sent a 23-page package of material to plaintiff and defense counsel in class and derivative actions that had been brought against Intel Corporation, relating to announced problems with Intel's "Pentium" microprocessor. The material argued that neither action had merit and that both should be dismissed. Letter from Joseph Grundfest, Professor of Law, Stanford Law School, to plaintiff and defense counsel (Feb. 22, 1995) (on file with authors). Both actions were voluntarily dismissed by plaintiffs' counsel. See Walsh, *supra* note 235, at 3. See generally Coffee, *Report*, *supra* note 270, at 869–71 (discussing other circumstances in which institutions might play leadership roles).

274. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2063–64 (1994) (discussing how institutional investors are inclined to become active on governance issues affecting corporations in which they have larger than average investments and to be passive on governance issues affecting corporations in which they have smaller than average investments).

comparatively more from a larger settlement than will other institutions.<sup>275</sup> The prospect of such an improvement in comparative performance might well lead some institutional investors to seek to become lead plaintiffs in those class actions in which they have the largest stake.

Consideration of their fiduciary obligations also may lead many institutional investors to decide that they should seek to serve as lead plaintiff whenever they are eligible to do so.

#### A. *Fiduciary Obligations*

When speaking of fiduciary obligations, it is useful to distinguish between institutional investors and their managers. It is the managers of institutional investors, not the institutions themselves, that are fiduciaries. If the procedural changes we propose are implemented, managers of institutions that are the largest members of plaintiff classes are likely to find themselves in a somewhat uncomfortable position. Instead, when such actions are initiated, the institution probably will be approached by one or more plaintiffs' attorneys seeking to enlist it to become lead plaintiff. If the institution's managers decide not to act, they will need to make a specific decision to that effect. Such acts of commission are more likely to give rise to concerns about possible liabilities than are acts of omission, such as institutions' current practice of passively depending on the efforts of attorneys representing figurehead plaintiffs.

Managers of most institutional investors are subject to the stringent fiduciary rules applicable to trusts; managers of others are governed by the somewhat more relaxed fiduciary standards applicable to corporations. Nevertheless, while courts in general "are much more reluctant to intervene in the management of a corporation than in the operation of a trust,"<sup>276</sup> it seems likely that courts will follow the same approach when reviewing the litigation-related decisions of managers both of institutional investors formally subject to trust law and of those, such as mutual funds and insurance companies, governed by corporate law.<sup>277</sup>

---

275. This might not always be the case. An institution could be the largest member of a plaintiff class and still have a smaller portion of its portfolio invested in that security than most other institutions involved in a class action. However, given the large percentage of the plaintiff class typically represented by the largest claimant, this scenario appears unlikely.

276. David Hughes, *Trust Principles and the Operation of a Trust-Controlled Corporation*, 30 U. TORONTO L.J. 151, 151 (1980).

277. In fact, much of the relevant case law dealing with a trustee's duty to bring suit is based on *General Rubber Co. v. Benedict*, 109 N.E. 96 (N.Y. 1915), a decision dealing with the fiduciary obligations of a corporate director. See *infra* text accompanying notes 288-95.

### 1. *Trustee's Duty of Care*

The Restatement, *Trusts*,<sup>278</sup> sets forth the basic principles governing a fiduciary's obligations to pursue claims that a trust has the right to assert.<sup>279</sup> In general, a fiduciary is responsible for investing and managing a trust's funds "as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust."<sup>280</sup> The fiduciary's duties apply "not only in making investments but also in monitoring and reviewing investments"<sup>281</sup> and "in keeping informed of rights and opportunities associated with those investments."<sup>282</sup>

The Restatement provides that a fiduciary must "keep informed of the bundle of rights and privileges associated with particular investments and make a deliberate judgment as to the exercise—or nonexercise—of those rights and privileges."<sup>283</sup> A fiduciary has a right to initiate and participate in litigation on behalf of the trust. A fiduciary has a duty to "take reasonable steps to realize on claims" that are the property of the trust, including claims in tort,<sup>284</sup> but should do so only when she believes that the probable benefit to the trust will exceed the costs the trust reasonably can expect to incur.<sup>285</sup> On the other hand, a fiduciary "cannot properly abandon claims affecting the trust property unless it reasonably appears that a suit would be futile or the expense of litigation or the character of the claim would make it reasonable not to bring suit."<sup>286</sup> A fiduciary also has the power to compromise on a claim of the trust that she has asserted where such action is reasonable.<sup>287</sup>

The case law relating to a fiduciary's duty to bring suit to protect a trust's interest in corporate stock is sparse. In large part, it builds on Judge Cardozo's

278. By "Restatement, *Trusts*," we mean RESTATEMENT (SECOND) OF TRUSTS (1959) as superseded in part by RESTATEMENT (THIRD) OF TRUSTS (1992).

279. A person responsible for managing an institution's investments is a "fiduciary" for the institution, to which we refer in this section as the "trust." The Restatement uses the term "trustee" rather than "fiduciary." Neither the Restatement nor any of the leading treatises on trust law or the law governing institutional investors discusses in any detail fiduciaries' obligations relating to litigation.

280. RESTATEMENT (THIRD) OF TRUSTS § 227 (1992) (Prudent Investor Rule).

281. *Id.* cmt. b.

282. *Id.* cmt. d. A trustee who possesses a greater than ordinary degree of skill or who "procured appointment as trustee by expressly or impliedly representing that it possessed greater skill than that of an individual of ordinary intelligence, . . . is liable for a loss that results from failure to make reasonably diligent use of that skill." *Id.*

283. *Id.* Reporter's Note cmt d (quoting A.A. Sommer, Jr. et al., *Corporate Social Responsibility Panel: The Role of the SEC*, 28 BUS. LAW. 215, 219 (Special Issue Mar. 1973) (remarks of Bevis Longstreth)).

284. RESTATEMENT (SECOND) OF TRUSTS § 177 (1959).

285. *Id.* cmt. c; see also *id.* § 192 cmt. a (citation omitted):

The [manager] has a power as well as a duty to take such steps as are reasonable to realize on claims which are a part of the [institution's] property. If the only reasonable step under the circumstances would be to bring suit to enforce the claims, he has a duty to bring such suit.

286. RESTATEMENT (SECOND) OF TRUSTS § 192 cmt. c (1959).

287. *Id.* cmt. a.

opinion in *General Rubber Co. v. Benedict*,<sup>288</sup> a decision dealing with the analogous obligations of a corporate director. A parent corporation alleged that one of its directors knew funds were being stolen from one of its wholly owned subsidiaries, failed to apprise the parent of the theft, and should be held liable to the parent for the loss it incurred in the value of that subsidiary.

Cardozo noted that while the claim was by a corporation against one of its directors, "the legal problem would be the same if the plaintiff were a natural person, and the defendant an executor or trustee . . . [or] if the plaintiff, instead of being substantially the sole stockholder, were one stockholder among many."<sup>289</sup> He held that the defendant director owed the parent corporation a duty to take "the same care of its property that men of average prudence take of their own property."<sup>290</sup> More specifically, the director's duty was to inform the parent of what he knew so that, in its role as a shareholder, the parent could initiate remedial action.

Relying on *Benedict*, the New York Court of Appeals held in *In re Auditore's Will*<sup>291</sup> that a trustee was liable for failing to stop, or promptly remedy, a misappropriation of funds from a corporation fifty percent owned by a trust. *In re Greenberg's Estate* reached the same conclusion, holding a trustee liable for his "negligent failure to prosecute enforceable rights" that the trust had as a corporate shareholder.<sup>292</sup> *In re Davidson's Estate*<sup>293</sup> applied similar reasoning to allow a trust beneficiary to pursue a claim against a trustee for failing to assert the trust's right to challenge an unfair transaction involving a corporation in which the trust was a minority shareholder.

These post-*Benedict* cases all involved claims against fiduciaries who had been involved in, or benefited from, the transactions that injured the corporation in which the trust held stock.<sup>294</sup> However, the Minnesota Supreme Court recently relied on the same principle to hold that the beneficiaries of a trust could maintain a suit against the trustees for failing to bring suit against persons who had fraudulently, through misrepresentations, purchased stock from the trust.<sup>295</sup> It thus seems clear that a fiduciary has a duty to sue one whose fraud or misrepresentations cause a trust to incur a loss in connection with its purchase or sale of corporate stock.

On the other hand, while a fiduciary must "take all reasonable steps to realize claims held in trust," she need not act where it appears likely that a suit

---

288. 109 N.E. 96 (N.Y. 1915) (Cardozo, J.).

289. *Id.* at 97.

290. *Id.*

291. 164 N.E. 242 (N.Y. 1928).

292. 267 N.Y.S. 384, 387 (Sur. Ct. 1933).

293. 89 N.Y.S.2d 221 (Sur. Ct. 1949).

294. See also *O'Hayer v. St. Aubin*, 293 N.Y.S.2d 147 (App. Div. 1968).

295. *Uselman v. Uselman*, 464 N.W.2d 130 (Minn. 1990). The court characterized the claim the trustees should have brought as derivative in nature. *Id.* at 137-38. On the facts given, however, it appears that the claim actually could have been brought as a direct claim by the trust.

will fail or that the expenses involved in bringing suit will be disproportionate to any recovery the trust is likely to realize.<sup>296</sup> Absent self-dealing, which insures close judicial scrutiny,<sup>297</sup> it is unclear what approach courts will employ to review decisions by fiduciaries not to sue. Some authority indicates that courts will give considerable deference to such decisions;<sup>298</sup> other authority indicates that they may review such decisions de novo and surcharge fiduciaries who they conclude have acted imprudently.<sup>299</sup>

The standard under the Employee Retirement Income Security Act (ERISA)<sup>300</sup> is much the same as that established by common law.<sup>301</sup> ERISA § 404(a)(1) defines a pension fund manager's duties as follows:

[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims . . . .<sup>302</sup>

The principal difference between this standard and the common law appears to be ERISA's reference to "a prudent man acting in a like capacity and familiar with such matters," which seems to require an ERISA fiduciary to possess a level of expertise greater than that of the "ordinary prudent investor." However, the Restatement imposes a similar requirement on a fiduciary who possesses a greater-than-ordinary degree of skill or who obtained appointment as a fiduciary by holding herself out as possessing a greater-than-ordinary

296. *Richards v. Midkiff*, 396 P.2d 49 (Haw. 1964); *see also Bullis v. DuPage Trust Co.*, 391 N.E.2d 227, 231 (Ill. App. Ct. 1979); *Estate of Stetson*, 345 A.2d 679 (Pa. 1975).

297. *See infra* text accompanying notes 314–23.

298. *See In re Sackler*, 596 N.Y.S.2d 837 (App. Div. 1993) (declining to interfere with trustee's decision not to initiate litigation); *cf. Kosty v. Lewis*, 319 F.2d 744 (D.C. Cir. 1963) (administration of trust subject to correction only if trustee's actions are arbitrary and capricious), *cert. denied*, 375 U.S. 964 (1964); *In re Estate of Geffen*, 202 N.Y.S.2d 599 (Sur. Ct. 1960) (refusing to order trustee to discontinue lawsuit because "court may not interfere with the exercise of judgment and discretion on the part of a fiduciary"). Moreover, if the fiduciary negligently fails to bring a claim on behalf of a trust, or is not reasonably prudent in compromising or settling a claim, she still can avoid liability by proving that the trust would have incurred the loss in any event. *See Seven G Ranching Co. v. Stewart Title & Trust of Tucson*, 627 P.2d 1088 (Ariz. Ct. App. 1981).

299. *In re San Juan Hotel Corp.*, 71 B.R. 413 (D.P.R. 1987) (surcharging trustee who wrote off collectible accounts and failed to investigate misappropriation of trust property of corporation, of which he had notice, for losses caused to trust), *aff'd in part and rev'd in part*, 847 F.2d 931 (1988) (acknowledging that trustee can be held liable for improper write-offs but finding that no such situation arose in case at bar); RESTATEMENT (THIRD) OF TRUSTS § 205(b) (1992); *see In re Bank of New York*, 323 N.E.2d 700 (N.Y. 1974) (surcharging trustee for loss on investment deemed imprudent); *see also Stark v. United States Trust Co.*, 445 F. Supp. 670 (S.D.N.Y. 1978) (analyzing investments individually, but holding none was imprudent); *Chase v. Pevear*, 419 N.E.2d 1358 (Mass. 1981) (same); *In re Newhoff*, 486 N.Y.S.2d 956 (App. Div.) (same), *appeal denied*, 489 N.E.2d 1302 (1985).

300. Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001–1461 (1988).

301. *See Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110 (1989).

302. 29 U.S.C. § 1104(a)(1).

degree of skill.<sup>303</sup> Most managers of institutional investors will possess such skill or will have obtained appointment by holding themselves out as having such skill.

An ERISA fiduciary's duties include the "duty to take reasonable steps to realize on claims held in trust." In *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*,<sup>304</sup> the Supreme Court traced this duty to the common law trustee's duty to preserve and maintain trust assets.<sup>305</sup> This duty includes the obligation to pursue minority shareholder claims.<sup>306</sup>

*Canale v. Yegen*<sup>307</sup> involved a fiduciary who had defrauded a corporation owned by an employee stock ownership plan (ESOP). The court held that it was the fiduciary's failure to initiate a derivative suit against himself, not his misappropriation of corporate funds, that constituted a breach of his duty to the ESOP:

[W]here plan fiduciaries can be charged with knowledge of fraudulent actions undertaken by an entity in which the plan has invested; and a reasonably prudent person acting in a like capacity would conclude that those fraudulent acts threaten to impair and diminish the value of the plan's investment; and the plan administrator has a personal interest in the accomplishment of those fraudulent acts; and the plan administrator conceals the fact that those acts have occurred; and he or she fails to protect the plan's assets from loss or dissipation resulting from the fraud perpetrated by or on the entity in which it has invested, then the administrator will be liable, under ERISA, for breach of his or her fiduciary duties . . . .<sup>308</sup>

Similarly, *Martin v. Feilen*<sup>309</sup> upheld claims against fiduciaries of an ESOP for failing to initiate a derivative suit challenging the misappropriation of a corporate opportunity by a corporation's principal shareholders and certain transactions that a successor controlling shareholder effectuated for its sole or primary benefit.

*Canale* and *Martin* both involved claims against fiduciaries of ESOPs, but nothing in those decisions suggests that fiduciaries of other ERISA plans do

303. See *supra* note 282 and accompanying text. See generally Jane Kheel Stanley, *The Definition of a Fiduciary Under ERISA: Basic Principles*, 27 REAL PROP., PROB. & TR. J. 237 (1992) (discussing applicable standards for defining fiduciary).

304. 472 U.S. 559 (1985).

305. See *id.* at 559-60; *Donovan v. Bryans*, 566 F. Supp. 1258, 1262 (E.D. Pa. 1983); see also *Nedd v. United Mine Workers*, 556 F.2d 190, 197 (3d Cir. 1977), *cert. denied*, 434 U.S. 1013 (1978) (where "trustee [of a union pension fund] may sue" to collect delinquent obligations to the funds and "wrongfully fails to do so, the beneficiary may sue the trustee as well as the party or parties the trustee failed to sue").

306. *Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan Enters.*, 793 F.2d 1456, 1468-69 (5th Cir. 1986), *cert. denied*, 479 U.S. 1034, and *cert. denied*, 479 U.S. 1089 (1987).

307. 782 F. Supp. 963 (D.N.J. 1992).

308. *Id.* at 969.

309. 965 F.2d 660, 667-68 (8th Cir. 1992), *cert. denied*, 113 S. Ct. 979 (1993).



not have the same obligations. Under ERISA, as at common law, a fiduciary has a duty to consider initiating a suit where she becomes aware that the trust has a valid claim in connection with trust property. The kinds of claims typically asserted by class action plaintiffs—FOM, liability under § 11 and § 12(2) of the 1933 Act, and unfair treatment of corporate shareholders—all would seem to qualify.

As is the case under common law, an ERISA trustee also must make a judgment as to whether a trust is likely to benefit by prosecuting such a claim.<sup>310</sup> Her decision will be “judged under the circumstances that existed at the time the decision was made.”<sup>311</sup> Even if an ERISA trustee acts imprudently, she will not be held liable unless it can be proven that a decision to initiate, or not to initiate, litigation caused the plan to incur a loss.<sup>312</sup> But an ERISA trustee who deals imprudently with the question of whether to initiate litigation—for example, by devoting no thought to that question—could be subjected to an appropriate equitable remedy, which might include removal from office.<sup>313</sup>

As applied to class actions, these principles imply that the manager of an institutional investor (including a pension fund subject to ERISA), on being informed of the pendency of a class action or the possibility of initiating such an action, first has a duty to determine whether the action appears to have merit and is likely to result in a substantial recovery for the institution. If it does, the manager then should consider whether the benefit the institution is likely to realize from serving as lead plaintiff exceeds the probable cost to the institution of such service. If the manager’s decision is tainted by self-interest, a court probably will not allow the manager much room to maneuver in making this cost-benefit determination.

## 2. *Trustee’s Duty of Loyalty*

An institutional manager’s decision to participate in class action litigation may cause the manager to incur litigation-related costs for which she has no right to reimbursement under her management contract or which will jeopardize her competitive position.<sup>314</sup> Such a decision also may cause the manager to incur the displeasure of clients or customers. The presence of either of these factors could cause a court to impose on the manager the burden of

---

310. See *McMahon v. McDowell*, 794 F.2d 100, 110 (3d Cir.), *cert. denied*, 479 U.S. 971 (1986).

311. *Roth v. Sawyer-Cleator Lumber Co. Employee Stock Ownership Plan*, 805 F. Supp. 1475, 1482 (D. Minn. 1992), *rev’d on other grounds*, 16 F.3d 915 (8th Cir. 1994).

312. See, e.g., *Brock v. Robbins*, 830 F.2d 640, 647 (7th Cir. 1987).

313. See *id.* at 647–48 (holding trustee who approved contract without appropriate study could be subjected to appropriate equitable remedies, even though inattention caused fund no financial loss).

314. See *Black & Coffee*, *supra* note 274, at 2057; *Coffee, Report*, *supra* note 270, at 863–64.

demonstrating that her decision not to participate in a class action advances the trust's interests.

*In re Estate of Rothko*<sup>315</sup> held that where a trustee might realize reputational or career benefits from a decision, a sufficient conflict of interest existed to invoke the duty of loyalty. The case law under ERISA is to similar effect. In any situation in which an ERISA trustee arguably will benefit from her decision not to initiate litigation, a court is likely to scrutinize that decision considerably more closely than it would a comparable decision by a disinterested trustee. ERISA § 404(a) requires an ERISA trustee to act solely in the interests of a fund's beneficiaries and for their exclusive benefit.<sup>316</sup>

*Leigh v. Engle* interpreted this charge to require an ERISA trustee, in a situation where a potential conflict of interest exists, to pursue one of two alternatives. If the potential for conflict is substantial, the trustee "may need to step aside, at least temporarily, from the management of assets [in question]."<sup>317</sup> Where the potential for conflict is less substantial, but "[w]here it might be possible to question the fiduciaries' loyalty, they are obliged at a minimum to engage in an intensive and scrupulous independent investigation of their options to insure that they act in the best interests of the plan beneficiaries."<sup>318</sup> Because the trustees in the case "undertook no genuinely independent investigation of the trust's investment options" before making an investment involving a possible conflict of interest, the *Leigh* court reversed a decision exculpating those trustees from liability for losses the trust incurred on the investment in question.<sup>319</sup>

No subsequent decision has considered how this principle applies to a trustee's failure to initiate or participate in a class action, but two courts have applied that principle to decisions involving how a pension plan should vote

---

315. 372 N.E.2d 291 (N.Y. 1977).

316. Some courts have held that a trustee's duties to a class, were it to become the lead plaintiff in a class action, might conflict with the trustee's fiduciary duties. *See, e.g.,* *First Interstate Bank v. Chapman & Cutler*, 837 F.2d 775, 781–82 (7th Cir. 1988) (finding that bank's obligations to class if it were approved as representative would conflict with bank's duty as administrator to act for benefit of estate); *Norman v. Arcs Equities Corp.*, 72 F.R.D. 502, 504 (S.D.N.Y. 1976) (holding ERISA § 1104 precludes ERISA plan payment of costs associated with class action, except to extent they benefit plan's beneficiaries). Other courts have rejected this line of argument. *See, e.g.,* *Kreuzfeld A.G. v. Carnehammar*, 138 F.R.D. 594, 600 (S.D. Fla. 1991) (finding that trustee not rendered incapable of acting as class representative so long as other prerequisites for certification met); *In re Pizza Time Theatre Sec. Litig.*, 112 F.R.D. 15, 22 (N.D. Cal. 1986) (holding that not all beneficiaries of plan had to agree in order for trust to act as class representative). Any apparent conflict between an institution's fiduciary duties to its beneficiaries and a class representative's fiduciary duties to class members is illusory, at least if plaintiffs' attorneys are prepared to advance expenses for institutional investors as they now do for figurehead plaintiffs. Moreover, courts have not interpreted ERISA to preclude a plan from taking actions that incidentally benefit third parties. *See, e.g.,* *Trenton v. Scott Paper Co.*, 832 F.2d 806, 809 (3d Cir. 1987), *cert. denied*, 485 U.S. 1022 (1988); *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982). Thus, these concerns should not lead courts to hold that institutional investors are not adequate class representatives.

317. 727 F.2d 113, 125 (7th Cir. 1984). The court based its analysis in large part on *Donovan v. Bierwirth*, 680 F.2d at 271–72.

318. 727 F.2d at 125–26.

319. *Id.* at 129.

stock. In *O'Neill v. Davis*,<sup>320</sup> the court refused to dismiss a challenge to the ESOP trustees' decision to vote the approximately ninety percent of a company's stock the ESOP owned in support of a plan to reconstitute the company's board because it furthered the trustees' interests, not the interests of plan participants. The court held that "the voting of Plan-owned shares by the Plan's trustees was a fiduciary act under ERISA, and one which the trustees were bound to exercise in the sole interests of the Plan participants."<sup>321</sup> It therefore denied the trustees' motion to dismiss plaintiff's complaint.

*Newton v. Van Otterloo*<sup>322</sup> extended this principle. Plaintiffs challenged a decision by ESOP trustees to abstain from voting the ESOP's stock at an annual meeting of South Bend Lathe, Inc. (SBL). Because SBL's chief executive owned almost all the remaining stock, the trustees' decision was tantamount to voting to reelect management's candidates to the board and to adopt a provision staggering the terms of SBL's directors. Plaintiffs, relying on *Leigh v. Engle*, charged that the trustees violated their fiduciary duties because as officers of SBL the trustees had a substantial conflict of interest.

The court first held that the *Leigh* analysis governed its evaluation of the trustees' decisions on how to vote the ESOP's stock. Then it concluded that although the trustees' conflict of interest was not so great as to require them to delegate to others the voting decision, the trustees "at best, [had] divided loyalties with respect to decisions on how to vote the ESOP's shares."<sup>323</sup> Because the trustees had not engaged in a suitably "intensive and scrupulous independent investigation of their options," the court entered judgment against them.

The results reached in *Newton v. Van Otterloo* and *O'Neill v. Davis* are consistent with the position the Department of Labor has taken on the responsibility of ERISA trustees to vote plan stock and otherwise manage plan assets. Secretary William Brock stated in 1986:

With regard to corporate governance, plan fiduciaries cannot be passive shareholders. Specifically, proxy votes that may effect the economic value of plan investments unquestionably involve the exercise of fiduciary responsibility. Those votes must be cast in a way that a fiduciary believes will maximize the economic value of plan holdings.<sup>324</sup>

---

320. 721 F. Supp. 1013 (N.D. Ill. 1989).

321. *Id.* at 1015.

322. 756 F. Supp. 1121 (N.D. Ind. 1991).

323. *Id.* at 1128.

324. William Brock, Remarks at the Annual Meeting of the Association of Private Pension and Welfare Plans (1986), quoted in Norman Stein, *Trust Law and Pension Plans*, in PROXY VOTING OF PENSION PLAN EQUITY SECURITIES, *supra* note 270, at 45.

In what is generally referred to as the "Avon letter," the Department took the position that voting corporate stock was a fiduciary act governed by § 404(a)(1).<sup>325</sup> The Department recently reaffirmed that an investment manager whose responsibilities include voting plan-owned stock has a fiduciary duty to determine how that stock should be voted and should not take voting instructions from any other person.<sup>326</sup> The Department also advised that an investment manager's fiduciary responsibility to manage plan assets extends beyond proxy voting to "active monitoring and communication with corporate management . . . where the responsible fiduciary concludes that there is a reasonable expectation that such activities by the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved."<sup>327</sup>

All this has obvious implications for an ERISA trustee's decisions concerning whether to initiate a class action on behalf of a plan or to become a lead plaintiff. A trustee should make such a decision on her own and on the merits; she should not follow the instructions of other persons. Moreover, where a trustee has conflicting interests with respect to a decision to initiate or become involved in a class action, how she should proceed depends on the extent of the conflict. If it is serious, the trustee must delegate to others decisions on how to proceed; if it is minor, the trustee must engage in "intensive and scrupulous independent investigation of [her] options to insure that [she] act[s] in the best interests of the plan beneficiaries."

### B. *Balancing Costs and Benefits*

Almost never will an institutional investor's decision whether to get involved in a class action determine whether that action is brought. Absent institutional participation, plaintiffs' attorneys no doubt will continue to rely on figurehead plaintiffs to initiate class actions that they believe have merit. Thus, the choice for institutional investors will be whether to become more active participants in class actions or to continue to remain passive in class actions brought in the name of figurehead plaintiffs. Three factors are likely to influence the choices institutional investors make: how much better results they would be likely to achieve, were they to begin serving as lead plaintiffs; what costs they would be likely to incur to achieve such results; and what threats of liability institutions would face were they to remain passive.

---

325. See Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. 38,860, 38,860-61 (1994).

326. See *id.* at 38,861.

327. *Id.* at 38,862. The Department stated that the same standard would apply whether a plan pursued a strategy of actively managing investments or of buying and holding an "index fund" portfolio. *Id.* at 38,862 n.6.

### 1. *The Potential Benefits of Institutional Activism*

We are confident that institutional investors could realize substantial benefits by serving as lead plaintiffs in class actions. Courts, commentators, and many institutional investors agree that excessive agency costs currently infect class actions. The standard strategy for reducing agency costs is to find the mechanism that best aligns the agent's interests with those of the principal.<sup>328</sup> Rule 23 attempts to do this by requiring courts to approve settlements and award attorneys' fees.

Institutions with the largest stakes in class actions are better situated than plaintiffs' attorneys or courts to protect class members' interests.<sup>329</sup> Those institutions' interests parallel the interests of the plaintiff class much more closely than do the interests of plaintiffs' attorneys or district judges, the parties now responsible for protecting the class.<sup>330</sup> Moreover, the size of those institutions' stakes suggests they are likely to be reasonably diligent in seeking to ensure that plaintiffs' counsel represent effectively their interests and the interests of the plaintiff class.

The largest benefit of institutional supervision of class actions is likely to be settlement terms that are more favorable to the plaintiff class, on average, than those now negotiated by essentially unsupervised plaintiffs' attorneys.<sup>331</sup> *Arsam Co. v. Salomon Bros.*<sup>332</sup> suggests the kind of benefits institutional lead

---

328. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 9-11 (1991).

329. Recall that the largest claimant's allowable loss averages 13.1% of all class members' losses and often amounts to several million dollars. The second largest claimant's allowable loss is about two-thirds as large. Almost all these claimants are institutional investors. See *supra* text accompanying notes 200-02.

330. The greatest disparity between an institutional plaintiff's interests and those of class members is likely to be in a situation where subclasses of plaintiffs have potentially competing interests. See, e.g., *In re Seagate Technology II Sec. Litig.*, 843 F. Supp. 1341, 1367 (N.D. Cal. 1994) ("Because of the potential for conflicts created by the fraud-on-the-market theory and the out-of-pocket damages, the adequacy of representation cannot be ascertained without examining the composition of the class."). While institutional plaintiffs (or their attorneys) may be tempted to structure settlements to favor subclasses in which those institutions have the largest stake, the potential conflicts involved in such situations are much more transparent than those involved in class actions currently, and thus are much more amenable to effective judicial oversight. For example, courts could appoint different lead plaintiffs to represent different subclasses. That might represent a marked improvement over the current situation, where self-appointed plaintiffs' attorneys often find themselves making Solomonian judgments concerning how a settlement fund should be divided among subclasses of plaintiffs. For example, counsel for the plaintiff class in *Trief v. Dun & Bradstreet Corp.* agreed to a settlement that limited recovery to class members who had incurred an economic loss on their investments. 840 F. Supp. 277, 281 n.1 (S.D.N.Y. 1993). Substantial authority indicates that defrauded investors are entitled to recover the difference between the value of what they paid and the value of what they received. See, e.g., *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971). In *Dun & Bradstreet*, class counsel justified his decision to allocate the settlement fund in this fashion as a more equitable distribution of a limited fund. Letter from Edward Labaton to Elliott Weiss, *supra* note 118, at 2.

331. In addition, it seems highly unlikely that attorneys representing an institutional plaintiff would propose a settlement including a reliance provision or that an institutional plaintiff would agree to such a provision.

332. *In re Revco Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,809 (N.D. Ohio Sept. 14, 1993).

plaintiffs might produce. Arsam had purchased \$1 million in high-yield notes issued to finance a leveraged buyout of Revco. Salomon Brothers had underwritten the notes and sold them primarily to institutional investors. Shortly after the leveraged buyout, Revco was bankrupt. Arsam, which lost \$514,000 of its investment, became lead plaintiff in a class action against Salomon Brothers and others.

After two and a half years of litigation, Salomon Brothers settled for \$29,750,000. The court characterized the benefits to the class from this partial settlement as "enormous" and granted Arsam an incentive award of \$200,000.<sup>333</sup> A year after the settlement, other defendants settled for an additional \$6,235,000 and the court awarded Arsam a supplemental incentive award of \$90,000.<sup>334</sup>

At the second settlement hearing, class counsel described Arsam's participation as lead plaintiff as follows:

Mr. Phelan [a senior executive of Arsam] was the one that monitored the case for the first three years. Mr. Phelan . . . , until his retirement in August of 1992, read every single paper and pleading in this case. If something didn't get to him on time, he was on the phone calling me or [one of my associates] up to say "Where is this paper? I want to read it." He often contributed his . . . input and closely supervised class counsel. He really performed in an admirable role.

. . . .  
I think this was a labor of princip[le] as well as money for them because they felt that Solomon [sic] Brothers primarily and others did wrong in this case, and they were willing to commence a class action.<sup>335</sup>

If institutions were to adopt a systemic perspective when they negotiate fee arrangements, they also might be able to discourage their lawyers from pursuing strike suits. Strike suits can result in modest recoveries for members of the plaintiff class, but they also impose substantial costs directly on defendant corporations and indirectly on those corporations' shareholders.<sup>336</sup> Consequently, an investor with a diversified portfolio, viewing such suits *ex ante*, would want to discourage them.

An institutional investor might be able to achieve that result by agreeing to pay class counsel only a nominal fee if counsel proposes to settle the case for less than an amount approximating defendants' estimated defense costs. Such a fee arrangement should discourage counsel from exploiting the most

333. *Id.*

334. *In re Revco Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,810 (N.D. Ohio Sept. 14, 1993).

335. *Id.*

336. Strike suits also impede rather than advance the policies underlying the federal securities laws. See *supra* text accompanying notes 133-37.

common strike suit situation—one in which plaintiff files an apparently meritorious complaint and then learns, through discovery, that the action lacks merit.<sup>337</sup> If such a fee arrangement did not prove to be an effective deterrent, more effective fee arrangements might well evolve over time.

Institutions also might decide that they, and investors generally, would be better off if fewer class actions were settled.<sup>338</sup> Adjudication serves two distinct purposes: dispute resolution and rulemaking.<sup>339</sup> Settlements resolve disputes but do nothing to clarify substantive law. The substantive issues courts address when ruling on pretrial motions in class actions—materiality and scienter—involve mixed questions of fact and law. A decision not to dismiss a complaint or to deny a motion for summary judgment provides little guidance as to the court's view of the governing substantive standard. It only tells the parties—and the world—that the allegations in the complaint or the evidence produced by plaintiff are sufficient to raise an issue of fact as to whether certain information is material or certain defendants acted with scienter. Uncertainty abounds.<sup>340</sup>

“[F]rom a social viewpoint, trials are a mechanism . . . for interpreting and creating laws to regulate and govern society.”<sup>341</sup> There is a public, or systemic benefit to having courts reach decisions on the merits, because they serve to clarify for all participants in the system how courts will interpret the rules applicable to their conduct. Reducing uncertainty reduces transaction costs. Clarifying the rules governing corporations' disclosure responsibilities should reduce corporations' costs. Institutional investors would be prime beneficiaries because they hold widely diversified portfolios; what benefits corporations also benefits them. Realizing that, institutions acting as lead plaintiffs might well decide that more actions should be tried on the merits. They could then negotiate fee arrangements with their attorneys that took account of that possibility.<sup>342</sup>

---

337. Such a fee arrangement would give class counsel an incentive to press for a settlement above the threshold amount, but defendants presumably would refuse, preferring to incur the lower cost of litigating a case that they feel confident of winning. *See supra* note 173.

338. This also would reflect concern about the systemic impact of class actions.

339. Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067, 1070 (1989); *cf.* Owen Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1085 (1984).

340. *See* JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 62 (1991) (“Determining what is material is a normative judgment having the same level of precision as determining what the reasonable person would do under the circumstances.”); *id.* at 739 (discussing ambiguities in the cases defining scienter).

341. Cooter & Rubinfeld, *supra* note 339, at 1070.

342. An attorney working on a contingent fee basis faces a greater risk if she knows her client is likely to want her to take a case to trial. We assume that the fee arrangements that institutions work out with their attorneys would reflect those added risks in some appropriate fashion.

## 2. *The Potential Costs*

The litigation-related costs an institutional investor that becomes a lead plaintiff is likely to incur should exceed only modestly the costs it would bear as a passive member of the plaintiff class. We assume that attorneys will be prepared to represent institutional lead plaintiffs on a contingent fee basis and to advance litigation costs as plaintiffs' attorneys now do for nominal plaintiffs.<sup>343</sup>

The incremental costs an institutional plaintiff is likely to incur relate to monitoring and to discovery.<sup>344</sup> The cost of monitoring lead counsel should be modest. If the process for appointing lead counsel is modified as we suggest, attorneys interested in representing institutional plaintiffs in class actions will recognize that to compete successfully for clients, they will need to enhance and protect their reputations as investors' "faithful champions." That will align their interests more closely with the interests of class members, which, in turn, will mitigate considerably the burden of monitoring how they prosecute class actions. Detailed monitoring of the kind involved in *Arsam* should not often be necessary.

Similarly, institutions' incremental costs relating to discovery should not be too large. The relevant attorneys' fees could be covered, as they now are, by the fee arrangements institutions make with the lawyers they select to represent the class.<sup>345</sup> Institutions will incur other costs; their personnel will spend time locating and producing documents, preparing for depositions, and the like. But, as *Arsam* illustrates, courts grant expenses and incentive awards to plaintiffs in some class actions.<sup>346</sup> We see no reason why they would not do the same for institutional plaintiffs.

---

343. A plaintiffs' lawyer can advance expenses to a client with repayment contingent on the outcome of the litigation. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(e)(1) (1989). Kirchoff v. Flynn, 786 F.2d 320, 325-26 (7th Cir. 1986), explains the circumstances in which a contingency fee arrangement optimally aligns the interests of lawyer and client. Securities class actions are one such group of cases. Of course, in any given case an institution might conclude that its interests and the interests of the plaintiff class would be better protected by alternative fee arrangements.

344. We assume that institutions would avoid foolish actions such as those involved in *Anita Found., Inc. v. ILGWU Nat'l Retirement Fund*, 902 F.2d 185 (2d Cir. 1990). There, a pension fund attempted to reopen a settlement it had reached with defendant on the point at issue. The courts ordered the fund to pay defendants' attorneys' fees for having initiated such frivolous litigation.

345. That is, plaintiffs' attorneys presumably would continue to represent lead plaintiffs during discovery as part of their contingency fee arrangement.

346. See, e.g., *In re Revco Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,809 (N.D. Ohio Sept. 14, 1993); *In re Surgical Laser Technologies, Inc. Sec. Litig.*, Civ. A. No. 91-2478, 1992 WL 328809, at \*3 (E.D. Pa. Oct. 30, 1992); *Enterprise Energy Corp. v. Columbia Gas Transmission Corp.*, 137 F.R.D. 240, 250-51 (S.D. Ohio 1991); *In re VMS Ltd. Partnership Sec. Litig.*, No. 90 C 2412, 1991 U.S. Dist. LEXIS 9624, at \*10-11 (N.D. Ill. July 15, 1991); *In re Dun & Bradstreet Credit Servs. Customer Litig.*, 130 F.R.D. 366, 373-74 (S.D. Ohio 1990); *In re Smithkline Beckman Corp. Sec. Litig.*, 751 F. Supp. 525, 534-35 (E.D. Pa. 1990).



### 3. *Concerns About Liability for Breach of Fiduciary Duty*

It seems almost certain that institutional investors would realize substantial net benefit by serving as lead plaintiffs in class actions, if courts were to implement the procedural changes we propose. Institutions are likely to incur only minor costs, which could be offset by court-awarded incentive fees in cases where institutional plaintiffs' efforts contribute to substantial recoveries.

Whether institutions would act remains an open question. Some institutions may have remained passive in the past because they shared the widely held but mistaken belief that neither they nor other members of plaintiff classes have stakes in class actions large enough to justify becoming involved.<sup>347</sup> With timely information about class actions in which they have large stakes, they might well decide that a more activist strategy would better advance their interests, especially with respect to the two or three class actions a year in which any given institution is likely to be the largest claimant.<sup>348</sup>

Many institutional investors, however, are likely to change course only if continued passivity subjects them to some threat of liability. The procedural changes we propose, if implemented by the courts and acted upon by plaintiffs' lawyers, should lead to creation of at least a modest threat.

Institutional investors now can justify remaining passive with respect to class actions affecting their rights by pointing out that they are unaware of the pendency of such suits or that seeking to become actively involved in cases already under way is likely to be an expensive and ultimately futile proposition. But if courts create the procedural environment we propose, institutions will no longer be able to rely on that line of argument. With respect to class actions in which they have the largest stake of any class member, plaintiffs' attorneys are likely to confront institutions with requests that they become lead plaintiffs. Institutions then will have to make, and may well feel the need to document, explicit decisions concerning whether or not to get involved. Absent some valid grounds on which to base decisions to remain passive, risk-averse institutions may well conclude that applying to be named class representative is the safest course.

Two developments could increase the pressure on institutions.<sup>349</sup> First, courts could hold that an institution's decision not to serve as lead plaintiff

---

347. For example, the General Counsel of SWIB, which has been quite active on other corporate governance issues, recently wrote, "There is typically no plaintiff with a large enough interest to provide the guidance of a real client and counterbalance the interests of plaintiffs' counsel." Letter from Kurt N. Schacht to Sen. Pete V. Dominici, *supra* note 235, at 2. Yet SWIB had large stakes in several class actions in one recent year, including the largest stake in at least one action, Rykoff-Sexton. *See supra* text accompanying note 207.

348. *See supra* note 273.

349. Changes in institutional investors' processes are most likely to occur when external pressures are brought to bear on fiduciaries. *Cf.* BEVIS LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 21* (1986).

violated its duty of care or, more likely, its duty of loyalty.<sup>350</sup> Second, the Department of Labor could issue guidance to ERISA fiduciaries concerning their responsibilities with respect to class actions similar in tone to the guidance the Department recently issued relating to proxy voting and other corporate governance issues.<sup>351</sup> Faced with such guidance, institutions would be likely to devote significant resources to reviewing and/or participating in class action litigation, as they now do with respect to proxy voting.

### VIII. CONCLUSION

Class actions under the federal securities laws have been a prominent feature of the American legal landscape for more than three decades. Originally conceived as a necessary supplement to the SEC's efforts to deter securities fraud,<sup>352</sup> class actions also have become the principal vehicle for compensating investors injured by securities fraud.

In recent years, the belief has grown that the primary function served by class actions is not the protection of investors but the enrichment of plaintiffs' attorneys who initiate and then prosecute such suits, without meaningful client supervision and primarily to advance their own interests. Current congressional reform proposals are directed at the problem of legitimacy posed by such litigation. Bills now pending in Congress would require courts hearing class actions to appoint a guardian *ad litem* or plaintiff steering committee for the class; would limit the number of class action complaints that "professional" plaintiffs can file annually; and would disqualify as class action plaintiffs investors with only trivial amounts at stake.<sup>353</sup>

These reform measures attempt to ensure that plaintiffs' attorneys do a better job of representing class members' interests, and to restore to class actions the legitimacy that many people believe they now lack. The reforms proposed in this Article would do a better job of restoring legitimacy to class actions. By changing their practices relating to selection of lead counsel, notice, and discovery by defendants, courts could make it much easier for institutional investors to serve as class representatives. Those investors have the knowledge and financial sophistication necessary to serve as effective litigation monitors. Their stake in the outcome of class actions would give them an incentive to do that job well. Suits brought or controlled by major

---

350. For example, a court might conclude that an institutional investor's manager faced a conflict of interest because the manager did not have a clear right to be reimbursed for any incremental costs the manager might incur by serving as a lead plaintiff, and that the manager had not carried the burden of proving that her decision to remain passive was in the best interests of the institution. See *supra* text accompanying notes 316–23.

351. See *supra* text accompanying notes 325–27.

352. See *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

353. See H.R. 10, 104th Cong., 1st Sess. §§ 202, 203 (1995); *Securities Litigation Reform Topic of Separate House, Senate Legislation*, *supra* note 6.

financial institutions, we believe, would be perceived as much more legitimate than suits brought in the name of figurehead plaintiffs.

The possibility that institutions will seek to serve as lead plaintiffs could be further enhanced by judicial decisions or Department of Labor pronouncements clarifying that those who manage institutional investors have a fiduciary responsibility to give serious consideration to serving as class representatives in cases where they are eligible to do so.

The first steps, however, must be taken by the courts. A federal district judge acting *sua sponte* in some given class action could adopt the practices we propose relating to selection of lead counsel, notice, and discovery by defendants, much as Judge Walker did when he auctioned off the lead plaintiff position in *Oracle*. Institutional investors or the SEC could move to have courts implement these practices in a pending case. A judicial task force or an appellate court could implement these practices on a circuit-wide or national basis. Whatever the mechanism by which these changes are made, we believe they will bear substantial fruit. The time has come for the courts to act.

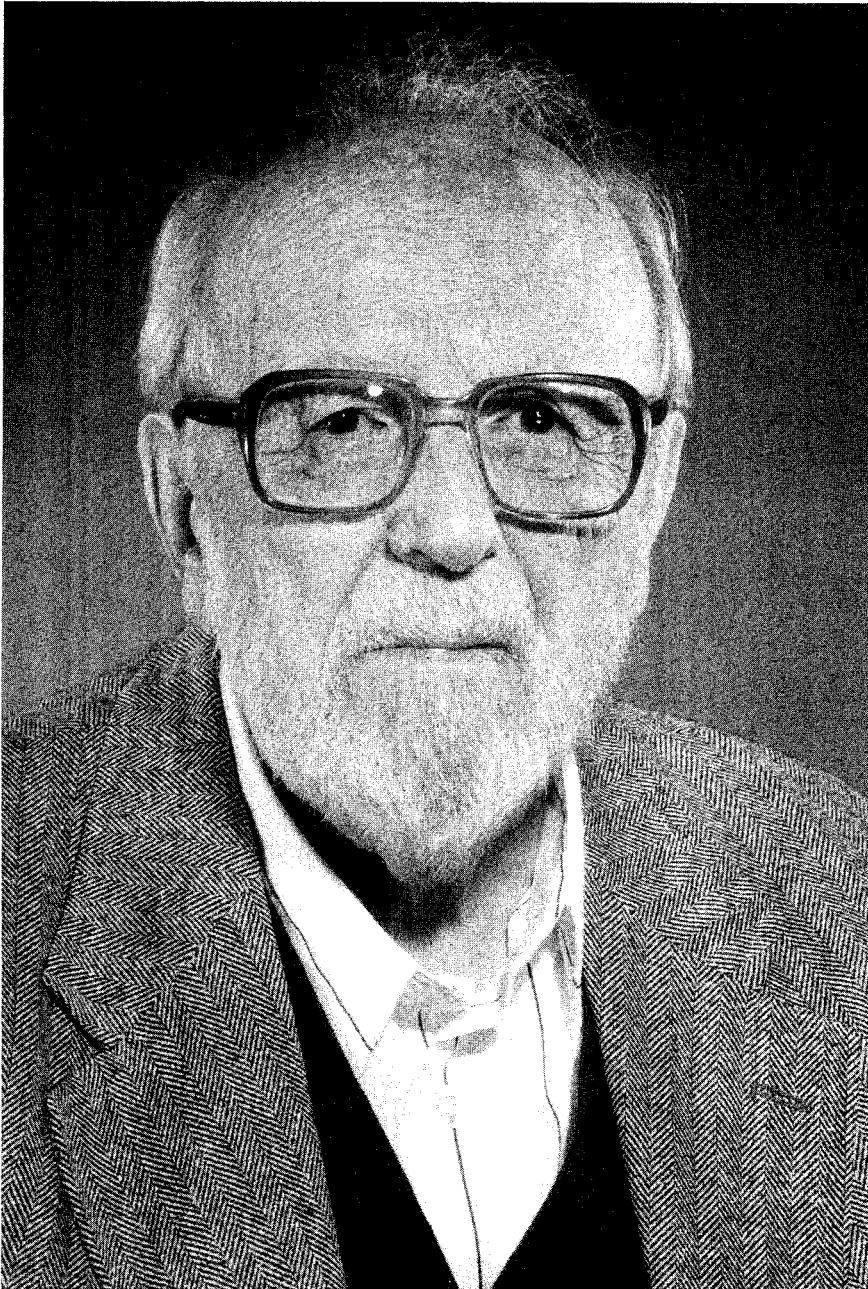


Photo by Ed Kirwan Graphic Arts.