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# The Plight of the Individual Investor in Securities Class Actions

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## THE PLIGHT OF THE INDIVIDUAL INVESTOR IN SECURITIES CLASS ACTIONS

*David H. Webber*

**ABSTRACT**—Individual investors victimized by securities fraud have no voice in directing class actions brought on their behalf once institutional investors obtain lead plaintiff appointments. The same holds for state-level transactional class actions claiming breaches of fiduciary duty by boards of directors in connection with mergers and acquisitions. In theory, the interests of institutional and individual investors align, nullifying the need for a separate voice for individuals; one rationale for the lead plaintiff modifications of the Private Securities Litigation Reform Act of 1995 was that individuals would benefit from the sophistication of institutional investor lead plaintiffs. But in practice, individual investors' interests in these actions often differ from, and may directly conflict with, those of institutional lead plaintiffs. The routine appointment of institutional lead plaintiffs without regard to these conflicts effectively elevates the interests of institutional over individual investors, running afoul of procedural requirements that lead plaintiffs be typical and adequate class representatives. This Article examines the recurrent conflicts between these two groups of investors and suggests that the best remedy is for courts to appoint representative individual investors as co-lead plaintiffs with institutional investors. This Article proposes a procedure for selecting such individual co-lead plaintiffs from the pool of sophisticated individuals who are likely to be class members.

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INTRODUCTION

Individual investors victimized by securities fraud have no voice in directing class actions brought on their behalf once institutional investors obtain lead plaintiff appointments. The same holds for state-level transactional class actions claiming breaches of fiduciary duty by boards of directors in connection with mergers and acquisitions. Advocates for the status quo, and those who see no reason to change it, justify this marginalization of individual investors by institutional ones in three ways. First, institutional and individual investors share the same deterrent and compensatory interests in class actions; therefore, in representing their own interests, institutional investors represent those of individuals too. Second, the superior legal and financial acumen of institutional investors makes them more motivated and sophisticated monitors of class counsel than individual investors.<sup>1</sup> Third, individual investors are “at best uninformed, at

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<sup>1</sup> See *In re Cendant Corp. Litig.*, 264 F.3d 201, 266, 273–74 (3d Cir. 2001) (“[T]he goal of the Reform Act’s lead plaintiff provision is to locate a person or entity whose sophistication and interest in

worst fools,”<sup>2</sup> whose interests are best looked after by institutions.<sup>3</sup> In this Article, I challenge all three of these assertions. I argue that institutional and individual investors do not always share the same interests in litigation, that individual investors can be highly motivated lead plaintiffs, and that there is substantial evidence in the finance literature suggesting that at least a subset of such investors are sophisticated and consistently outperform institutions.<sup>4</sup>

This is not to deny the fact that institutional investors have brought numerous benefits to federal securities class actions since passage of the Private Securities Litigation Reform Act (PSLRA) in 1995. Such benefits include decreasing the probability of a case being dismissed, increasing monetary recoveries, and improving the independence of boards at defendant companies.<sup>5</sup> Some of these benefits have carried over to state-level transactional cases since Delaware imported the PSLRA’s preference for institutional investor lead plaintiffs into its law.<sup>6</sup> For example, in a separate empirical project, I found that institutional lead plaintiffs challenge poorer quality deals than do individual investors and that some institutional lead plaintiffs—notably public pension funds—correlate with improved outcomes for shareholders.<sup>7</sup> Without ignoring those benefits, this Article argues that troubling conflicts of interest between institutional and

the litigation are sufficient to permit that person or entity to function as an active agent for the class . . .” (citing H.R. REP. NO. 104-369, at 32 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 731 and S. REP. NO. 104-98, at 10 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 689); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2126 (1995) (“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.”).

<sup>2</sup> Joshua D. Coval, David A. Hirshleifer & Tyler Shumway, *Can Individual Investors Beat the Market?* 6 (Harvard Univ. Sch. of Fin., Working Paper No. 04-025, 2005), *available at* <http://ssrn.com/abstract=364000>.

<sup>3</sup> See S. REP. NO. 104-98, at 11 & n.34 (noting that settlements negotiated under the supervision of institutional plaintiffs will be more “fair and reasonable” than other settlements (quoting Weiss & Beckerman, *supra* note 1, at 2105)).

<sup>4</sup> See discussion *infra* Part III.

<sup>5</sup> E.g., C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. ECON. 356, 380–81 (2009); James D. Cox et al., *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1636–39 (2006) (finding that institutional investors “increase settlements by 0.04% for every 1% increase in Provable Losses”); Michael A. Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* 24, 30–31 (St. John’s Univ. Sch. of Law, Legal Studies Research Paper No. 06-0055, 2006), *available at* <http://ssrn.com/abstract=938722> (finding that cases with public-pension-fund lead plaintiffs settle for greater amounts than cases with individual lead plaintiffs).

<sup>6</sup> E.g., *TCW Tech. Ltd. P’ship v. Intermedia Commc’ns, Inc.*, No. 18336, 2000 WL 1654504, at \*4 (Del. Ch. Oct. 17, 2000) (establishing standard for selection of lead plaintiffs favoring institutional investors similar to PSLRA).

<sup>7</sup> David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Litigation* 22–24, 34–36 (July 5, 2011) (unpublished manuscript), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1879647](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1879647).

individual investors strongly suggest that institutions are often not typical and adequate representatives for the shareholder class as they are required to be by the PSLRA, Federal Rule of Civil Procedure 23 (Rule 23), and Rule 23's state-law equivalents.<sup>8</sup> As discussed below, the typicality and adequacy of lead plaintiffs is crucial to the legitimacy of class actions, justifying adjudication of the rights of absent parties by assuring that these parties' interests have been adequately represented by lead plaintiffs who share them.<sup>9</sup>

In the sixteen years since passage of the PSLRA, several conflicts have emerged between institutional and individual investors. Institutions' frequent use of derivatives trading, their inability to sell their substantial stakes in the defendant even after a fraud is revealed for fear of further harming the share price,<sup>10</sup> their implicit willingness to exchange monetary compensation for corporate governance reform,<sup>11</sup> and, in the transactional context, their occasional ownership of both target and bidder companies give them litigation incentives that at times clash with those of individual investors. In practice, as will be shown below, courts have disregarded these conflicts in continuing to appoint institutional lead plaintiffs. This typicality and adequacy problem is compounded by the fact that courts scarcely address it when selecting a lead plaintiff, instead reserving the inquiry for the class certification stage, by which time the case may already have been settled by the potentially atypical and inadequate class representative.<sup>12</sup> Addressing the problem at this later stage increases costs to the class, either by imposing a new lead plaintiff in midstream and jeopardizing a settlement or, more likely, by not imposing a new lead plaintiff and accepting a settlement negotiated by a party of questionable representativeness.

By elucidating these clashes, this Article makes an early contribution to the emerging literature on shareholder conflicts with other minority

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<sup>8</sup> 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2006); FED. R. CIV. P. 23(a)(3)-(4); *see, e.g.*, MD. R. CIV. P. 2-231; MASS. R. CIV. P. 23.

<sup>9</sup> *See* discussion *infra* Part III.A (discussing Rule 23's typicality and adequacy requirements); *see also* SAMUEL ISSACHAROFF, CIVIL PROCEDURE 80-83 (Found. Press 2d ed. 2008) (discussing Rule 23's requirement of adequacy of representation in class action lawsuits).

<sup>10</sup> *See, e.g., In re Cendant Corp. Litig.*, 264 F.3d 201, 244 (3d Cir. 2001) ("[A]n institutional investor with enormous stakes in a company is highly unlikely to divest all of its holdings in that company, even after a securities class action is filed in which it is a class member."); *In re Royal Dutch/Shell Transp. Sec. Litig.*, 404 F. Supp. 2d 605, 611 (D.N.J. 2005) ("[B]ecause of the very size of an institutional investor's shareholdings, an institutional investor might be discouraged from divesting itself of the stock.")

<sup>11</sup> *See, e.g., Cendant*, 264 F.3d at 219, 246-47 (noting objector's grievance that the lead plaintiff negotiated a settlement including corporate governance changes that would only benefit class members that continued to hold Cendant stock after revelation of the fraud).

<sup>12</sup> *See, e.g., The PSLRA and Securities Class Actions*, BOLOGNESE-LAW.COM, [http://www.bolognese-law.com/PSLRA\\_and\\_Securities.html](http://www.bolognese-law.com/PSLRA_and_Securities.html) (last visited Mar. 24, 2012) (noting the existence of "pre-certification settlement negotiations" by lead plaintiffs).

shareholders,<sup>13</sup> diverging from corporate and securities law's traditional preoccupation with conflicts between minority and majority shareholders or between shareholders and management.<sup>14</sup> In an age of increasing shareholder democracy, such conflicts will proliferate and intensify. This Article breaks new ground by addressing these conflicts in the context of securities class actions.<sup>15</sup>

While the primary purpose of this Article is to address this typicality and adequacy problem, it also presents an opportunity to focus on a related issue in the selection of lead plaintiffs: the potential motivation gap between individual and institutional investors. The PSLRA makes whoever has the largest absolute financial interest in the fraud the presumptive lead plaintiff among applicants for the position.<sup>16</sup> The purpose of this provision is to favor selection of institutional investors who, because of their larger assets, are more widely and deeply invested in the markets and therefore are more likely to be exposed to fraud and to have the largest losses when they are so exposed.<sup>17</sup> Yet, the large absolute losses that qualify institutions for lead plaintiff appointments are frequently trivial relative to their overall assets.<sup>18</sup> In contrast, comparatively small losses incurred by individuals may constitute a far higher percentage of the individuals' assets, rendering the loss far more material to them than to institutions.<sup>19</sup> The high materiality of

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<sup>13</sup> See, e.g., Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 828–30 (2006) (discussing investors' use of empty voting to advance their own interests at the expense of fellow shareholders); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power* (U.C.L.A. Law & Econ. Research Paper Series, Research Paper No. 05-16, 2005), available at <http://ssrn.com/abstract=783044> (discussing several types of conflicts between shareholders).

<sup>14</sup> See, e.g., Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 739 (1997) (noting the importance of management, large shareholders, and individual shareholders to corporate governance).

<sup>15</sup> For simplicity, I use "securities class actions" to mean securities fraud class actions and state-level transactional class actions.

<sup>16</sup> 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2006).

<sup>17</sup> H.R. REP. NO. 104-369, at 34 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 733 (noting that Congress "intend[ed] that the lead plaintiff provision will encourage institutional investors to take a more active role in securities class action lawsuits"); S. REP. NO. 104-98, at 11 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 690 ("The Committee intends to increase the likelihood that institutional investors will serve as lead plaintiffs by requiring the court to presume that the member of the purported class with the largest financial stake in the relief sought is the 'most adequate plaintiff.'").

<sup>18</sup> See, e.g., *Armour v. Network Assocs., Inc.*, 171 F. Supp. 2d 1044, 1053 (N.D. Cal. 2001) ("If a prospective lead plaintiff shows it suffered the largest financial loss, that class member has sufficiently satisfied the second requirement of the lead plaintiff presumption, regardless of how that amount compares with the total damages in the case or the prospective lead plaintiff's total assets.>").

<sup>19</sup> See e.g., *In re Del Monte Foods Co. S'holders Litig.*, C.A. No. 6027-VCL, 2010 WL 5550677, at \*6–7 (Del. Ch. Dec. 31, 2010) (assessing lead plaintiff applicants' economic stakes in the lawsuit relative to their overall portfolios and expressing concern about the "rational apathy" of lead plaintiff applicants with large absolute stakes in the case, but for whom those stakes represent a negligible portion of their portfolios).

these losses may make an individual investor monitor class counsel more zealously than an institution.<sup>20</sup> Moreover, institutions incur agency costs that individual investors do not, partially inhibiting optimal monitoring.<sup>21</sup> This Article asserts that in addition to improving the typicality and adequacy of the lead plaintiff group, its proposed solution—the appointment of individual and institutional co-lead plaintiffs—has the potential to improve the motivation and sophistication of the group as well.

Appointment of qualified individuals as co-lead plaintiffs<sup>22</sup> with institutional investors offers a relatively undisruptive remedy to the typicality and adequacy problem. Utilizing a procedure that mirrors the current process of identifying the investor with the largest financial interest in the litigation, courts can assure selection of individual co-lead plaintiffs who are both sophisticated and highly motivated. Contrary to the caricature of individual investors as unsophisticated dupes,<sup>23</sup> a survey of the recent financial literature provides evidence that there are a substantial number of individual investors who are at least as sophisticated and arguably more motivated to serve as lead plaintiffs than institutional investors.<sup>24</sup> Such co-lead plaintiff individual investors would be screened for the conflicts described below and would owe the same fiduciary duties to the class that the institutional investor lead plaintiff does,<sup>25</sup> while serving as more natural advocates for individual investor class members and more motivated representatives for the class as a whole.

This Article argues that this solution not only ameliorates the typicality and adequacy problems but causes little disruption to the established rhythms of securities class action practice, allowing courts to continue deferring their “searching inquiry” from the lead plaintiff appointment stage to the class certification stage.<sup>26</sup> It will improve the overall motivation of the lead plaintiffs to maximize recovery for the class. It is calibrated to reduce conflicts without driving away institutional investor lead plaintiff

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<sup>20</sup> See discussion *infra* Part I.C.1.

<sup>21</sup> See, e.g., Kasper Meisner Nielsen, *Institutional Investors and Private Equity*, 12 REV. FIN. 185, 190–91 (2007) (discussing agency costs incurred by institutional investors when monitoring private equity).

<sup>22</sup> Throughout this Article, I use the term “co-lead plaintiff” when courts name more than one party as lead plaintiff.

<sup>23</sup> See Coval, Hirshleifer & Shumway, *supra* note 2, at 6.

<sup>24</sup> See discussion *infra* Part III.

<sup>25</sup> See generally *In re Milestone Scientific Sec. Litig.*, 187 F.R.D. 165, 176 (D.N.J. 1999) (stating that any lead plaintiff has significant duties).

<sup>26</sup> See e.g., *In re New Motor Vehicles Canadian Exp. Antitrust Litig.*, No. 07-2257, 2008 WL 820922, at \*26 (1st Cir. Mar. 28, 2008) (“[W]hen a Rule 23 requirement relies on a novel or complex theory as to injury, . . . the district court must engage in a searching inquiry into the viability of that theory and the existence of the facts necessary for the theory to succeed.”); see also Seth H. Yeager, *In re New Motor Vehicles Canadian Export Antitrust Litigation: Examining the Requisite Levels of Inquiry into the Merits of a Case at the Class Certification Stage*, 34 DEL. J. CORP. L. 563, 566–68 (2009) (noting that, when appropriate, courts conduct a searching inquiry at the class certification stage).

applicants. While it is true that institutional lead plaintiffs would have to adjust to operating with an individual co-lead plaintiff, this Article argues that the advantages of an individual co-lead outweigh the disadvantages, even from the institutional perspective. For example, individual co-lead plaintiffs will help insulate the settlement from individual investor objectors who appear at the settlement hearing to confront the court with the conflicts addressed in this Article.<sup>27</sup> This improved insulation results from the enhanced procedural protections for individual investors offered by the co-lead plaintiff structure, cohering with a primary objective of the securities laws<sup>28</sup> without inhibiting market integrity and efficiency.

An individual co-lead plaintiff can also help blunt defense arguments that the institutions have not been seriously harmed by the purported fraud and are instead engaging in political grandstanding, taking legal action for nonpecuniary reasons, or simply fronting for lawyers seeking to maximize their own compensation. As trial lawyers like to say, individuals will put a “human face” on the fraud.<sup>29</sup> Participation by individual investors at mediation sessions, settlement conferences, or court hearings will better reflect the actual costs of securities fraud, shifting these negotiations from confrontations between financial behemoths into confrontations between financial behemoths plus individuals devastated by the fraud. Institutional plaintiffs may also benefit from this dynamic. Under this Article’s proposal, the individual co-lead plaintiff would have been screened and selected by the court and would be an official member of the lead plaintiff group. He or she would be treated differently than most individual investors who may appear at such events, with or without lawyers. Such individuals are perceived to be annoying interlopers,<sup>30</sup> sometimes unfairly and sometimes not. Institutions can hardly complain if qualified and credible individual lead plaintiffs help push their settlements towards higher monetary compensation and more effective deterrence.

Finally, the co-lead plaintiff approach is superior to both the status quo and the more extreme remedy of dividing individual and institutional investors into subclasses, a cure that may be more harmful than the disease. Subclasses may be necessary in extreme cases in order to remedy otherwise-insoluble conflicts, safeguard the interests of individual investors, and preserve their bargaining power with class counsel, institutional co-lead

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<sup>27</sup> See discussion *infra* Part III.B.

<sup>28</sup> 141 CONG. REC. 35, 273–76 (1995) (statement of Sen. Pete Domenici) (stating the ways in which the PSLRA protects individual investors).

<sup>29</sup> See, e.g., Thomas G. Shapiro, *Trial of a Securities Class Action* (ALI-ABA Course of Study, June 17, 1994), WL C938 ALI-ABA 205, 208 (“From a strategic point of view, trial counsel may want to put a human face on the victims of the fraud, particularly if they are sympathetic.”).

<sup>30</sup> See, e.g., C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1137 (noting the disparate treatment of sophisticated and unsophisticated investors in securities class action suits).



plaintiffs, and defendants.<sup>31</sup> But because subclasses run afoul of Congress's intent that institutional investors be appointed lead plaintiffs, deprive individual investors of the sophistication of such institutional lead plaintiffs, and expose the subclasses to divide-and-conquer strategies by defendants, this Article concludes that the optimal solution to these intraclass conflicts is appointment of individual and institutional co-lead plaintiffs. Courts should only create subclasses as a last resort, preferably on motion from a co-lead plaintiff, not *sua sponte* to avoid unnecessary work for overburdened courts.

The Article proceeds as follows. Part I tracks the preference for institutional investor lead plaintiffs at both the federal and state levels. Part II surveys the recent finance literature on individual investors, suggesting that individual investors are not per se unsophisticated, as is commonly believed, and could be highly qualified monitors of class counsel, if selected skillfully. Part III explores the ways in which the interests of individual and institutional investors may be misaligned, including conflicts over derivatives trading and corporate governance reform, conflicts between selling and holding shareholders, and conflicts created by institutional ownership of both target and bidder companies in mergers and acquisitions. Part IV assesses possible solutions to these conflicts, including the use of subclasses, and ultimately concludes that the optimal solution is appointment of a sophisticated and motivated individual investor as a co-lead plaintiff with an institutional investor, reserving the creation of subclasses for extreme cases and preferably on motion from the individual co-lead plaintiff. Part IV also outlines the simple procedure by which such an individual lead plaintiff could be selected. A brief conclusion follows.

## I. FEDERAL AND STATE LAW'S PREFERENCE FOR INSTITUTIONAL INVESTOR LEAD PLAINTIFFS IN SECURITIES AND TRANSACTIONAL CLASS ACTIONS

### A. *The PSLRA Creates a Preference for Institutional Investor Lead Plaintiffs in Federal Securities Class Actions*

The PSLRA introduced a practice of favoring institutional investor lead plaintiffs in securities class actions.<sup>32</sup> In part, the purpose of this new practice was to remedy the high agency costs of class action plaintiffs' lawyers. Prior to the PSLRA, lead-plaintiff appointments for securities class actions were awarded to whichever plaintiff filed the first lawsuit.<sup>33</sup>

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<sup>31</sup> See discussion *infra* Part IV.B.

<sup>32</sup> S. REP. NO. 104-98, at 11 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 690 ("The Committee believes that increasing the role of institutional investors in class actions will ultimately benefit the class and assist the courts.").

<sup>33</sup> *Id.* at 11 ("Courts traditionally appoint the lead plaintiff and lead counsel in class action lawsuits on a 'first come, first serve' basis.").

Congress found that as a result of this race to the courthouse, plaintiffs' law firms maintained stables of "professional plaintiffs"—individual investors with very small financial stakes in a broad array of companies, as opposed to the individuals with concentrated losses proposed as co-lead plaintiffs in this Article.<sup>34</sup> When a stock fraud was revealed at one of these companies, the lawyers would quickly sue on behalf of one of their professional plaintiffs.<sup>35</sup> Such lead plaintiffs, with their minimal financial interest in the outcome of the case, had little incentive to actively monitor class counsel, allowing counsel to act primarily in its own interests rather than in those of the class, thus increasing agency costs for the class.<sup>36</sup>

Congress believed that these agency costs could be reduced if the lead plaintiff had a large enough stake in the outcome to be incentivized to monitor class counsel and if the lead plaintiff were sufficiently sophisticated to act skillfully on its incentive.<sup>37</sup> Hence the PSLRA's lead plaintiff provision creates a presumption that

the most adequate plaintiff in any private action arising under this chapter is the person or group of persons that . . . in the determination of the court, has the largest financial interest in the relief sought by the class; and . . . otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.<sup>38</sup>

This presumption may be rebutted "only upon proof by a member of the purported plaintiff class that the presumptively most adequate plaintiff . . . will not fairly and adequately protect the interests of the class; or . . . is subject to unique defenses that render such plaintiff incapable of adequately representing the class."<sup>39</sup> In adopting these provisions, Congress endeavored "to increase the likelihood that institutional investors will serve as lead plaintiffs."<sup>40</sup> Inspired by an argument originated by Elliott Weiss and John Beckerman in their article, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, Congress concluded that "[i]nstitutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus,

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<sup>34</sup> See *id.* at 9 (describing professional plaintiffs).

<sup>35</sup> Weiss & Beckerman, *supra* note 1, at 2060–61 (stating that "the usual pattern is for a lawyer who specializes in representing plaintiffs to take the initiative," and "plaintiffs' attorneys recruit most of the investors in whose names they initiate class actions").

<sup>36</sup> *Cf. id.* at 2056, 2061 & n.35 (noting that institutional investors have large stakes in most class actions and are well situated to monitor the conduct of plaintiffs' attorneys).

<sup>37</sup> S. REP. NO. 104-98, at 11 (intending to increase the likelihood that institutional investors be chosen as lead plaintiff); see also Weiss & Beckerman, *supra* note 1, at 2105 ("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>38</sup> 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (2006) (emphasis added).

<sup>39</sup> *Id.* § 78u-4(a)(3)(B)(iii)(I)–(II).

<sup>40</sup> S. REP. NO. 104-98, at 11.

courts could be more confident settlements negotiated under the supervision of institutional plaintiffs were ‘fair and reasonable’ than is the case with settlements negotiated by unsupervised plaintiffs’ attorneys.”<sup>41</sup> This strong language provides the federal courts with a mandate to place institutional plaintiffs at the head of class actions.

Rule 23 of the Rules of the Court of Chancery of the State of Delaware tracks the language of its federal counterpart and similarly requires typicality and adequacy in a lead plaintiff.<sup>42</sup> Subsequent to the PSLRA, Delaware courts adopted a similar requirement regarding the lead plaintiff’s financial stakes in securities class actions, with one critical difference. Delaware courts weigh the “relative economic stakes” of competing lead plaintiff movants in the outcome of the lawsuit,<sup>43</sup> which suggests the possibility that the lead plaintiff that has the most at stake relative to its own assets, and not on an absolute scale, could be appointed lead plaintiff.<sup>44</sup> Below, I will discuss this possibility further.

As Congress intended, federal courts have since interpreted the PSLRA’s “largest financial interest” clause to mean the largest absolute loss.<sup>45</sup> Thus, whichever individual or entity incurs the largest loss and moves for the position becomes the presumptive lead plaintiff. As predicted, institutional investors now lead over 40% of securities fraud class actions<sup>46</sup> and around 40% of transactional class actions in Delaware.<sup>47</sup>

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<sup>41</sup> See *id.* (quoting Weiss & Beckerman, *supra* note 1, at 2105) (internal quotation marks omitted).

<sup>42</sup> DEL. CH. CT. R. 23(a)(3)–(4), available at <http://courts.delaware.gov/forms/download.aspx?id=39138>.

<sup>43</sup> *Hirt v. U.S. Timberlands Serv. Co.*, No. CIV.A. 19575, 2002 WL1558342, at \*2 (Del. Ch. July 3, 2002) (citing *TCW Tech. Ltd. P’ship v. Intermedia Commc’ns, Inc.*, No. 18336, 2000 WL 1654504, at \*4 (Del. Ch. Oct. 17, 2000) and according “the relative economic stakes” of the competing litigants great weight); see also *Dutiel v. Tween Brands, Inc.*, No. 4743-CC, 2009 WL 3494626, at \*3 (Del. Ch. Oct. 28, 2009) (“[T]he motivating force behind the rulings in *TCW Tech.*, *Hirt*, and *Wiehl* [discussing ‘relative economic stakes’] is . . . the significance of an individual’s stake in the litigation and the resulting incentive the individual has to participate in the litigation and monitor his or her counsel.”).

<sup>44</sup> See *Dutiel*, 2009 WL 3494626, at \*3 (critiquing view of “relative economic stakes” language as calling for comparison of lead plaintiff applicants’ stakes relative to each other). This opinion is silent about the notion that relative economic stakes could refer to the applicants’ stakes in the case relative to their overall portfolios or assets, but favorably cites language in *Wiehl v. Eon Labs*, No. Civ.A. 1116-N, 2005 WL 696764, at \*1 (Del. Ch. Mar. 22, 2005) that is supportive of this view. See *infra* note 82.

<sup>45</sup> See, e.g., *Armour v. Network Assocs., Inc.*, 171 F. Supp. 2d 1044, 1053 (N.D. Cal. 2001) (“If a prospective lead plaintiff shows it suffered the largest financial loss, that class member has sufficiently satisfied the second requirement of the lead plaintiff presumption, regardless of how that amount compares with the total damages in the case or the prospective lead plaintiff’s total assets.”).

<sup>46</sup> See, e.g., *2003 Securities Litigation Study*, PWC SEC. LITIG. STUDY (PriceWaterhouseCoopers LLP, New York, N.Y.), 2004, at 6, available at [http://10b5.pwc.com/pdf/2003\\_study\\_final.pdf](http://10b5.pwc.com/pdf/2003_study_final.pdf) (“In 2002 institutional investors and public investment or pension funds comprised 51 percent of the lead plaintiffs for all cases filed. In 2003 these major investors represented 42 percent of the lead plaintiffs in cases filed.”).

Overall, the use of institutional investors as lead plaintiffs correlates with better outcomes for shareholders in securities class actions, although it remains disputed whether this is because they are better lead plaintiffs or because they cherry-pick the best cases.<sup>48</sup>

As a practical matter, many institutions interested in obtaining lead plaintiff appointments enter into portfolio-monitoring arrangements with plaintiffs' law firms.<sup>49</sup> The law firms directly access the investment portfolios of the institutions.<sup>50</sup> In many instances, the law firms will discover a potential fraud or a suspiciously unattractive deal and notify institutions with significant exposure that they may qualify for lead plaintiff status.<sup>51</sup> Once notified of the fraud or suspicious transaction, institutions typically issue a request for proposals to the firms monitoring their portfolios.<sup>52</sup> The proposals state the law firms' assessments of the strengths and weaknesses of the case, argue that the fund should or should not pursue it, and, of course, if the fund does pursue it, why it should select that firm as lead counsel.<sup>53</sup> Portfolio monitoring is a likely explanation for the fact that institutional investors obtain lower attorneys' fees for the class.<sup>54</sup> The institutions are ideally situated to force the firms to compete with one another, particularly on price.<sup>55</sup>

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<sup>47</sup> This statistic is based on a dataset I have collected and analyzed as part of a forthcoming empirical project on institutional investors as lead plaintiffs in Delaware class actions. Webber, *supra* note 7, at 7.

<sup>48</sup> See Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 341 (2008) (stating that "studies cannot determine the frequency with which funds participate actively," and thus, "it is possible that . . . funds simply cherry pick the stronger securities suits").

<sup>49</sup> William B. Rubenstein, *What We Now Know About How Lead Plaintiffs Select Lead Counsel (And Hence Who Gets Attorneys Fees!) in Securities Cases*, 3 CLASS ACTION ATT'Y FEE DIG. 219, 220 (2009).

<sup>50</sup> See, e.g., *Portfolio Monitoring Service*, MOTLEY RICE, <http://www.motleyrice.com/securities-and-consumer-fraud/portfolio-monitoring-service> (last visited Mar. 24, 2012) (advertising portfolio monitoring services).

<sup>51</sup> *Id.* at 219–20.

<sup>52</sup> See *id.* (stating that funds typically have a securities firm monitor their investments for irregularities); see also *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Sys., Inc.*, No. C 01-20418 JW, 2004 WL 5326262, at \*4 (N.D. Cal. May 27, 2004) ("Nothing about these [monitoring agreements] renders Carpenters inadequate as a class representative.").

<sup>53</sup> See Rubenstein, *supra* note 49, at 219 (describing requests for proposals).

<sup>54</sup> See *id.* at 220 (discussing *Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing & Securitization, LLC*, 616 F. Supp. 2d. 461, 466 (S.D.N.Y. 2009) (finding MissPERS's arrangement with twelve monitoring law firms to be permissible because of MissPERS's ability to play each firm off the other to lower fees)); see also Michael A. Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* 25, 30–31 (St. John's Legal Studies Research, Working Paper No. 06-0055, 2006), available at <http://ssrn.com/abstract=938722> (finding that the size of attorney fee requests and awards negatively correlate with public pension lead plaintiffs in securities class actions).

<sup>55</sup> See Rubenstein, *supra* note 49, at 220.

Despite these benefits to all plaintiffs, portfolio monitoring may also reflect a passive approach to the lead plaintiff role. The mere existence of the practice is indicative of a simple fact: even the large absolute losses that qualify institutions for lead plaintiff appointments may still be too small for the institutions to notice them without assistance. This will rarely, if ever, be true for the individuals proposed here as co-lead plaintiffs. It is one illustration of why the use of individual investors who suffer lower absolute losses but higher losses relative to their total assets may be a superior means of achieving Congress's objective: improving the lead plaintiff's motivation to monitor class counsel.<sup>56</sup>

Concern for individual investors coheres well with both traditional and more contemporary justifications for securities regulation and for private securities class actions specifically. The protection of individual investors has always been a core mission of securities regulation,<sup>57</sup> and recent research suggests that individual investors serve the market by improving share price accuracy.<sup>58</sup> Traditionally, the purpose of private securities class actions has been to deter fraud and to compensate shareholders.<sup>59</sup> In the past decade, academics and policymakers have debated vigorously whether such litigation in its current form successfully accomplishes either objective. The primary criticism of securities class actions is the purported "circularity problem."<sup>60</sup> Like most civil litigation, securities class actions are almost always either dismissed or settled.<sup>61</sup> These actions settle through payments made either directly by the issuer, by the issuer's directors and officers' liability insurers, or occasionally by underwriters and professionals (and their insurers).<sup>62</sup> In effect, the portion of the settlement paid by the issuer

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<sup>56</sup> Individuals' motivation and the phenomenon of portfolio monitoring are discussed further below in Part I.C.1.

<sup>57</sup> See, e.g., 141 CONG. REC. 35,291 (1995) (statement of Sen. Carol Moseley-Braun) (stating that the PSLRA "was designed to maintain strong investor protection").

<sup>58</sup> Alicia J. Davis, *Do Individual Investors Affect Share Price Accuracy? Some Preliminary Evidence I* (Univ. Mich. Empirical Legal Studies Ctr., Working Paper No. 07-018, 2010), available at <http://ssrn.com/abstract=998093> ("[C]ontrary to the received wisdom, retail trading increases share price accuracy." (emphasis omitted)).

<sup>59</sup> Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 704–06 (noting that "[t]he central aim of the securities laws is to deter fraud" and arguing that a rule of agent liability supplemented by criminal enforcement is more optimal than the current system of enterprise liability); see also Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 380–86 (2007) (discussing deterrence by private class actions and optimal investor compensation).

<sup>60</sup> Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 334 (describing the circularity problem as "private securities litigation [being] socially wasteful because it merely transfers funds from one set of shareholders to another").

<sup>61</sup> See Arlen & Carney, *supra* note 59, at 721 ("[G]enerally Fraud on the Market cases are either dismissed at a preliminary stage or settled.").

<sup>62</sup> See, e.g., Hillary A. Sale, *Judges Who Settle* 9–10 (Wash. Univ. in St. Louis Sch. of Law Legal Studies Research Paper Series, Research Paper No. 11-03-02, 2011), available at <http://papers.ssrn.com/>

constitutes a circular payment from current shareholders to class-period shareholders. If a class-period shareholder held at least some of its shares after the fraud, one could argue that in participating in a securities class action it is de facto shifting money from its left pocket to its right, minus an attorney's fee. There can be a similarly circular quality to payments made by publicly held underwriters and insurers, which may also be owned by diversified shareholders of the issuer. In the long run, the argument goes, a diversified shareholder will be as likely to pay into these settlements as it is to be compensated by them, netting out somewhere close to zero, minus attorneys' fees. But recent work suggests that diversified investors can be harmed by fraud.<sup>63</sup> One empirical study shows that numerous large, diversified institutional investors suffered substantial losses over a ten-year period from securities fraud.<sup>64</sup> Moreover, the entire market could suffer a discount if fraud increases, thus harming investors.<sup>65</sup>

Even if one concludes that diversified investors are not harmed by fraud, such investors should not necessarily be the focus of securities class actions because it is concentrated, informed investors who add unique value that is worthy of investor protection laws. For example, Jill Fisch notes that capital-market efficiency is promoted by informed traders.<sup>66</sup> Informed traders research and analyze firm-specific information and then act on that information by trading.<sup>67</sup> Such traders do the work of efficient markets that transparency alone cannot do—they incorporate public information into stock prices.<sup>68</sup> To make a profit, informed traders must obtain returns that

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sol3/papers.cfm?abstract\_id=1785618 (noting that settlements are paid in substantial part by corporate or insurer rather than individual payments).

<sup>63</sup> Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 225 (2007) (“All investors, including diversified investors, can suffer substantial injury from securities fraud.”); James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 341 (2009) (arguing that the entire market may suffer fraud discount if fraud increases, thus harming diversified investors).

<sup>64</sup> Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 230 (2007) (citing ANJAN V. THAKOR ET AL., *THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION* 12 (2005), available at <http://www.instituteforlegalreform.com/doc/the-economic-reality-of-securities-class-action-litigation>).

<sup>65</sup> James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 341 (2009) (arguing that the entire market may suffer fraud discount if fraud increases, thus harming diversified investors).

<sup>66</sup> See Fisch, *supra* note 60, at 347 (“[I]nformed traders are a critical component of the market that enables mandated disclosure to serve as a corporate-governance mechanism.”). For additional responses to the circularity problem, see Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297; Lawrence E. Mitchell, *The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243; and Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

<sup>67</sup> Fisch, *supra* note 60, at 347.

<sup>68</sup> See *id.* at 346–47.

exceed the costs of research and analysis.<sup>69</sup> Therefore, they adopt undiversified (or concentrated) investment strategies.<sup>70</sup>

In contrast, diversified investors seek “a market rate of return by eliminating firm-specific risk” (and reward).<sup>71</sup> Perfectly diversified investors reduce to zero their incentives to engage in costly information gathering and analysis. While such passive diversified investing may be rational from the perspective of a particular investor, taken to an extreme it can be problematic for the market overall.<sup>72</sup> Such investors freeloading off of the market efficiency created by informed traders without compensating these traders for the costs of their research.<sup>73</sup>

Because informed traders concentrate their risks and trade on information, they are likely to be net losers from fraud.<sup>74</sup> Thus, securities fraud class actions compensate concentrated investors at the expense of insurance companies, underwriters, and diversified investors.<sup>75</sup> Class actions constitute a form of insurance provided by diversified investors to informed traders in compensation for the positive externality of efficiency generated by these informed traders.<sup>76</sup>

This rationale for securities class actions also supports the proposition that they should be led by at least one undiversified lead plaintiff, a role that would easily be inhabited here by an individual co-lead plaintiff. As is described further below, individual investors tend to be concentrated investors and if subjected to the screening process advocated in Part IV.A they will likely also be informed traders. In contrast, the large institutional investors that obtain lead plaintiff appointments tend to be more diversified than most investors; in fact, some of them are required to be diversified.<sup>77</sup> One need not embrace the view that concentrated, informed traders should

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<sup>69</sup> *Id.* at 346 (“[F]or an investor to benefit from firm-specific research, the potential profit from that research must exceed the costs of research and analysis.”).

<sup>70</sup> *See, e.g.,* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1069–70 (2007) (“Hedge funds, in contrast, do not see themselves as vehicles for diversification; they engage in targeted hedges, rather than diversification, to eliminate unwanted risk. More narrowly tailored strategies—such as activism—are thus more appropriate for hedge funds than for mutual funds.” (footnote omitted)); *see also* Fisch, *supra* note 60, at 346–47 (“Thus, informed trading requires investors to limit their diversification and concentrate their holdings in a limited number of issuers.”).

<sup>71</sup> Fisch, *supra* note 60, at 346 (“The objective of diversification is to achieve a market rate of return by eliminating firm-specific risk.”).

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 347.

<sup>74</sup> *Id.*

<sup>75</sup> *See id.*

<sup>76</sup> *See id.* at 347–48.

<sup>77</sup> *See, e.g.,* Craig C. Martin & Matthew H. Metcalf, *The Fiduciary Duties of Institutional Investors in Securities Litigation*, 56 BUS. LAW. 1381, 1404–05 (2001) (stating that institutional investors such as pension plans have affirmative duties under ERISA, such as diversifying the plan’s investments to decrease the risk of losses).

be the focus of securities class actions to recognize that, at a minimum, adding an undiversified voice to the lead plaintiff group will make it more representative of the class of fraud victims.

*B. Delaware Adopts a Lead Plaintiff Selection Process  
Modeled on the PSLRA*

In *Hirt v. United States Timberlands Service Co.*,<sup>78</sup> the Delaware Chancery Court settled upon criteria for selecting lead plaintiffs modeled on the PSLRA procedure and Delaware's own *TCW Technology Ltd. Partnership v. Intermedia Communications, Inc.*<sup>79</sup> But in contrast to federal courts' congressional mandate to favor lead plaintiffs with the largest absolute loss, Delaware's "relative economic stakes" language has opened the possibility for selection of a lead plaintiff with the largest loss relative to its own assets. In *Wiehl v. Eon Labs*, Vice Chancellor Lamb encountered a dispute between competing lead plaintiffs over who should represent the class of shareholders.<sup>80</sup> In so doing, he rejected the PSLRA approach of appointing the lead plaintiff with the largest absolute loss. "If every difference in economic stakes were given great weight, the court could simply add up the number of shares and select the law firm with the largest absolute representation. This is not Delaware law."<sup>81</sup> Vice Chancellor Lamb then compared the relative stakes of the competing plaintiffs, who held 57,000 shares, 38,000 shares, and 1000 shares, respectively, noting that "[o]ne supposes that this investment [of 1000 shares] is of some significance to Huntsinger, an individual investor, and would cause him to monitor his counsels' conduct of the litigation."<sup>82</sup>

More recently, in selecting lead plaintiffs and lead counsel in *In re Del Monte Foods Co. Shareholders Litigation*, Vice Chancellor Laster noted the size of lead-plaintiff applicants' losses relative to their overall assets under management in selecting a lead plaintiff that had a smaller absolute but larger relative loss.<sup>83</sup> This Article seeks to build on the principle suggested in *Hirt* and *In re Del Monte*—that the incentive to monitor class counsel stems, at least in part, from the relative size of the investor's loss. The appointment of an individual co-lead plaintiff would almost certainly mean

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<sup>78</sup> No. Civ.A. 19575, 2002 WL 1558342 (Del. Ch. July 3, 2002).

<sup>79</sup> No. 18336, 2000 WL 1654504, at \*4 (Del. Ch. Oct. 17, 2000) (instituting system of selecting lead plaintiffs that is similar to PSLRA).

<sup>80</sup> No. Civ.A. 1116-N, 2005 WL 696764, at \*1 (Del. Ch. Mar. 22, 2005).

<sup>81</sup> *Id.* at \*3. Ultimately, as is frequently the approach to lead plaintiff disputes in Delaware, Vice Chancellor Lamb ordered the parties to settle it on their own. *Id.* at \*4. *But see, e.g., In re Del Monte Foods Co. S'holders Litig.*, C.A. No. 6027-VCL, 2010 WL 5550677, at \*2-3 (Del. Ch. Dec. 31, 2010) (ordering submission of motions for appointment of lead plaintiff and lead counsel after failed efforts by attorneys to form leadership structure).

<sup>82</sup> *Wiehl*, 2005 WL 696764, at \*3.

<sup>83</sup> 2010 WL 5550677, at \*6-7.



appointment of an individual whose losses are larger on a relative basis than that of its institutional co-lead and who presumably would be more motivated to seek a high settlement than the institution.

*C. The Search for a Motivated and Sophisticated Lead Plaintiff*

*1. The Lead Plaintiff's Motivation.*—Consider two lead plaintiff applicants: an institutional investor with \$100 billion in assets and a \$1 million loss and an individual with \$1 million in assets and a \$250,000 loss. Under current practice, the institution will be selected lead plaintiff. Who has greater incentive to zealously monitor class counsel? Some might argue that the institutional investor does. First, the institution has the most to gain from monitoring in absolute terms. On account of its experience and legal acumen, it may also be able to monitor less expensively than an individual can. On the other hand, institutions have agency costs that individuals do not. Manager performance is based on measures that affect the institution's bottom line, including total assets, returns on investment, and growth of the overall portfolio.<sup>84</sup> Managers will concentrate their attention and expertise on firm activities that contribute most to these measures, and that likely excludes litigation over losses in one particular security.<sup>85</sup>

Consider recent research demonstrating the failure by institutional investors to claim billions of dollars set aside for them in class action settlements. In an empirical study whose results are as astonishing as they are depressing, James Cox and Randall Thomas found that, on average, just 28% of eligible institutional investors filed claims in settled securities class actions.<sup>86</sup> The institutions' average loss in these cases was \$850,000 and the average available recovery was \$280,000.<sup>87</sup> All these institutions needed to do to recover these funds was fill out a claim form and mail it in. Failure to do so breached the institutions' fiduciary duties to their investors.<sup>88</sup> In an attempt to explain these lapses, Cox and Thomas noted:

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<sup>84</sup> See, e.g., Jonathan B. Berk & Richard Stanton, *Managerial Ability, Compensation, and the Closed-End Fund Discount*, 62 J. FIN. 529, 530–31 (2007) (discussing types of manager compensation and performance measures).

<sup>85</sup> See, e.g., James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 412 (2005) (finding that large financial institutions frequently do not make claims on money owed from class action litigation); see also Charles Silver & Sam Dinkin, *Incentivizing Institutional Investors to Serve as Lead Plaintiffs in Securities Fraud Class Actions*, 57 DEPAUL L. REV. 471, 481 (2008) (discussing high opportunity costs for institutional investors who serve as lead plaintiffs in securities class actions).

<sup>86</sup> Cox & Thomas, *supra* note 85, at 424.

<sup>87</sup> *Id.* at 424–25.

<sup>88</sup> See James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 867, 879 (2002) (noting noncollection could be a potential breach of fiduciary duty).

[I]nstitutional managers who . . . assess the desirability of identifying and submitting claims in the context of the overall activities of the fund can easily conclude that there are far better places to expend the fund's resources. That is, managers who view their objective as being well-performing traders (i.e., beating the market) are less likely to value operations that are removed from that role. For example, a few fund managers commented rather casually to us that they did not value submitting claims because the expected gains of doing so were dwarfed by both the size of the fund's assets and the average yearly returns earned by the fund through wise investment strategies.<sup>89</sup>

Concededly, institutional investors who obtain lead plaintiff appointments have incurred large losses that attracted their attention to the fraud (or attracted the lawyers' attention to the fraud) and have committed to the litigation in a way that differentiates them from the passive institutional investors described in the Cox and Thomas paper. But their commitment should not be overstated. As noted earlier, institutions are frequently alerted to their losses by the plaintiffs' law firms that monitor their portfolios.<sup>90</sup> It is possible that, even though these losses are large enough to qualify them for lead plaintiff appointments, they might never act on them on their own because of their relative triviality on the balance sheet. Litigating these losses remains outside the managers' core competencies, and a successful outcome adds little to the fund's bottom line. Oversight of the suit may be assigned to peripheral personnel within the institution.<sup>91</sup> And the institution may also defer to those who alerted them to the loss in the first place—those who have the greatest interest in the outcome of the suit and the greatest expertise—the lawyers. This delegation might occur despite the fact that under the class action system, the courts charge lead plaintiffs with the responsibility to monitor the attorneys rather than allowing attorneys to police themselves.

The purpose of this argument is not to impugn institutional investor lead plaintiffs who have, in many respects, improved outcomes for shareholders since embracing pursuit of securities class actions at the beginning of the last decade.<sup>92</sup> It is to demonstrate that consideration of the fraud's impact relative to the total assets of the lead plaintiff may signify

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<sup>89</sup> Cox & Thomas, *supra* note 85, at 431 (footnote omitted).

<sup>90</sup> Rubenstein, *supra* note 49, at 219 (noting that monitoring firms alert institutional investors to potential suits).

<sup>91</sup> Cox & Thomas, *supra* note 85, at 432 (“There is also the distinct possibility that breakdowns occur within the institution or the custodian. Lines of authority, once clearly established, may, with the passage of time and personnel, become blurred or forgotten. One can imagine that institutions or custodians could assign to one of their staffers responsibility for handling all matters related to the institution's possible securities claims.”).

<sup>92</sup> See, e.g., *2009 Securities Litigation Study*, PWC SEC. LITIG. STUDY (PriceWaterhouseCoopers LLP, New York, N.Y.), Apr. 2010, at 22, available at [http://10b5.pwc.com/pdf/ny-10-0559%20sec%20lit%20study\\_v7%20print.pdf](http://10b5.pwc.com/pdf/ny-10-0559%20sec%20lit%20study_v7%20print.pdf) (“[N]ine of the top ten settlements reached in 2009 had institutional investors as the lead plaintiff.”).

the plaintiff's motivation to monitor class counsel and maximize class recovery. This relative impact should not be the only consideration. No one wants lead plaintiffs who lost all \$28.34 of their net worth in one stock fraud; substantial absolute losses remain probative of lead plaintiff interest, effort, and sophistication. But it remains true that for institutional investors, most stock frauds are rounding errors. For individuals, they can be life-altering experiences.<sup>93</sup>

Skeptics might argue that it is not enough for individual lead plaintiffs to have incurred high losses on a relative or absolute basis. Such plaintiffs must believe that the increased recovery they can obtain by personally serving as lead plaintiffs will outweigh the costs of service (notwithstanding that they are entitled to reimbursement of reasonable costs and expenses).<sup>94</sup> Their optimal position would be to free ride off the efforts of other sophisticated and motivated individual lead plaintiffs. Of course, the same arguments hold for institutional lead plaintiffs, whose interests might be optimally served through appointment of another sophisticated institutional lead plaintiff. Nevertheless, institutional investors comprise 40% of all lead plaintiffs.<sup>95</sup>

This may be because lead plaintiff applicants, whether they be institutions or individuals, are not motivated by purely economic interests in deciding to take part in litigation. In addition to believing that they can improve settlements to their own benefit, lead plaintiff applicants may be motivated to serve by a sense of moral and civic duty to act in the face of fraud.<sup>96</sup> As Bobby Deal, a sheriff and board member of the repeat-lead-plaintiff Jacksonville Police and Fire Pension Fund once told me: "Half of my guys carry axes, and the other half carry guns. We put bad guys in jail for a living. We are not about to sit back and let someone steal from our members and the investing public."<sup>97</sup> Just as an individual who serves on the board of an institution may be motivated to vote in favor of seeking a lead-plaintiff appointment by a sense of personal outrage in the face of

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<sup>93</sup> See, e.g., *In re Critical Path, Inc. Sec. Litig.*, 156 F. Supp. 2d 1102, 1108, 1113 (N.D. Cal. 2001) (declining to appoint as lead plaintiff an individual who lost \$1.9 million in the alleged fraud, a "very substantial portion" of his family's net worth, instead appointing the Florida State Board of Administration with losses of \$2.3 million on total assets under management of \$125.6 billion).

<sup>94</sup> Under the PSLRA, lead plaintiffs are entitled to reimbursement of "reasonable costs and expenses." 15 U.S.C. § 78u-4(a)(4) (2006). Still, some potential applicants may prefer not to incur even reimbursable expenses devoted to litigation.

<sup>95</sup> See *2003 Securities Litigation Study*, *supra* note 46, at 6. For a more in-depth discussion of institutional investor participation as lead plaintiffs in state-level transactional class actions, which have many parallels to securities fraud class actions, see Webber, *supra* note 7 (section entitled "Basic Statistics—Institutional Lead Plaintiff Characteristics").

<sup>96</sup> David H. Webber, *Is "Pay-to-Play" Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031, 2071 (2010).

<sup>97</sup> *Id.* In Part IV.A, I discuss some cases in which apparently qualified individual investors have applied for lead plaintiff appointments but were rejected in favor of institutions.

fraud, individual investors acting on their own behalf might be similarly motivated.

2. *The Sophistication of the Lead Plaintiff.*—Ideally, in addition to being motivated, a lead plaintiff should also be sufficiently sophisticated to manage class counsel.<sup>98</sup> There is, however, some controversy about this point too. Some courts have noted that Congress’s adoption of the “largest financial interest” test meant that Congress did not in fact value sophistication as an important quality in a lead plaintiff.<sup>99</sup> But these courts were addressing cases in which institutional investors challenged an individual’s presumptive lead plaintiff status, charging that the individual lacked the requisite sophistication to be lead plaintiff.<sup>100</sup> That these courts refused to override the largest financial interest requirement in favor of the purportedly superior sophistication of the institutions does not mean that sophistication is not a valued factor in selecting lead plaintiffs. Two circuit courts of appeals and one district court in the Southern District of New York—the most frequent venue for securities class actions—have noted that the quest for a sophisticated lead plaintiff is one of the purposes of the PSLRA.<sup>101</sup> Arguably, the PSLRA standard creating a presumption favoring selection of the applicant with the largest loss implicitly prioritizes

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<sup>98</sup> *In re Cendant Corp. Sec. Litig.*, 404 F.3d 173, 192 (3d Cir. 2005) (“Thus the PSLRA strives to ensure that the lead plaintiff will have both the incentive and the capability to supervise its counsel in the best interests of the class.”). For a more general discussion of the adequacy of representation of lead plaintiffs in class actions, see Jay Tidmarsh, *Rethinking Adequacy of Representation*, 87 TEX. L. REV. 1136, 1151 (2009) (describing the doctrine of adequate representation as handling two distinct problems: the “incompetence” and “indifference” of lead plaintiffs).

<sup>99</sup> *In re Cavanaugh*, 306 F.3d 726, 737 n.20 (9th Cir. 2002) (“If financial sophistication had been Congress’ principal concern, it would not have made the plaintiff who *lost* the most money the presumptive lead plaintiff.”).

<sup>100</sup> *See, e.g., Zhu v. UCBH Holdings, Inc.*, 682 F. Supp. 2d 1049, 1054 (N.D. Cal. 2010) (declining to appoint an institutional lead plaintiff over an individual lead plaintiff with a larger stake, even though the individual may have been less sophisticated than the institution); *Tanne v. Autobyte, Inc.*, 226 F.R.D. 659, 670 (C.D. Cal. 2005) (“Although the PSLRA was enacted to encourage institutional investors to take a more active role in securities litigation, the Ninth Circuit has held that it does not require[ ] the district court to select the plaintiff it believes is the most sophisticated investor available. As a consequence, there is no *per se* rule requiring that an institutional investor be appointed lead plaintiff in lieu of an individual who has a larger stake in the litigation.” (alteration in original) (internal quotation marks and citation omitted)).

<sup>101</sup> *See Berger v. Compaq Computer Corp.*, 279 F.3d 313 (5th Cir. 2002) (per curiam) (“[W]e mean to emphasize that Congress enacted the ‘lead plaintiff’ provisions of the PSLRA, 15 U.S.C. § 78u-4(a)(3)(B), to direct courts to appoint, as lead plaintiff, the most sophisticated investor available and willing so to serve in a putative securities class action.”); *In re Cendant Corp. Litig.*, 264 F.3d 201, 266 (3d Cir. 2001) (“[T]he goal of the Reform Act’s lead plaintiff provision is to locate a person or entity whose sophistication and interest in the litigation are sufficient to permit that person or entity to function as an active agent for the class.”); *In re EVCI Career Colls. Holding Corp. Sec. Litig.*, No. 05 Civ. 10240(CM), 2007 WL 2230177, at \*1 (S.D.N.Y. July 27, 2007) (“The PSLRA was enacted in part to ensure that sophisticated institutional investors . . . would participate in and control securities litigation.”).

sophistication in a lead plaintiff. The entities with the largest losses are not just institutions, but often the very largest institutions, who are most likely to be both financially and legally sophisticated.

What constitutes sophistication sufficient for lead plaintiff purposes remains hazy. The few courts that have addressed the issue suggest that it is a combination of financial and legal sophistication, with evidence of the former regularly taken as evidence of the latter. In addition to judging a lead plaintiff's acumen by reference to which law firm it selected as lead counsel, courts have concluded that individual investors making substantial securities decisions—such as trading in tens of thousands of shares<sup>102</sup> or serving as officers or directors of private companies<sup>103</sup>—have the sophistication necessary to serve as lead plaintiffs in a securities class action. Institutional investors, on the other hand, tend to be viewed as *per se* sophisticated.<sup>104</sup>

The prospect of appointing individual-investor lead plaintiffs raises the concern that individuals who suffer relatively large losses—who may be among the least diversified members of the class—may not be sophisticated enough for the job. Put bluntly, could individuals with large losses be the biggest buffoons in the class? They might be. For example, they might have irrationally invested their life savings in one stock. In theory, such plaintiffs could still furnish some value to the class; the institution could provide the sophistication and these foolish individuals the motivation. But it is just as likely, perhaps more likely, that such individuals are former employees who amassed significant shareholdings in the course of their employment or are the heirs of such employees. Or it may be that they are sophisticated individuals who believed in the company and relied on the integrity of its public filings to take a calculated risk to aggressively invest in what turned out to be a fraudulent enterprise. A core mission of securities enforcement generally, including securities class actions, is to ensure that mere reliance on the integrity of our system of disclosure does not itself become a mark of an investor's lack of sophistication.<sup>105</sup> In the next Part, I survey the finance literature on individual investors, including individual investors who pursue the kinds of concentrated investment strategies that could make them motivated candidates for lead-plaintiff appointments. The purpose of this review is to dispel the notion that individual investors, even those pursuing

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<sup>102</sup> See, e.g., *Ferrari v. Gisch*, 225 F.R.D. 599, 609 (C.D. Cal. 2004) (appointing a three-person lead plaintiff group who purchased 20,000 shares, 11,600 shares, and 897 shares, respectively).

<sup>103</sup> See, e.g., *Mohanty v. BigBand Networks, Inc.*, No. C 07-5101 SBA, 2008 WL 426250, at \*9 (N.D. Cal. Feb. 14, 2008) (appointing a lead plaintiff because, in part, of his work on boards “of both privately held and NASDAQ listed companies”).

<sup>104</sup> See, e.g., *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1029 (4th Cir. 1997) (finding a bank to be a sophisticated investor); Fletcher, *supra* note 30, at 1152–53 (concluding there should be a “conclusive presumption” that all institutional investors are sophisticated).

<sup>105</sup> See generally Fletcher, *supra* note 30, at 1149–53 (discussing investor sophistication, or lack thereof).

such strategies, are per se unsophisticated and therefore unsuited for even cursory consideration as lead plaintiffs.

## II. ARE INDIVIDUAL INVESTORS INHERENTLY UNSOPHISTICATED? SURVEYING THE CURRENT FINANCE LITERATURE

Historically, individual investors have fared poorly in the finance literature, securing a reputation for being “at best uninformed, at worst fools.”<sup>106</sup> Brad Barber and Terrance Odean report that an average individual investor owns just four stocks,<sup>107</sup> and several studies suggest that the portfolios of American households are underdiversified.<sup>108</sup> A recent study by William Goetzmann and Alok Kumar concludes that U.S. individual investors hold underdiversified portfolios in which the level of underdiversification “is greater among younger, low-income, less-educated, and less-sophisticated investors. The level of under-diversification is also correlated with investment choices that are consistent with over-confidence, trend-following behavior, and local bias.”<sup>109</sup> Frequent explanations for individual investors’ underdiversification include a lack of sophistication and the fact that they incur transaction fees when actively trading their own stocks.<sup>110</sup>

But a fair reading of the current finance literature presents a more complex picture of individual investors. Even Goetzmann and Kumar report the “most surprising” result that high-turnover, underdiversified portfolios outperform high-turnover, better-diversified portfolios, indicating that “a small, active group of under-diversified investors might be skilled.”<sup>111</sup> And while they still conclude that most investors could improve their performance by simply investing in passive, diversified index funds, they

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<sup>106</sup> See, e.g., Coval, Hirshleifer & Shumway, *supra* note 2, at 6.

<sup>107</sup> Brad M. Barber & Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 J. FIN. 773, 796 (2000).

<sup>108</sup> See, e.g., Marshall E. Blume & Irwin Friend, *The Asset Structure of Individual Portfolios and Some Implications for Utility Functions*, 30 J. FIN., 585 (1975); Morgan Kelly, *All Their Eggs in One Basket: Portfolio Diversification of US Households*, 27 J. ECON. BEHAV. & ORG. 87 (1995); Ronald C. Lease, Wilbur G. Lewellen & Gary G. Schlarbaum, *The Individual Investor: Attributes and Attitudes*, 29 J. FIN. 413, 429–31 (1974) (explaining that the individual investor tends to invest almost entirely in equity securities to the exclusion of other asset categories).

<sup>109</sup> William N. Goetzmann & Alok Kumar, *Equity Portfolio Diversification*, 12 REV. FIN. 433, 449–52 (2008). (“[W]ealthier, more experienced, and financially sophisticated investors and those who exhibit a stronger propensity to diversify in other settings hold relatively better diversified stock portfolios. . . . At least three psychological biases could be associated with investors’ diversification choices, [including] over-confidence in their investment abilities, . . . stronger propensity to hold local stocks, [and] . . . greater sensitivity to past price trends.”)

<sup>110</sup> See Barber & Odean, *supra* note 107, at 776 (finding that the costs and frequency of trading damaged the amount of individuals’ portfolio returns).

<sup>111</sup> Goetzmann & Kumar, *supra* note 109, at 435.

also conclude that “some investors under-diversify because they might have superior private information.”<sup>112</sup>

Current financial scholarship supports this notion that there are undiversified yet skilled individual investors who outperform the market. Zoran Ivković, Clemens Sialm, and Scott Weisbrenner’s study of individual investors concludes that “among households with portfolios large enough to diversify among many stocks, *if desired*, the holdings and trades made by those focusing their attention on a few securities tend to perform significantly better than the investments made by those diversifying across many stocks.”<sup>113</sup> They further conclude that “wealthy households who concentrate their holdings in a few stocks tend to have the ability to identify superior stock picks.”<sup>114</sup> Their data show, *inter alia*, that purchases made by diversified investors of any portfolio size underperform the Fama/French benchmark portfolios,<sup>115</sup> as do concentrated households with small portfolios.<sup>116</sup> However, concentrated households with large portfolios exceed Fama/French benchmark portfolios by 1.3% for those with relatively large portfolios (defined as at least \$25,000) and by 2.2% for those with large portfolios (defined as at least \$100,000).<sup>117</sup> At least some individual investors outperform the market for some period of time.

Such skilled investors “exploit information asymmetries by concentrating their portfolios in the stocks about which they have favorable information.”<sup>118</sup> Earlier articles by Ivković and Weisbenner and by Massimo Massa and Andrei Simonov demonstrate that individual investments in local stocks outperform their investments in nonlocal stocks, that investors exhibit a strong tendency to hold stocks in companies to which they are geographically or professionally close, and that such investments earn, on average, excess returns.<sup>119</sup> Thus, Ivković, Sialm, and Weisbenner suggest

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<sup>112</sup> *Id.* at 461.

<sup>113</sup> Zoran Ivković, Clemens Sialm & Scott Weisbenner, *Portfolio Concentration and the Performance of Individual Investors*, 43 J. FIN. & QUALITATIVE ANALYSIS 613, 653 (2008) (emphasis added).

<sup>114</sup> *Id.*

<sup>115</sup> The Fama/French Benchmark Portfolios are six single-asset-class portfolios categorized by market equity and book-to-market ratio against which other portfolios may be compared. See Kenneth R. French, *Description of Fama/French Benchmark Portfolios*, KENNETH R. FRENCH, [http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data\\_Library/f-f\\_portfolios.html](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/f-f_portfolios.html) (last visited Mar. 24, 2012).

<sup>116</sup> Ivković, Sialm & Wiesbenner, *supra* note 113, at 616.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 617; see also Zoran Ivković & Scott Weisbenner, *Local Does as Local Is: Information Content of the Geography of Individual Investors’ Common Stock Investments*, 60 J. FIN. 267, 267 (2005) (“Behold, the fool saith, ‘Put not all thine eggs in the one basket’—which is but a manner of saying, ‘Scatter your money and your attention’; but the wise man saith, ‘Put all your eggs in the one basket and—*watch that basket.*’” (quoting Mark Twain)).

<sup>119</sup> Ivković & Weisbenner, *supra* note 118, at 268–69; Massimo Massa & Andrei Simonov, *Hedging, Familiarity and Portfolio Choice*, 19 REV. FIN. STUD. 633, 667–69 (2006).

that at least some underdiversification or concentration may be driven not by typical hallmarks of the unsophisticated investor, such as familiarity bias or overconfidence, but by favorable information, particularly in the form of local investment.<sup>120</sup>

Joshua Coval, David Hirshleifer, and Tyler Shumway echo a similar theme. Using a large sample of accounts at a major discount brokerage firm, they test the persistence of individual performance results evaluating both long horizons (the holding period for the investment) and short horizons (average returns the week after each purchase).<sup>121</sup> Their results demonstrate, *inter alia*, that for the long horizon, investors in the top performance decile outperform those in the bottom decile by about 8% per year.<sup>122</sup> Over the short horizon, individual investors in the top decile earn between twelve and fifteen basis points a day; individuals in the bottom decile lose between eleven and twelve basis points per day.<sup>123</sup> As the authors note, “If those individual investors who have performed abnormally well in the past continue to perform abnormally well in the future by an amount that is not explained by mere chance, market efficiency may be violated.”<sup>124</sup> In explanation, the authors note that these consistently high-performing individual investors may be better able to exploit informational advantages than, say, mutual fund managers (whose abnormal performance typically lags behind the market overall). For example, because these individual investors trade small positions, their trades have little if any impact on prices, allowing them to better exploit smaller or short-term deviations from fundamental values.<sup>125</sup> Moreover, unlike mutual funds, individuals are not obliged to maintain diversified investment portfolios.<sup>126</sup>

The presence of sophisticated and concentrated individual investors in the marketplace does not mean they are to be found as class members in every—or, in theory, in any—class action or that they would be willing to serve as lead plaintiffs. Nor are such investors identical to the potential individual lead plaintiffs outlined above, whose losses, relative to their total assets, are high. The concentrated investors described in the finance literature have not necessarily invested a large percentage of their net worth in one stock (or a few stocks); rather, they have invested a large percentage of their portfolio in one stock (or a few stocks). It is possible that their portfolio represents a small percentage of their overall assets. It is possible that on account of their sophistication, they are much less likely to be defrauded, although to believe this one would have to believe that they

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<sup>120</sup> Ivković, Sialm & Weisbenner, *supra* note 113, at 617.

<sup>121</sup> Coval, Hirshleifer & Shumway, *supra* note 2, at 3.

<sup>122</sup> *Id.* at 5.

<sup>123</sup> *Id.* at 4.

<sup>124</sup> *Id.* at 1.

<sup>125</sup> *Id.* at 7.

<sup>126</sup> *Id.*



know of or can detect the fraud before the rest of the market. Despite these positive indicators that there are many savvy individual investors out there, it is possible that a rule favoring an individual co-lead plaintiff who suffered the largest relative loss would hand a leadership role to the biggest fool in the class (though the judicial screening of such plaintiffs proposed below should eliminate this possibility). Of course, it is also possible that sophisticated, concentrated investors who have invested a substantial portion of their assets in one stock or a few stocks and were defrauded would like to obtain lead plaintiff appointments and would make excellent lead plaintiffs for the class as a whole (and in particular, for individual investors), but have no chance to obtain a leadership role under the current system, even if they wanted to.

The point of reviewing the finance literature is not to suggest that such ideal individual investors may be found to co-lead every class action (though with classes composed of thousands or tens of thousands of investors, there likely would be some candidates). It is to respond to the view that individual investors, particularly concentrated ones, are per se unsophisticated, need to be protected from themselves, and cannot serve as guardians for other investors. As a group, individual investors may underperform institutional investors, but that does not automatically make institutional investors the optimal class representatives. The finance literature suggests that some concentrated individual investors are sophisticated; basic economic and psychological principles suggest they are likely to be highly motivated. The question of whether it is worthwhile to invest the small effort required to open a co-lead plaintiff appointment to individuals requires an assessment of why institutional investors may not adequately represent individuals.

### III. THE POTENTIALLY MISALIGNED INTERESTS OF INDIVIDUAL AND INSTITUTIONAL INVESTORS

#### A. *Federal Rule of Civil Procedure 23's Typicality and Adequacy Requirements*

It is a bedrock principle of American law, one that has been repeatedly (and recently) reaffirmed by the Supreme Court, that a person cannot be bound to a judgment in a court proceeding to which she was not a party.<sup>127</sup> That principle has been strained but not broken by the rise of the modern class action.<sup>128</sup> Among the modern concessions embodied in Rule 23 was the grouping together of claims into a class action simply because it was

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<sup>127</sup> Taylor v. Sturgell, 553 U.S. 880, 906 (2008) (stating that under agency law, “preclusion is appropriate only if the putative agent’s conduct of the suit is subject to the control of the party who is bound by the prior adjudication”).

<sup>128</sup> See, e.g., ISSACHAROFF, *supra* note 9, at 80–83.

more efficient to resolve similar claims in one unified case.<sup>129</sup> Specifically, Rule 23(b)(3) permits certification of a class upon a determination that “questions of law or fact common to class members *predominate* over any questions affecting only individual members, and that a class action is *superior* to other available methods for fairly and efficiently adjudicating the controversy.”<sup>130</sup> Words like “predominate” and “superior” allow for the inclusion of overlapping but not identical claims in the class action mechanism for efficiency purposes.<sup>131</sup> Virtually all securities class actions are brought under this mechanism.<sup>132</sup> Ordinarily, because only parties that actually participate in a lawsuit are bound by the judgment, Rule 23 requires the trial court to inquire directly into the adequacy of the representation that absent class members will be afforded by a prospective lead plaintiff.<sup>133</sup>

Rule 23(a)(3) requires that “the claims or defenses of the representative parties are typical of the claims or defenses of the class,” and Rule 23(a)(4) requires that the named parties “will fairly and adequately protect the interests of the class.”<sup>134</sup> The adequacy inquiry under Rule 23(a)(4) serves “to uncover conflicts of interest between named parties and the class they seek to represent.”<sup>135</sup> This adequacy inquiry has heightened importance in the context of Rule 23(b)(3) damages class actions because such actions by definition encompass claims by absent class members that may not align perfectly with those of the lead plaintiffs. A party may be bound to a judgment in which it arguably had no meaningful opportunity to participate as long as the representative plaintiff was just that—representative of class members.<sup>136</sup> By asserting claims that are typical of the class’s claims and by furnishing adequate representation of those claims in terms of competent, supervised counsel, the class’s interests are actually represented in the court proceeding to which they will be bound.<sup>137</sup> As a further procedural

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<sup>129</sup> *Id.* at 83.

<sup>130</sup> FED. R. CIV. P. 23(b)(3) (emphasis added).

<sup>131</sup> See ISSACHAROFF, *supra* note 9, at 86.

<sup>132</sup> see also Hannah L. Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 46 COLUM. J. TRANSNAT’L L. 14, 30 (2007) (“Plaintiffs in securities class actions generally proceed under Rule 23(b)(3) . . . .”); cf. ISSACHAROFF, *supra* note 9, at 82 (“[T]he 1966 reforms to Rule 23 brought to life a range of economic harm cases that were almost unimaginable previously, as with securities class actions.”).

<sup>133</sup> ISSACHAROFF, *supra* note 9, at 80.

<sup>134</sup> FED. R. CIV. P. 23(a)(3)–(4).

<sup>135</sup> *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 625–26 (1997) (“[A] class representative must be part of the class and ‘possess the same interest and suffer the same injury’ as the class members.” (quoting *Schlesinger v. Reservists Comm. to Stop the War*, 418 U.S. 208, 216 (1974))).

<sup>136</sup> See FED. R. CIV. P. 23(a) (stating the class action requirements); G. Chin Chao, *Securities Class Actions and Due Process*, 1996 COLUM. BUS. L. REV. 547, 559 (noting that Rule 23(b)(3) class members are bound by res judicata if they do not opt out of the class).

<sup>137</sup> See Chao, *supra* note 136, at 558 (discussing certification of a class action under Rule 23); see also ISSACHAROFF, *supra* note 9, at 79 (“For those whose rights are to be decided *in absentia* the critical

safeguard for the rights of absent class members, these members retain the right to opt out of the class action and bring their own suit.<sup>138</sup> However, as a practical matter, because many claims made by individual investors are negative-value claims, opting out is rarely an economically feasible option.<sup>139</sup> Either they will obtain a remedy for the losses through a class action, or they will obtain no remedy at all.

The ensuing sections discuss four conflicts between institutional and individual investors that implicate Rule 23, including: (1) derivatives trading, (2) selling versus holding shareholders, (3) corporate governance activism, and (4) state-level transactional litigation in which institutional investors hold a stake in both the acquirer and the target. Although I will argue that these conflicts largely break down along institutional versus individual lines, they do not do so perfectly. There may be individuals who trade derivatives or pursue corporate governance activism while there may be institutions that do neither or that hold a stake only in a target company in a litigation. Taking a purist approach, one could transform the lead plaintiff group into a noisy parliament by separately selecting lead plaintiffs for derivatives traders, sellers, holders, class members seeking corporate governance reform, 10b-5 claimants, § 11 claimants, etc., increasing the group's size and reducing its cohesiveness, perhaps solving these conflicts without reference to the institutional–individual dichotomy at all.

But maintaining this dichotomy as an analytical framework for intraclass conflicts retains several advantages. First, much of securities regulation as currently constituted makes distinctions between institutional and individual investors. Second, the institutional–individual dichotomy reflects not just the law, but also the reality of the marketplace. Institutions and individuals trade through different brokerage platforms and may even pay different prices for the same securities.<sup>140</sup> Finally, because these

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due process issue is the quality of the representation that was afforded. It is the adequacy of that representation that allows this extraordinary departure from the conventional rule that each individual is entitled to his or her own opportunity to control any litigation that threatens to impose liability or terminate a claim.”).

<sup>138</sup> FED. R. CIV. P. 23(c)(2)(B)(v); Chao, *supra* note 136, at 574–75 (“[T]he current practice is to require notice and an opportunity to appear or to opt out only for (b)(3) classes while (b)(1) and (b)(2) classes receive notice only in certain instances such as settlements.”).

<sup>139</sup> See Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1532–33 (2004) (discussing rarity of opt-outs and objectors in class actions).

<sup>140</sup> See Graham Bowley, *Stock Exchange Shrinks as Rivals Take Over Trades*, N.Y. TIMES, Oct. 15, 2009, at A1 (noting the existence of “dark pools” and their availability to institutional investors only). Compare *Contact Us*, BLOOMBERG TRADEBOOK, <http://www.bloombertradebook.com/landing> (last visited Mar. 24, 2012) (“Please note that Bloomberg Tradebook is only available for institutional trading.”), and *Electronic Trading Services*, MF GLOBAL, <http://www.mfglobal.com/equities/electronic-trading-services> (last visited Mar. 24, 2012) (“MF Global’s team of electronic trading professionals provides execution and clearing services to institutional clients.”), with *About Us*, E\*TRADE, <https://us.etrade.com/e/t/home/aboutus> (last visited Mar. 24, 2012) (“[E\*TRADE] empower[s]

conflicts tend to break down along institutional and individual lines, selection of one additional (individual) lead plaintiff who has been properly screened for these conflicts allows a court to solve several of them with just one additional appointment. For these reasons, this Article maintains the institutional–individual dichotomy in analyzing intraclass conflicts in securities class actions.

### *B. Conflicts Between Institutional and Individual Investors*

#### *1. Derivatives Trading and Lead Plaintiff Appointments.—*

Derivatives trading and the failure to properly account for it causes two problems with regard to the lead plaintiff selection process. The first problem is that omission of derivatives from the largest financial interest calculation may lead to the appointment of lead plaintiff applicants who do not actually have the largest financial interest in the litigation.<sup>141</sup> Theoretically, they may even have a negative interest in it. The second problem is that derivatives trading, when accounted for properly, raises unique defenses that may render derivatives traders atypical and inadequate class representatives. The current treatment of derivatives disproportionately harms individual investors who stand to benefit most from resolution of these conflicts.

*a. Calculation of the Largest Financial Interest.—*Derivatives are financial instruments such as put options, call options, and equity swaps whose value derives from the value of an underlying asset.<sup>142</sup> Some derivatives are defined as securities in both the Securities Act of 1933<sup>143</sup> and the Securities Exchange Act of 1934.<sup>144</sup> In *Blue Chip Stamps v. Manor Drug Stores*, the United States Supreme Court noted that the Securities Exchange Act of 1934 treats such derivative investors as purchasers or sellers of

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individuals to take control of their financial futures by providing the products, tools and services they need to meet their near- and long-term investing goals.”).

<sup>141</sup> See *Mohanty v. BigBand Networks, Inc.*, No. C 07-5101 SBA, 2008 WL 426250, at \*6–7 (N.D. Cal. Feb. 14, 2008) (“[D]istrict courts typically equate ‘largest financial interest’ with the amount of potential recovery.” (citing *In re Critical Path, Inc. Sec. Litig.*, 156 F. Supp. 2d 1102, 1107–08 (N.D. Cal. 2001))).

<sup>142</sup> See JOHN C. COFFEE, JR. & HILLARY A. SALE, *SECURITIES REGULATION: CASES AND MATERIALS* 334–36 (11th ed. 2009) (discussing treatment of derivatives, particularly swaps, under securities laws).

<sup>143</sup> Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2006) (“The term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, . . . or . . . any put, call, straddle, [or] option . . .”).

<sup>144</sup> Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2006) (“The term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, . . . or any put, call, straddle, [or] option . . .”).

securities for purposes of Rule 10b-5.<sup>145</sup> Subsequently, the Commodity Futures Modernization Act of 2000 (CFMA) amended Section 10(b) of the Securities Exchange Act to cover “security-based swap agreements,” although it simultaneously exempted such agreements from the registration requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>146</sup>

More recently, Title VII of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) was passed to provide for comprehensive regulation of previously unregulated swaps and security-based swap agreements.<sup>147</sup> Some securities-based swap agreements will now be cleared through clearinghouses rather than traded over-the-counter via bilateral agreements whose infamous opaqueness was at least partly responsible for the financial panic of 2008.<sup>148</sup> Dodd–Frank instructed the appropriate regulators, including the Commodity Futures Trading Commission and, more relevantly for purposes of this Article, the Securities and Exchange Commission (SEC), to issue rules designating which swap agreements required clearance and which could continue to be traded over-

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<sup>145</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 751 (1975) (“[T]he holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as ‘purchasers’ or ‘sellers’ of securities for purposes of Rule 10b-5 . . . .”); *id.* at 750–51 (citing 15 U.S.C. § 78c(a)(13) (defining “buy” or “purchase” as including contracts to “buy, purchase, or otherwise acquire”) and § 78c(a)(14) (defining terms “sale” and “sell” to include contracts “to sell or otherwise dispose of”)).

<sup>146</sup> Pub. L. No. 106-554, § E302-03, 114 Stat. 2763, 2763A-451 to 454; *see also* *Caiola v. Citibank*, N.A., 295 F.3d 312, 327 (2d Cir. 2002) (implying that prior to passage of CFMA, some derivatives such as equity swaps were neither registered as securities nor subject to the antifraud provisions of the securities laws).

<sup>147</sup> Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 763(g), 124 Stat. 1376, 1777–78 (2010) (amending Section 9 of the Exchange Act); *see also* *New Rules for Derivatives*, COVINGTON & BURLING LLP 1 (July 21, 2010), <http://www.cov.com/files/Publication/f11bd6db-d8f2-46d1-b91b-da0b30a44157/Presentation/PublicationAttachment/88322576-8e12-48ab-8c61-daca964bb4e0/Dodd-Frank%20Act%20-%20New%20Rules%20for%20Derivatives.pdf>.

<sup>148</sup> Press Release, House Democratic Comm. on Fin. Servs., *In the Wake of Global Debt Crises, House Democrats Call for Implementation of Reforms in the Wall Street Reform and Consumer Protection Act* (June 29, 2011), *available at* <http://democrats.financialservices.house.gov/press/PRArticle.aspx?NewsID=1427> (“The lack of transparency—particularly in derivatives markets—was a major cause of the recent crisis and remains a clear and present danger to the financial system.”); *see also* *New Rules for Derivatives*, *supra* note 147, at 2 (“The effort to require central clearing and exchange trading for many derivative actions is at the heart of two basic purposes of the [Dodd–Frank] Act—reducing systemic risk and increasing market transparency.”).

the-counter as they were prior to Dodd–Frank.<sup>149</sup> This rulemaking process was scheduled for completion in July 2011, though it remains ongoing.<sup>150</sup>

Undoubtedly, many derivatives that previously traded over the counter will now be cleared.<sup>151</sup> Clearing will provide transparent pricing that will, among other things, simplify the calculation of investors' exposure to securities fraud or pending transactions.<sup>152</sup> As discussed below, whether it is because of the pre-Dodd–Frank (and hopefully not post-Dodd–Frank) complexity of calculating such exposure or some other reason, lead plaintiff applicants have often failed to plead, and courts have failed to include, derivatives in the calculation of the “largest financial interest” for lead plaintiff purposes. This omission is important, chiefly because a lead plaintiff's derivatives exposure affects its incentives to maximize recovery.

There are two legal impediments to including derivatives in calculation of the largest financial interest. The first is the traditional notion that the plaintiff is the “master of his complaint” and may therefore decide what claims to include in it.<sup>153</sup> If the “master” excludes derivatives from the complaint, deliberately or otherwise, then derivatives almost certainly won't be incorporated into the case (even if an ideal social planner would

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<sup>149</sup> *New Rules for Derivatives*, *supra* note 147, at 2–3; *see also* Dan Awrey, *Regulating Financial Innovation: A More Principles-Based Proposal?*, 5 *BROOK. J. CORP. FIN. & COM. L.* 273, 297–302 (2011) (discussing OTC derivatives, the role they have played in the global financial collapse, and the difficulty of regulating them).

<sup>150</sup> *See Dodd-Frank Progress Report*, DAVIS POLK 2–4 (July 22, 2011), [http://www.davispolk.com/files/uploads/FIG/072211\\_Dodd\\_Frank\\_Progress\\_Report.pdf](http://www.davispolk.com/files/uploads/FIG/072211_Dodd_Frank_Progress_Report.pdf) (noting July 2011 implementation deadline and the SEC's failure to meet it in several categories); *see also Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Upcoming Activity*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml> (last modified Mar. 24, 2012) (setting forth schedule for further implementation of Dodd–Frank by the Securities and Exchange Commission).

<sup>151</sup> *See* Press Release, House Democratic Comm. on Fin. Servs., *supra* note 148 (“The [Dodd–Frank Act] brings the derivatives markets out of the shadows by requiring reporting of all swap transactions and by requiring exchange-trading and central clearing for *most* of them.” (emphasis added)).

<sup>152</sup> *See The Monitor*, 29 *BANKING & FIN. SERVICES POL'Y REP.*, May 2010, at 29–30 (“To promote public transparency, standard over-the-counter derivatives should be traded on exchanges or other trading platforms. The more transparent a marketplace, the more liquid it is, the more competitive it is, and the lower the costs for companies that use derivatives to hedge risk. Transparency brings better pricing and lowers risk for all parties to a derivatives transaction. During the financial crisis, Wall Street and the Federal Government had no price reference for particular assets. Financial reform is incomplete without public market transparency.”); *see also Derivatives—Protection Without Suffocation: Thriving in a New Era of Regulatory and Market Transformation*, BNY MELLON 4 (May 2010), <http://www.bnymellon.com/foresight/pdf/derivatives.pdf> (“Central clearing has been shown to increase transparency and reduce a variety of risks for OTC derivatives markets.”).

<sup>153</sup> Matthew O'Brien, *Choice of Forum in Securities Class Actions: Confronting “Reform” of the Securities Act of 1933*, 28 *REV. LITIG.* 845, 895 (2009) (citing *Katz v. Gerardi*, No. 08CV04035, 2008 U.S. Dist. LEXIS 76322, at \*11 (N.D. Ill. Sept. 23, 2008) (noting plaintiff's right to plead only claims under the Securities Act of 1933 in securities litigation because “a plaintiff is the master of his complaint”), *rev'd on other grounds*, 552 F.3d 558 (7th Cir. 2009)).

include them) unless the “master” changes her mind or some other derivatives complainant appears. The second, related impediment is the unique timeline of securities class actions, in which the lead plaintiff is selected based on the value of her claims in a complaint that may easily be changed afterwards to include different claims. Therefore, whether derivative claimants will ultimately be included in the class may not be known until after the lead plaintiff has been selected. In short, it is never certain that derivatives will be included in the case or, even if they are ultimately included, that they will be taken into consideration at the lead plaintiff selection stage.

As to the first point, plaintiffs are the “masters of the complaint” and may select the claims presented.<sup>154</sup> Thus, if a securities class action plaintiff chooses to claim only for losses related to the common stock, even if that plaintiff (or others) has losses in preferred stock or derivatives, the court will not force the plaintiff to add claims for preferred stock or derivatives. When applicants move for lead plaintiff status, the PSLRA requires merely that they disclose their transactions “in the security that is the *subject of the complaint*.”<sup>155</sup> Thus, the court or the class may never know what other securities the lead-plaintiff applicants bought or sold during the class period. This Article will address the consequences of this below.

The second legal impediment relates to the timeline of securities class actions. In most securities class actions, a plaintiffs’ law firm representing an individual with a small financial stake files the initial complaint.<sup>156</sup> Such complaints tend to be filed within days after the fraud has been revealed.<sup>157</sup> The initial plaintiff must then publish, in a “widely circulated national business-oriented publication or wire service,” notice of the pendency of the action advising class members that they have sixty days to seek the lead plaintiff appointment.<sup>158</sup> As a matter of practice, when institutional investors move for lead plaintiff appointments, they do so within this sixty-day window, typically taking several weeks to assess their exposure to the fraud, the merits of the case, and the costs and benefits of obtaining the

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<sup>154</sup> See MARTIN H. REDISH, *WHOLESALE JUSTICE: CONSTITUTIONAL DEMOCRACY AND THE PROBLEM OF THE CLASS ACTION LAWSUIT* 23 (2009).

<sup>155</sup> 15 U.S.C. § 78u-4(a)(2)(A)(iv) (2006) (emphasis added).

<sup>156</sup> See, e.g., John F. Olson, David C. Mahaffey & Brian E. Casey, *Pleading Reform, Plaintiff Qualification and Discovery Stays Under the Reform Act*, 51 *BUS. LAW.* 1101, 1142–43 (1996) (discussing the use of professional plaintiffs, who have a relatively small stake in the litigation, to expedite filing a case).

<sup>157</sup> See, e.g., *id.* at 1104–05 (citing *In re Philip Morris Sec. Litig.*, 872 F. Supp. 97, 98 (S.D.N.Y. 1995), *aff’d in part, rev’d and remanded in part*, 75 F.3d 801 (2d Cir. 1996) (finding that plaintiffs filed the initial complaint fewer than five hours after Philip Morris’s announcement, with four more suits filed that day and five more filed the following day)).

<sup>158</sup> § 78u-4(a)(3)(A)(i).

appointment.<sup>159</sup> Thus, institutions frequently obtain lead-plaintiff appointments based on complaints written by another plaintiff,<sup>160</sup> often an individual who purchased common stock or who may use the formulaic phrase “all investors who purchased common stock” or “purchasers of the securities of [the issuer],”<sup>161</sup> which excludes third party transactions like derivatives.<sup>162</sup> The institutional lead plaintiff applicants are therefore disclosing their transactions “in the security that is the *subject of the complaint*”<sup>163</sup> that was written by someone else. For lead plaintiff purposes, they calculate their financial interest in the case based on the securities fortuitously chosen by a plaintiff who usually will only become lead plaintiff if no one else is interested in the job. Alternatively, in the rarer instance in which institutional lead plaintiff applicants file an initial complaint, they may selectively plead claims over certain securities to maximize the appearance of their losses.

Thus, either because of manipulation of the initial complaint by a lead plaintiff applicant who authored it or, more likely, because of the fortuitous

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<sup>159</sup> See, e.g., *Ferrari v. Gisch*, 225 F.R.D. 599, 603 (C.D. Cal. 2004) (filing an original complaint on October 1, 2003, with four motions for appointment of lead counsel filed on December 1, 2003, two of which were filed by institutional investors).

<sup>160</sup> See, e.g., *Climo v. Office Depot, Inc.*, No. 11-cv-80364-CIV (S.D. Fla. July 5, 2011) (granting Central Laborers’ Pension Fund’s motion for appointment as lead plaintiff and approving lead plaintiff’s selection of counsel); *Mallen v. Alphatec Holding, Inc.*, No. 10-cv-01673-BEN (CAB), 2011 WL 175687, at \*2 (S.D. Cal. Jan. 19, 2011) (granting the unopposed motion to appoint FCERA as lead plaintiff and approving selection of counsel); *Wozniak v. Align Tech., Inc.*, No. 09-cv-03671-MMC (N.D. Cal. Nov. 13, 2009), available at [http://securities.stanford.edu/1043/ALGN09\\_01/20091113\\_f01x\\_09CV03671.pdf](http://securities.stanford.edu/1043/ALGN09_01/20091113_f01x_09CV03671.pdf) (granting the motion to appoint PPNPF as lead plaintiff, denying the motion to appoint Charles Wozniak as lead plaintiff, and approving lead plaintiff’s selection of counsel).

<sup>161</sup> See, e.g., *Complaint at 1, DeAngelis v. Corzine*, No. 11-cv-07866-VM (S.D.N.Y. Nov. 3, 2011), available at [http://securities.stanford.edu/1047/MF00\\_01/20111113\\_f01c\\_1107866.pdf](http://securities.stanford.edu/1047/MF00_01/20111113_f01c_1107866.pdf) (“This is a federal securities class action filed on behalf of all investors who purchased or otherwise acquired MF Global common stock between May 20, 2011 and October 28, 2011, inclusive (‘the Class Period’) for violations of the Securities Exchange Act of 1934 . . . and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission . . .”); *Complaint at 2, Short v. Dondanville*, No. 11-cv-00615-VAP (C.D. Cal. Apr. 19, 2011), available at [http://securities.stanford.edu/1046/FCEN00\\_01/2011419\\_f01c\\_1100615.pdf](http://securities.stanford.edu/1046/FCEN00_01/2011419_f01c_1100615.pdf) (“This is a securities class action brought by plaintiff on behalf of all persons who purchased or otherwise acquired 1st Centennial Bancorp . . . securities . . .”); *Complaint at 1, Richman v. Goldman Sachs Grp., Inc.*, 274 F.R.D. 473 (S.D.N.Y. 2010) (No. 10-cv-03461-UA), available at [http://securities.stanford.edu/1044/GS10\\_01/2010426\\_f01c\\_10CV03461.pdf](http://securities.stanford.edu/1044/GS10_01/2010426_f01c_10CV03461.pdf) (“This is a securities class action on behalf of all persons who were damaged in connection their purchases of Goldman Sachs Group, Inc. . . . common stock . . . .”); *Complaint at 2, Bristol Cnty. Ret. Sys. v. Wachovia Corp.*, No. 08-cv-02844-SC (N.D. Cal. June 6, 2008), available at [http://securities.stanford.edu/1040/WB\\_03/200866\\_f01c\\_082844.pdf](http://securities.stanford.edu/1040/WB_03/200866_f01c_082844.pdf) (“This is a federal securities class action on behalf of purchasers of the securities of Wachovia . . . .”).

<sup>162</sup> Cf. COFFEE & SALE, *supra* note 142, at 20–21 (explaining that derivative securities are issued by third parties and thus do not raise capital for the issuer); ALASTAIR HUDSON, *THE LAW ON FINANCIAL DERIVATIVES* 92 (2d ed. 1998) (explaining that financial derivatives are the product of real-time negotiation between institutional traders).

<sup>163</sup> § 78u-4(a)(2)(A)(iv) (emphasis added).



selection of securities by the filer of the initial complaint, two problems arise. First, the entity that has the largest financial interest in the securities identified in the initial complaint will be selected lead plaintiff, rather than the entity that actually has the largest financial interest in the lawsuit as a whole. Thus, for example, whoever had the largest common stock loss will be selected rather than the entity that had the largest loss in both common and preferred stock. Second, and of greater concern, is the exclusion of derivatives from the initial complaint and therefore from calculation of the largest financial interest. Exclusion of derivatives means that a lead plaintiff could collect more damages than it lost in the fraud. It could even collect damages if it profited from the fraud.

Consider a lead plaintiff applicant whose common stock lost \$10 million in value, but who purchased put options to hedge \$9 million of its exposure. Upon revelation of the fraud, it exercised the put options.<sup>164</sup> Thus, its net loss in the fraud is \$1 million. But if all the complaint pleads are the common stock losses, the PSLRA only requires it to disclose the \$10 million loss in its lead plaintiff application. It could win the lead plaintiff appointment and collect all \$10 million in damages, or \$9 million more than it lost. (It could also claim \$10 million in losses even if it were not selected lead plaintiff.) Meanwhile, traders who used derivatives to increase—rather than hedge—their exposure to the issuer would be ineligible to collect damages at all because derivatives were not claimed in the complaint. Assuming unsuccessful attempts at intervention by derivatives traders, the lead plaintiff could proceed with its suit as filed. The lack of transparency and clarity about the treatment of derivatives may fail to alert such long derivatives traders to the problem until they are time-barred or precluded from bringing separate claims, assuming such claims were substantial enough to bring as an independent action.

The prospect of some investors reaping windfalls from the fraud while others lack a remedy raises questions about the fundamental fairness of the “master of the complaint” rule in this context. But it also raises issues from the more narrow perspective of how hidden gains (or hidden offset losses) may affect the lead plaintiffs’ motivation to monitor class counsel. For purposes of this motivation alone, does it matter whether the \$10 million the lead plaintiff applicant can obtain in the class action is a windfall or a recovery? From a purely rationalist point of view, it should make no difference. All that matters for purposes of motivating the lead plaintiff’s monitoring is how much it can recover from the suit: \$10 million. What it gained or lost in the fraud is irrelevant. A behavioralist might argue that whether the \$10 million is viewed by the investor as a windfall or as

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<sup>164</sup> Options, as well as futures and swaps, are financial instruments known as derivatives. Options give the buyer a right to buy (a “call” option) or sell (a “put” option) an underlying asset, usually a security or commodity, for a predetermined price (the “strike” price) at some point in the future. For more information, see COFFEE & SALE, *supra* note 142, at 20–25.

recovery may substantially affect its zeal for monitoring.<sup>165</sup> There is evidence that people are more responsive to loss aversion than windfalls.<sup>166</sup>

Derivatives pose a further complication when a complaint is later amended to include them. As noted above, the “relief sought by the class” may be expanded beyond the initial complaint to encompass nearly all securities, including derivatives. The most likely scenario in which this would occur is if the institution is forced to amend by late-arriving derivatives complainants.<sup>167</sup> Such complainants may not have incurred large enough losses to obtain the lead plaintiff appointment but may seek to intervene in the case. Alternatively, they may just approach the judge or the plaintiffs’ lawyers seeking inclusion.

Returning to the above example, the hedged portion of the institutional investor lead plaintiff’s \$10 million common stock loss will now count against it. The lead plaintiff who was once eligible to collect \$10 million is now limited to collecting no more than the \$1 million of its actual loss.<sup>168</sup> While this may be a more just result from the societal point of view, the lead plaintiff’s motivation to monitor class counsel has been substantially reduced. The plaintiffs’ lawyers who obtained the lucrative lead counsel position, having been selected by a lead plaintiff with large common stock losses, now report to a lead plaintiff with significantly diminished stakes in the case and far lower monitoring incentives. This was exactly the problem the PSLRA was designed to avoid.<sup>169</sup>

In the absence of hard data, certain proxies reveal the scope of the problems posed by derivatives and lead plaintiff selection. First, the case cited most frequently by district courts in calculating the largest financial interest for lead plaintiff purposes, *Lax v. First Merchants Acceptance*

<sup>165</sup> See discussion *infra* Part IV.A (advocating that courts consider both the relative and absolute losses of individual applicants for co-lead-plaintiff appointments with institutions).

<sup>166</sup> See Amos Tversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 (1992) (describing loss aversion biases).

<sup>167</sup> See, e.g., *In re Oxford Health Plans, Inc. Sec. Litig.*, 199 F.R.D. 119, 123–24 (S.D.N.Y. 2001) (certifying shareholder class of common stock and options purchasers and sellers eighteen months after appointing lead plaintiffs based on common stock losses alone).

<sup>168</sup> See, e.g., Notice of Pendency and Certifications of Class Actions and Proposed Settlements, Motions for Attorneys’ Fees and Settlement Fairness Hearings at 17, *In re Nortel Networks Corp. Sec. Litig.*, No. 04 Civ. 2115 (LAP) (S.D.N.Y. July 21, 2006), available at [http://www.nortelsecuritieslitigation.com/notice\\_en2.pdf](http://www.nortelsecuritieslitigation.com/notice_en2.pdf) (“To the extent a Claimant had a gain from his, her or its overall transactions in Nortel common stock and/or Nortel put and call options during the Class Period, the value of the Recognized Claim will be zero. Such claimants will in any event be bound by the Settlement. To the extent that a Claimant suffered an overall loss on his, her or its overall transactions in Nortel common stock and/or options during the Class Period, but that loss was less than the Recognized Claim calculated above, then the Recognized Claim shall be limited to the amount of the actual loss.”).

<sup>169</sup> See S. REP. NO. 104-98, at 8 & n.34 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 690 & n.34 (quoting Weiss & Beckerman, *supra* note 1, at 2105).

*Corp.*<sup>170</sup>—an unreported opinion subsequently cited in 106 opinions published on LexisNexis as of November 13, 2011 and in many more motions for lead plaintiff appointments—excludes derivatives from its calculation methodology.<sup>171</sup> Second, practitioners report that they rarely include derivatives in such calculations, in part because of the complexity of assessing their value.<sup>172</sup> The omission is likely a material one. Defendants in securities class actions are large public companies,<sup>173</sup> and defendants in securities class actions led by institutional lead plaintiffs are likely to be among the very largest public companies, as they generate high enough damages to attract institutional applicants.<sup>174</sup> Derivatives trading almost certainly exists in the securities of all of these defendants, and therefore, there are potential derivative claimants in all of these suits. It stands to reason that there are a substantial number of institutional lead plaintiffs who have hidden gains or offset losses potentially implicating their monitoring motivation, or who simply do not have the largest financial interest in the relief ultimately sought by the class.

As to how frequently complaints are expanded to include derivatives after selection of the lead plaintiffs, proxies will again have to substitute for hard data. There are two published opinions addressing the issue,<sup>175</sup>

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<sup>170</sup> No. 97 C 2715, 1997 U.S. Dist. LEXIS 11866 (N.D. Ill. Aug. 6, 1997). This case is an unreported opinion that has subsequently been cited in 106 opinions published on LexisNexis as of November 13, 2011 and many more motions for lead plaintiff appointments.

<sup>171</sup> *Id.* at \*17 (calculating the largest financial interest for lead plaintiff purposes based on “(1) the number of shares purchased; (2) the number of net shares purchased; (3) the total net funds expended by the plaintiffs during the class period; and (4) the approximate losses suffered by the plaintiffs”). No calculation of derivatives exposure is included.

<sup>172</sup> This is based on confidential conversations taking place on January 4, 2011, and February 14, 2011, with veteran litigators at leading plaintiffs’ securities class action firms. These individuals had direct and extensive experience drafting lead plaintiff applications.

<sup>173</sup> See, e.g., Complaint, *Richman v. Goldman Sachs Grp., Inc.*, 274 F.R.D. 473 (S.D.N.Y. 2010) (No. 10-cv-03461-UA), available at [http://securities.stanford.edu/1044/GS10\\_01/2010426\\_f01c\\_10CV03461.pdf](http://securities.stanford.edu/1044/GS10_01/2010426_f01c_10CV03461.pdf); Complaint, *Sklar v. Bank of Am., Corp.*, 258 F.R.D. 260 (S.D.N.Y. 2009) (No. 09-MDL-2058), available at [http://securities.stanford.edu/1042/BAC\\_01/2009121\\_f01c\\_09580.pdf](http://securities.stanford.edu/1042/BAC_01/2009121_f01c_09580.pdf); see also Stephen P. Ferris & A.C. Pritchard, *Stock Price Reactions to Securities Fraud Class Actions Under the Private Securities Litigation Reform Act 4* (Univ. of Mich. Law & Econ. Research Paper No. 01-009, 2001), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=288216](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=288216) (characterizing defendants in typical securities fraud class actions with traits unique to large public companies, such as a large trading volume in a secondary trading market).

<sup>174</sup> See James D. Cox et al., *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 373 tbl.4 (2008) (showing that the total assets for defendants in cases led by institutions are far higher than the total assets of defendants in cases led by noninstitutions).

<sup>175</sup> See, e.g., *In re Sepracor Inc. Sec. Litig.*, 233 F.R.D. 52, 54 (D. Mass. 2005) (declining to find that lead plaintiffs violated 15 U.S.C. § 78u-4(a)(2)(A)(iv) by failing to disclose derivative trades because the complaint did not mention derivatives trades); *In re Oxford Health Plans, Inc. Sec. Litig.*, 199 F.R.D. 119, 124 (S.D.N.Y. 2001) (declining to find that lead plaintiffs violated 15 U.S.C. § 78u-4(a)(2)(A)(iv) by failing to disclose derivative trades because the court had not defined the class to include such trades until after filing of lead plaintiff certifications).

although this is an issue that courts may often decide without a formal opinion. Growing understanding in the marketplace by derivatives traders that they should not assume that they are automatically class members but must look to how the class is defined may increase the frequency of expansion.<sup>176</sup> The actual or perceived frequency of expansion of the complaint might affect institutional investor behavior *ex ante*. An institution that has offsetting gains through derivatives might not seek a lead plaintiff appointment for fear that its derivatives trading will eventually be exposed. On the other hand, the participants who are most aware of such risks and are best positioned to warn against them are the lawyers. And as noted above, the lawyers frequently inform the institutions of their losses via portfolio monitoring.<sup>177</sup> The most cynical assessment of the lawyers' incentives suggests that their best case scenario is an institutional plaintiff with large enough common stock losses to win the lead plaintiff appointment and therefore select them as lead counsel, followed by disclosure and amendment of the claim to include derivatives that could substantially increase the class's damages while reducing the institution's stake in the outcome of the case. This reduced stake in the outcome would reduce the institution's incentive to monitor class counsel, undermining the primary purpose of the lead plaintiff provision of the PSLRA. A more benign view is that derivatives are difficult to cope with in litigation and that the lawyers will deal with them if raised but will not include them on their own. Because derivatives actually receive little scrutiny at the lead plaintiff stage itself, few institutions are likely to actually bother assessing their exposure in the first place. Such lack of attention to derivatives by both lawyers and institutions may also be motivated by the fact that derivatives trading may raise unique defenses affecting the typicality and adequacy of derivatives traders, which is discussed in the next Part.

A reexamination of the statute offers limited hope for a solution. As noted, the PSLRA creates a rebuttable presumption that the lead plaintiff is whoever the court determines "has the largest financial interest *in the relief sought by the class*."<sup>178</sup> One might argue that a lead plaintiff applicant's financial interest in the relief sought by the class may be broader than its holdings in the particular security or securities enumerated in the complaint. The unalleged ownership interest—e.g., derivatives or preferred stock in a case in which the operative complaint only addresses common stock—could still constitute a financial interest in the relief sought by the class because the relief sought in the complaint would directly affect the unalleged ownership stake. Therefore, a court could examine the applicant's

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<sup>176</sup> See, e.g., Memorandum of Law in Support of Lead Plaintiffs' Motion for Class Certification at 9 n.6, *In re Fed. Nat'l Mortg. Ass'n Sec.*, 503 F. Supp. 2d 25 (D.D.C. May 18, 2006) (No. 04-1639) (motioning to expand the class definition to include options traders).

<sup>177</sup> See *supra* notes 49–55 and accompanying text.

<sup>178</sup> 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2006) (emphasis added).

entire financial interest in all securities, even when selecting a lead plaintiff for a case in which the operative complaint pleads only common stock.

This reading would solve the problem. But it is in tension with the requirement that lead plaintiff applicants disclose their transactions “in the security that is the *subject of the complaint*.”<sup>179</sup> Implicitly, courts read “relief sought” by the class as synonymous with relief “that is the subject of the complaint.”<sup>180</sup> Arguably, Congress would not authorize courts to broadly examine a lead plaintiff applicant’s financial interest in the case but only require disclosure of transactions actually named in the complaint. Perhaps courts could simply order this disclosure on their own, reading the disclosure provision as a floor rather than a ceiling.

Barring a rereading of the statute or congressional action, the legal uncertainty surrounding derivatives in calculating the largest financial interest is likely to persist. This uncertainty harms most investors, who may be saddled with lead plaintiffs other than those who would be most motivated to represent them. Individual investors are disproportionately impacted by the unpredictability of derivatives treatment because they are far less likely to engage in derivatives trading than are institutions.<sup>181</sup> They have no horse in the race but are expected to pay their pro rata share of legal costs for it and run the risk, as class members, that their lead plaintiff or lead counsel might be replaced because of it. Yet their comparative lack of derivatives exposure makes them well-positioned to cure the problem. Individual investors with no derivatives exposure may be selected lead plaintiff with confidence that they have neither hidden gains nor hidden offset losses and zero risk that those losses will appear later in the litigation to significantly alter their monitoring incentives. The next Part further explores the problem of unique defenses posed by derivatives trading, and its disproportionate impact on individual investors.

*b. Derivatives Trading and the Challenge of Unique Defenses.*—Even assuming that a party’s derivatives trading is incorporated into calculation of the largest financial interest, derivatives traders may face another problem. They may be subject to typicality and

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<sup>179</sup> *Id.* § 78u-4(a)(2)(A)(iv) (emphasis added).

<sup>180</sup> *Lax v. First Merchs. Acceptance Corp.*, No. 97 C 2715, 1997 U.S. Dist. LEXIS 11866, at \*7, 22–23 (N.D. Ill. Aug. 6, 1997).

<sup>181</sup> Compare Robert Dubil, *Economic Derivatives Markets—New Opportunities for Individual Investors: A Research Agenda*, 16 FIN. SERVICES REV. 89, 91 (2007) (“Individual investors actively participate in cash markets for stocks and bonds. . . . Of the 25-million brokerage accounts in the U.S., less than 5% have any option positions, and practically none have futures.”), with RENÉ M. STULZ, DEMYSTIFYING FINANCIAL DERIVATIVES 8 (2006), available at [http://www.cornerstone.com/files/News/7fd495c7-8fac-4fa0-939d-0200b7819d8d/Presentation/NewsAttachment/d52f2901-b85b-4dfd-80d6-0bfc1865d6c1/Cornerstone\\_Research\\_Demystifying\\_Financial\\_Derivatives.pdf](http://www.cornerstone.com/files/News/7fd495c7-8fac-4fa0-939d-0200b7819d8d/Presentation/NewsAttachment/d52f2901-b85b-4dfd-80d6-0bfc1865d6c1/Cornerstone_Research_Demystifying_Financial_Derivatives.pdf) (“60 percent of [non-financial firms] use] derivatives.”), and Thomas F. Siems, *10 Myths About Financial Derivatives*, CATO INST. (Sept. 11, 1997), <http://www.cato.org/pubs/pas/pa-283.html> (“[L]arge [multinational corporations and banks] are the biggest users of derivative instruments.”).

adequacy challenges because they are arguably subject to unique defenses.<sup>182</sup> These defenses relate to two elements of a traditional securities fraud cause of action: (1) that the plaintiffs relied on the defendants' false and misleading statements and (2) that such reliance caused their injuries.<sup>183</sup>

Derivatives traders suing a defendant for fraud face two reliance arguments that a defendant could not advance against a purchaser of stock alone. The first is that traders who shorted the stock or otherwise hedged against its rise could not have relied on the purportedly false and misleading statements; only a purchaser or seller that assumed an increasing stock price could have.<sup>184</sup> Some courts have rejected derivatives-trading lead plaintiffs on such grounds or required them to serve as lead plaintiffs of a separate class of derivatives traders.<sup>185</sup> The second, related reliance argument faced by derivatives-trader plaintiffs is whether they can make use of the fraud-on-the-market theory. The Supreme Court embraced the fraud-on-the-market theory in the landmark case of *Basic Inc. v. Levinson*.<sup>186</sup> The theory is based on the efficient market hypothesis, which essentially states that a company's stock price reflects all publicly available information about the company.<sup>187</sup> Thus, misleading statements about the company will defraud a purchaser of stock trading in an efficient market even if the purchaser never directly relied on the statements because they were reflected in the stock

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<sup>182</sup> See, e.g., *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 176, 180 (2d Cir. 1990) (“[C]lass certification is inappropriate where a putative class representative is subject to unique defenses which threaten to become the focus of the litigation.”); see also 5 JAMES WM. MOORE ET AL., *MOORE’S FEDERAL PRACTICE* § 23.24[5] (3d ed. 2011).

<sup>183</sup> *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

<sup>184</sup> See, e.g., *In re Scientific-Atlanta, Inc. Sec. Litig.*, 571 F. Supp. 2d 1315, 1330 (N.D. Ga. 2007) (noting that a put option seller is not subject to unique defenses for class certification purposes because the seller anticipates that stock price will stagnate or rise, like a stock purchaser); *In re Priceline.com Inc. Sec. Litig.*, 236 F.R.D. 89, 99 (D. Conn. 2006) (allowing the appointment as lead plaintiff of a purchaser and holder of put options because he had testified that he assumed that the stock price would increase); *In re Adobe Sys., Inc. Sec. Litig.*, 139 F.R.D. 150, 155 (N.D. Cal. 1991) (finding the typicality requirement of Rule 23 was met for lead plaintiff options traders “since the value of options is directly related to the value of common stock”); *Deutschman v. Beneficial Corp.*, 132 F.R.D. 359, 371 (D. Del. 1990) (describing how call option purchasers are similar to stock purchasers, unlike short sellers “who profit when the market price decreases”); *Moskowitz v. Lopp*, 128 F.R.D. 624, 631 (E.D. Pa. 1989) (noting that option traders may use the fraud-on-the-market presumption of reliance absent special circumstances). *But see Zlotnick v. TIE Commc’ns*, 836 F.2d 818, 823 (3d Cir. 1988) (declining presumption of reliance for short seller); *Andrada v. Atherogenics, Inc.*, No. 05 Civ. 00061(RJH), 2005 WL 912359, at \*5 (S.D.N.Y. Apr. 19, 2005) (declining appointment of options trader as lead plaintiff because of unique defenses).

<sup>185</sup> See, e.g., *Andrada*, 2005 WL 912359, at \*5 (finding an options holder is subject to unique defenses); *Weikel v. Tower Semiconductor Ltd.*, 183 F.R.D. 377, 391 (D.N.J. 1998) (rejecting certification of options purchaser as class representative); *Margolis v. Caterpillar, Inc.*, 815 F. Supp. 1150, 1156 (C.D. Ill. 1991) (ordering subclasses of options holders and stock holders). *But see In re Donkenny Inc. Sec. Litig.*, 171 F.R.D. 156, 158 (S.D.N.Y. 1997) (finding that options trader met typicality and adequacy requirements).

<sup>186</sup> 485 U.S. 224 (1988).

<sup>187</sup> See *id.* at 241–42 (defining fraud-on-the-market theory).

price when the purchase was made.<sup>188</sup> The fraud-on-the-market theory creates a presumption that any purchaser of the security relied on the false and misleading statements simply by purchasing the security, since the stock price would have reflected and incorporated those false and misleading statements.<sup>189</sup> The question of whether a derivatives trader can rely upon the fraud-on-the-market theory has bedeviled courts; some have concluded that derivatives traders may rely on the theory, others that they may not.<sup>190</sup> The inquiry is fact specific.<sup>191</sup>

Thus, appointment of an institutional class member as lead plaintiff carries the risk that it will not have the desired motivation to monitor class counsel because of hidden derivatives trading, as noted in Part II. It also carries the risk that the institutions will be disqualified at the class certification stage because of unique defenses raised by this trading. It is a near certainty that the issue of whether the derivatives trader is typical and adequate will have to be litigated, which incurs costs for the class even if the initial lead plaintiff derivatives trader survives the class certification stage as lead plaintiff. Moreover, because the courts that have ruled on the issue are district courts<sup>192</sup> and because the standard of review for such a decision is abuse of discretion,<sup>193</sup> there is no jurisdiction in which the issue

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<sup>188</sup> See *id.* (citing *Peil v. Speiser*, 806 F.2d 1154, 1160–61 (3d Cir. 1986) (“Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.”)).

<sup>189</sup> *Id.* at 247 (“[W]here materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed.”).

<sup>190</sup> Compare *In re LDK Solar Sec. Litig.*, 255 F.R.D. 519, 532–33 (N.D. Cal. 2009) (denying that lead plaintiff’s options trading prevented him from relying on the fraud-on-the-market theory), and *Montoya v. Herley Indus. Inc.*, No. 06-2596, 2006 WL 3337485, at \*1 (E.D. Pa. Nov. 14, 2006) (citing *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp.*, 315 F. Supp. 2d 666, 676 (E.D. Pa. 2004)) (holding that lead plaintiff that shorted stock, but was net “long” the company, could maintain a claim based on the fraud-on-the-market theory), and *Crossen v. CV Therapeutics*, No. C 03-03709, 2005 WL 1910928, at \*5 (N.D. Cal. Aug. 10, 2005) (lead plaintiff seller of call options was not atypical of the class and could rely on the fraud-on-the-market theory), with *In re Critical Path, Inc. Sec. Litig.*, 156 F. Supp. 2d 1102, 1109–10 (N.D. Cal. 2001) (disqualifying lead plaintiff applicant that shorted the company’s stock because such a plaintiff could not rely upon the fraud-on-the-market theory), and *In re Bank One S’holders Class Actions*, 96 F. Supp. 2d 780, 783 (N.D. Ill. 2000) (same).

<sup>191</sup> See *Levinson*, 485 U.S. at 239 (1988) (explaining that the fraud-on-the-market theory of reliance is a fact-specific inquiry because “no particular event or factor short of closing the transaction need be either necessary or sufficient by itself”).

<sup>192</sup> See, e.g., *TCW Tech. Ltd. P’ship v. Intermedia Commc’ns, Inc.*, No. 18336, 2000 WL 1654504, at \*4 (Del. Ch. Oct. 17, 2000) (ruling on a lead plaintiff appointment).

<sup>193</sup> See, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 201, 231 (3d Cir. 2001) (“We review the District Court’s approval of a class action settlement, including its determination that the settlement was fair, reasonable, and adequate, for abuse of discretion.”); *Zeidman v. J. Ray McDermott & Co.*, 651 F.2d 1030, 1038–39 (5th Cir. 1981) (“[T]he decision to certify a class action [is] left to the sound discretion of the district court. Because certification of a class action has such great effect on the district court’s control of litigation before it, and because certification involves substantial fact questions, we will not reverse a district court’s decision on class certification absent an abuse of its discretion.”).

is truly settled, leaving it open to be litigated in every securities case led by an institution.

As argued below, appointment of an individual co-lead plaintiff who did not engage in derivatives trading would improve the typicality and adequacy of the lead plaintiff. It could allow the court to conclude that the lead plaintiff group as a whole may rely on the fraud-on-the-market theory, even if the court would not have allowed a derivatives-trading institution to serve as a lead plaintiff alone. Or, should the court disqualify the derivatives trading institutional lead plaintiff on typicality and adequacy grounds, the continuity of the litigation may be preserved because the individual lead plaintiff could remain as the lead, and, perhaps more importantly for continuity purposes, the lead counsel selected by the individual and institutional co-lead plaintiffs could remain in place with little or no disruption.<sup>194</sup>

In sum, the fact that individual investors are much less likely to engage in derivatives trading than are institutional investors means that, as lead plaintiffs, they would expose the class to much less risk that their stake in the outcome will change if derivatives are included. They also offer greater stability to the lead plaintiff group because they will not be subject to the unique defenses faced by derivatives traders.

## 2. *Holding Versus Selling Shareholder Plaintiffs.*

*a. Maximizing financial recovery.*—In *Gluck v. Cellstar Corp.*, the district court for the Northern District of Texas appointed an institutional investor plaintiff with the largest loss as the lead plaintiff despite a competing bid from a group including at least one individual whose loss was substantial relative to the individual's assets.<sup>195</sup> The competing group urged that it be appointed co-lead plaintiff with the institution because the institution had traded in derivatives.<sup>196</sup> The court held that by expressing a preference for institutional investors, Congress had preempted such typicality challenges based on derivatives trading.<sup>197</sup> The court appointed the institution as sole lead plaintiff.<sup>198</sup> It could have stopped there. But it offered an additional, revealing rationale for its holding. It reasoned that plaintiffs with a small absolute investment in the defendant company (and their lawyers) have strong incentives to seek the maximum

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<sup>194</sup> Courts could retain the same lead counsel even if they choose to replace the lead plaintiff, but they might be more inclined to retain the original lead counsel when at least part of the original lead plaintiff group remains.

<sup>195</sup> 976 F. Supp. 542, 545–46 (N.D. Tex. 1997); see HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 3C SEC & FED. CORP. L. § 16:146 (2d. ed 2004) (citing *Gluck*, 976 F. Supp. 542).

<sup>196</sup> *Gluck*, 976 F. Supp. at 545.

<sup>197</sup> *Id.* at 548 (“By expressing a strong preference for institutional investors to be Lead Plaintiffs, Congress rejected typicality and adequacy objections like those of the CellStar Plaintiffs Group.”).

<sup>198</sup> *Id.*



damage award possible without regard to future company performance or share appreciation.<sup>199</sup> Institutional investors—who the court assumed, probably correctly, would continue to hold shares in the defendant company after the fraud was revealed—would consider the long-term interests of the defendant and would reduce “immediate damage payments to the plaintiff class . . . [but] improve the chances that the company will experience future growth.”<sup>200</sup>

The court’s rationale distorted the original intent of the PSLRA. Congress reasoned that institutional investor lead plaintiffs were better class representatives than professional plaintiffs who were incapable of monitoring plaintiffs’ lawyers.<sup>201</sup> Congress did not say, as the *Gluck* court did,<sup>202</sup> that the interests of investors who retained their shares in the defendant company were a higher priority than those of individuals who sell their shares because holding investors have the interests of the defendant in mind. Here, the *Gluck* court elevated the legitimate interests of institutional investors (long term growth of their ongoing investment in the defendant) over the different but equally legitimate interests of individual investors (a maximum damage award). In relying upon this rationale for its holding, the court verbalized one of the key problems this Article seeks to address: in consistently appointing institutional lead plaintiffs, regardless of how such plaintiffs’ interests conflict with those of individual investors, courts de facto prioritize the interests of institutional investors—and arguably, the interests of defendants—over those of individual investors. That was never Congress’s intention, and it runs afoul of Rule 23.

In *Gluck*, the elevation of institutional over individual interests manifested itself in resolving a conflict that tends to break down along institutional–individual lines: the conflict between holding and selling shareholders of the defendant company.<sup>203</sup> Even after a fraud is revealed, institutional investors often hold some stake in the defendant company.<sup>204</sup>

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<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

<sup>201</sup> S. REP. NO. 104-98, at 11 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 690 (“Institutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus, courts could be more confident settlements negotiated under the supervision of institutional plaintiffs were ‘fair and reasonable’ than is the case with settlements negotiated by unsupervised plaintiffs’ attorneys.” (quoting Weiss & Beckerman, *supra* note 1, at 2105)).

<sup>202</sup> For an example of reasoning similar to the *Gluck* court, see *Naiditch v. Applied Micro Circuits Corp.*, No. 01-CV-0649-K-AJB, 2001 WL 1659115, at \*2–3 (S.D. Cal. Nov. 5, 2001) (citing *Gluck* and appointing institutional investor as lead plaintiff despite institutional investor qualifying as a professional plaintiff under the PSLRA). *But see In re BP, PLC Sec. Litig.*, 758 F. Supp. 2d 428, 441–42 (S.D. Tex. 2010) (noting differences between plaintiffs and ultimately creating subclasses).

<sup>203</sup> Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1505 (1996) (pursuing meritorious litigation may not be in the best interests of continuing shareholders).

<sup>204</sup> Note that in order to have standing in a securities class action, a plaintiff must have purchased or sold securities during the class period. *See, e.g., Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723,

They do so for two primary reasons: first, because their ownership stake is substantial enough to further depress share prices if sold, causing even more harm to them; second, because compliance with portfolio diversification requirements hampers the funds' ability to sell their positions even after a fraud.<sup>205</sup> On the other hand, individual shareholders whose buy-sell decisions will have no impact on the share price frequently do sell after a fraud.<sup>206</sup> This may not be a rational decision, particularly if the market has already priced in the harm of the fraud once it has been revealed. But it is not per se irrational for individual investors to sell, as it often is for institutions. Individual-investor stakes are not large enough to substantially impact the stock price when they sell; therefore, they do not further harm themselves through exit.

With no ongoing interest in the defendant issuer, selling shareholders have a straightforward objective in the litigation: to maximize the damage award. The incentives for holding shareholders are more complex. Holding shareholders may be willing to forego some monetary compensation in exchange for corporate governance reforms that would make their ongoing investments in the company more valuable or simply to avoid damaging the company in which they maintain an ongoing stake.<sup>207</sup>

The court in *In re Cendant Corp. Litigation* addressed this conflict, noting the "attractive[ness]" of plaintiffs' arguments that the lead plaintiff California Public Employees Retirement System (CalPERS) could not

747 (1975). A lead plaintiff may hold shares in the defendant that were purchased both before and during the class period. *Id.* at 736. The pre-class period purchases would not count towards the plaintiff's damages. *Id.*

<sup>205</sup> See, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 201, 244 (3d Cir. 2001) ("[A]n institutional investor with enormous stakes in a company is highly unlikely to divest all of its holdings in that company, even after a securities class action is filed in which it is a class member."); *In re Royal Dutch/Shell Transp. Sec. Litig.*, 404 F. Supp. 2d 605, 611 (D.N.J. 2005) ("[B]ecause of the very size of an institutional investor's shareholdings, an institutional investor might be discouraged from divesting itself of the stock."); Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective*, 1992 COLUM. BUS. L. REV. 223, 227 ("Institutional investors holding equity positions in the market generally diversify their holdings . . . . Several factors contribute to this behavior: for example, pension funds are subject to prudence and portfolio diversification requirements pursuant to the federal Employee Retirement Income Security Act of 1974 (ERISA) . . . .").

<sup>206</sup> BLOOMENTHAL & WOLFF, *supra* note 195, § 16:146 ("The problem, however, is that a substantial portion of the class are likely to have sold their stock soon after the bad news announcement and will not benefit from improvement of the company's future growth.")

<sup>207</sup> *Cendant*, 264 F.3d at 243 (noting that a lead plaintiff who retains a substantial investment faces a conflict between trying to get maximum recovery for the class and trying to protect its ongoing investment in the corporation "by settling cheap or by securing corporate governance changes in lieu of cash"); Alexander, *supra* note 203, at 1504 (arguing that current investors would prefer that sanctions be imposed on individuals responsible for the fraud rather than the company itself); Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 546 (1997) ("[A]n institution that continues to own stock is poorly suited to represent investors who are no longer invested in the company.").

adequately represent the class on account of its “huge” ongoing investment in the defendant company because such an investment conflicted with maximizing recovery for the class.<sup>208</sup> As the *Cendant* court noted:

[A] rational Sell Plaintiff would be perfectly willing to push the defendant firm one dollar short of declaring bankruptcy, [while] a rational Hold Plaintiff rarely would be so willing because the increased value of her share of the settlement fund would almost certainly be offset by a corresponding decrease in the value of her stock.<sup>209</sup>

Still, despite acknowledging the conflict, the *Cendant* court declined to disqualify CalPERS, concluding that Congress’s preference for institutional lead plaintiffs implied that the conflict between sell and hold plaintiffs was not per se disqualifying.<sup>210</sup> But the *Cendant* court discussed its concerns about the conflict in an extended footnote in which it called the issue to the attention of district courts, noting that the conflict could raise class certification issues and strongly implying that the creation of separate subclasses of selling and holding plaintiffs would be an acceptable remedy.<sup>211</sup> The court also noted that the conflict was mutual: selling lead plaintiffs might not adequately represent holding class members, just as holding lead plaintiffs might not adequately represent selling class members.<sup>212</sup>

Despite this clarion call from the Third Circuit, other courts have done little about the conflict, avoiding creation of subclasses of sell and hold plaintiffs while declining to disqualify holding institutional investors from representing selling class members.<sup>213</sup> What the Third Circuit acknowledged as a conflict—albeit not a disqualifying one—has been read by some courts as no conflict at all. For example, the court in *In re Gemstar TV Guide International, Inc. Securities Litigation* declined to acknowledge any conflict between selling and holding plaintiffs. The court first assumed that “[e]very class member shares an overriding common interest in establishing the existence and materiality of misrepresentations”<sup>214</sup> (which may be true, but which ignores the conflict over damages for such misrepresentations)

<sup>208</sup> *Cendant*, 264 F.3d at 243.

<sup>209</sup> *Id.* at 244 n.25.

<sup>210</sup> *Id.* at 243–44.

<sup>211</sup> *Id.* at 244 n.25 (“[T]he use of separate classes or sub-classes is not inconsistent with the Reform Act because that statute deals with the identification of a lead plaintiff, and not with the proper means for defining a class in the first place.”).

<sup>212</sup> *Id.*

<sup>213</sup> Westlaw and Lexis searches on November 11, 2011 revealed no cases in which courts created subclasses of individual and institutional lead plaintiffs or disqualified institutional investors from representing sell plaintiffs because of the sell–hold conflict. I used the following search terms: “subclass /s(/p) ‘lead plaintiff’ & conflict”, “subclass /s(/p) ‘sell plaintiff’ & institution!”, and “subclass! /p institution! /p individ! & securities”.

<sup>214</sup> 209 F.R.D. 447, 453 (C.D. Cal. 2002) (alteration in original) (quoting *Blackie v. Barrack*, 524 F.2d 891, 910 (9th Cir. 1975)).

and then cited caselaw supporting the proposition that there simply was no such conflict in the case.<sup>215</sup>

*Cendant* and *Gemstar TV* suggest that courts have not adopted a comprehensive approach to deal with the conflict between selling and holding plaintiffs. This is a problem which remains particularly relevant for individual investor members of the class, who almost exclusively suffer the consequences. As the *Cendant* court pointed out, it is true that selling lead plaintiffs are no more or less adequate as representatives of holding shareholders and vice versa.<sup>216</sup> But the reality is that cases in which individuals find themselves appointed lead plaintiff are likely to be ones in which institutional investors have incurred losses in such trivial amounts (on a relative or absolute basis) that they are virtually indifferent to the outcome of the case; otherwise, an institution would likely have obtained the lead plaintiff appointment because of their larger stakes in the defendant, on average. The conflict usually manifests with institutional plaintiffs who maintain an ongoing stake in the defendant representing selling individual shareholders.

In sum, the preference for institutional investor lead plaintiffs inherently favors hold plaintiffs over sell plaintiffs, raising Rule 23 concerns that can be solved by appointment of an individual co-lead plaintiff.

*b. Corporate Governance Reform.*—The corporate governance reform movement—a broad phrase used to describe efforts by shareholders to reform the rules and norms by which corporations are operated—has blossomed in recent years, particularly since the collapses of Enron and WorldCom.<sup>217</sup> Institutional investors have led this movement; union and public pension funds have actively participated, striving to increase the voice of shareholders in corporate governance and improve supervision of senior management through independent board members.<sup>218</sup> Institutional

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<sup>215</sup> *Id.* (citing *In re AST Research Sec. Litig.*, No. CV 94-1370 SVW, 1994 WL 722888, at \*4–5 (C.D. Cal. Nov. 8, 1994) (the Ninth Circuit has “rejected contentions that the interests of in/out traders can prevent certification of a class” that includes “retention plaintiffs”); *In re Unioil Sec. Litig.*, 107 F.R.D. 615, 621–22 (C.D. Cal. 1985) (finding no conflict between retention purchasers and “in-and-out” traders); 7 NEWBERG ON CLASS ACTIONS § 22.39, at 198 (4th ed. 2002) (“[A] plaintiff who has acquired and retained securities can thoroughly and adequately represent parties who purchased securities and then sold them, and vice versa.” (citations omitted)).

<sup>216</sup> *Cendant*, 264 F.3d at 244 n.25 (“[N]oting the possibility of a significant conflict in many securities class actions between the interests of individuals and institutions that purchased and then sold stock in the defendant firm—‘Sell Plaintiffs’—and those who bought and continue to hold such stock—‘Hold Plaintiffs.’” (citing *In re Party City Sec. Litig.*, 189 F.R.D. 91, 108–10 (D.N.J. 1999))).

<sup>217</sup> See Sherrie R. Savett, *Plaintiff’s Vision of Securities Litigation: Trends/Strategies in 2005-2007*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2007, at 57, 65 (2007) (noting “improved corporate governance in the wake of the Enron and WorldCom debacles”).

<sup>218</sup> The Council of Institutional Investors (CII) is a nonprofit association of public, union, and corporate pension funds with combined assets that exceed \$3 trillion. Its corporate governance policies

investors have experienced some success promoting say-on-pay initiatives, majority voting for election of directors, shareholder proxy access, and adoption of an independent board chairman.<sup>219</sup> The recent incorporation of proxy access into Dodd–Frank is a legislative triumph for shareholder rights that is largely attributable to the efforts of these institutions (although the SEC’s proposed implementation of proxy access via Rule 14a-11 was recently struck down by the D.C. Circuit).<sup>220</sup> Still, even if a revised form of proxy access ultimately passes legal scrutiny, it remains to be seen whether certain restrictions placed on this access will result in de facto inaccessibility of the proxy for shareholders.<sup>221</sup>

All investors, including individual investors, have benefited from these reforms. Academic research has shown that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower

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are a useful example of the corporate governance objectives that institutional investors have pursued over the past twenty years. For example, the council maintains policies with regard to the company board of directors, shareholder voting rights, shareholder meetings, executive compensation, director compensation, and the definition of an independent director. *See History*, COUNCIL INSTITUTIONAL INVESTORS, <http://www.cii.org/history> (last visited Mar. 24, 2012); *Corporate Governance Policies*, COUNCIL INSTITUTIONAL INVESTORS, <http://www.cii.org/UserFiles/file/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2009-29-10%20final.pdf> (last visited Mar. 24, 2012).

<sup>219</sup> *See* Louis M. Thompson, Jr., *The Individual Investor as Potential “Swing” Voter*, COMPLIANCE WK., June 2007, at 70.

<sup>220</sup> *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1146 (D.C. Cir. 2011).

<sup>221</sup> Under the Dodd–Frank Act, the SEC had authority to promulgate rules regarding shareholder proxy access. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010) (authorizing the SEC to promulgate rules regarding proxy access). Pursuant to this authority, the SEC established Rule 14a-11 which allowed a shareholder group holding at least 3% of total voting power to access management proxies and nominate up to 25% of the board, gaining additional benefits and voice. *See* Facilitating Shareholder Director Nominations, Release Nos. 33-9136, 34-62764, IC-29384, 75 Fed. Reg. 56,668, 56,782–87 (Sept. 16, 2010). This proxy access regulation was then challenged by the Business Roundtable and U.S. Chamber of Commerce, and vacated by the D.C. Circuit. *See* Gordon Smith, *Business Roundtable v. SEC*, CONGLOMERATE (July 22, 2011), <http://www.theconglomerate.org/2011/07/business-roundtable-v-sec.html>. Although the rule was struck down, the 3% requirement exemplifies a restriction that would put proxy access beyond the reach of most shareholders. *See, e.g.,* Ted Allen, *Three More Proxy Access Proposals Filed*, ISS (Dec. 1, 2011, 3:31 PM), <http://blog.issgovernance.com/gov/2011/12/three-more-proxy-access-proposals-filed.html> (“[T]he SEC’s universal access rule (Rule 14a-11) . . . would have required investor groups to hold a 3 percent stake for at least three years, and imposed a 25 percent cap on the board seats that could be contested by access nominees. That rule was overturned by a federal appeals court in July and the SEC appears unlikely to try to revive that rule in the coming year. While some institutional investors have expressed support for Rule 14a-11’s thresholds, . . . retail activists have argued that those hurdles would be too high and would bar small shareowners from nominating board candidates.”). Comparatively, investors must disclose the beneficial ownership of 5% or more of shares outstanding under Exchange Act Rule 13(d). 15 U.S.C. § 78m(d)(1) (2006). Although only 2% higher, this threshold was enacted to “alert the marketplace to every large, rapid aggregation or accumulation of securities . . . which might represent a potential shift in corporate control.” *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971); *accord* Amendments to Beneficial Ownership Reporting Requirements, Release No. 34-39538, 63 Fed. Reg. 2854, 2584 (Jan. 16, 1998) (noting that the 5% trigger alerts investors to the actions of large shareholders).

capital expenditures, and fewer corporate acquisitions.<sup>222</sup> An investment strategy that bought firms with the strongest shareholder rights and sold those with the weakest rights would have earned abnormal returns of 8.5% per year during the sample period.<sup>223</sup> All of the top shareholder plaintiffs' law firms tout their successes in obtaining corporate governance reform on behalf of institutional clients.<sup>224</sup>

Actual corporate governance activism manifests itself in two basic forms: nonlitigation activism and litigation activism.<sup>225</sup> Nonlitigation activism includes a broad range of activities such as writing a letter to management or a comment letter to the SEC, participating in proxy contests in support of nonmanagement board nominees, withholding votes from a management director candidate, or lobbying state legislatures with respect to corporate governance.<sup>226</sup> Litigation activism mostly includes serving as a lead plaintiff in a securities class action.<sup>227</sup> While serving as a lead plaintiff may itself be viewed as a form of corporate governance activism, how an

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<sup>222</sup> See generally Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783, 813 (2009) ("Firms with a low [shareholder-friendly] E Index score are associated with statistically significant abnormal returns both during the 1990–1999 period . . . and the longer 1999–2003 time period . . ."); Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 119–21 (2003) (noting that strong shareholder rights are "positively correlated with size, share price, trading volume, and institutional ownership").

<sup>223</sup> Gompers, Ishii & Metrick, *supra* note 222, at 109, 122.

<sup>224</sup> See, e.g., *Corporate Governance and Reform*, BARRACK, RODOS & BACINE, <http://www.barrack.com/Corporate-Governance-and-Reform.html> (last visited Mar. 24, 2012) (providing examples of the types of corporate governance reforms attained by the firm); *Corporate Governance Reforms*, BERNSTEIN LIEBHARD LLP, <http://www.bernlieb.com/results/Corporate-Governance-Reforms/index.html> (last visited Mar. 24, 2012) (noting firm's "particular success using litigation to accomplish corporate governance improvements for shareholders"); *Leadership in Corporate Governance Reforms*, BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP, [http://www.blbglaw.com/our\\_record\\_results/leadership\\_corp\\_gov](http://www.blbglaw.com/our_record_results/leadership_corp_gov) (last visited Mar. 24, 2012) (touting firm as "among the first law firms to ever obtain meaningful corporate governance reforms through securities litigation"); *Corporate Governance*, KESSLER TOPAZ METZLER CHECK LLP, [http://www.ktmc.com/investors\\_governance.php](http://www.ktmc.com/investors_governance.php) (last visited Mar. 24, 2012) (noting the firm's belief that "litigation can be used not only as a means to recover monetary losses, but also as a vehicle to implement corporate governance reform"); *Corporate Governance*, LABATON SUCHAROW, <http://www.labaton.com/en/practiceareas/Corporate-Governance.cfm> (last visited Mar. 24, 2012) (stating that the firm "has been leading corporate governance reform efforts for more than a decade"); *Corporate Governance Principles*, MILBERG LLP, <http://www.milberg.com/rigorous-corporate-governance-principles-institutional-investors> (last visited Mar. 24, 2012) ("Milberg's work with institutional clients is based on the premise that good corporate governance is critical to the protection of shareholder assets and the sustainability of a corporation."); *Corporate Governance*, ROBBINS GELLER RUDMAN & ROBBINS LLP, <http://www.rgrdlaw.com/services-institutional-investor-corporate-governance-reform.html> (last visited Mar. 24, 2012) (noting firm's corporate governance achievements).

<sup>225</sup> Choi & Fisch, *supra* note 48, at 326–32 (describing corporate governance activism).

<sup>226</sup> *Id.* at 326–29.

<sup>227</sup> *Id.* at 330–31.

institution performs in that role is a function of how much it prioritizes corporate governance reform.

A securities fraud class action offers the shareholder class, and in particular the lead plaintiff, a unique opportunity to demand corporate governance reform from the issuer defendant.<sup>228</sup> With the corporation reeling from a publicly disclosed fraud, sharp investor losses, negative press coverage, and a breakdown in the corporation's self-policing mechanisms designed to root out the fraud in the first place, it is often eager to make at least cosmetic and hopefully substantive reforms designed to restore investor confidence and prevent renewed abuses.<sup>229</sup> Institutional investors have successfully utilized their positions as lead plaintiffs to obtain such reforms. For example, in their capacity as lead plaintiffs in the UnitedHealth Group shareholder litigation—the largest ever stock options backdating case—CalPERS and the Alaska Plumbing and Pipefitting Industry Pension Trust obtained a \$925 million recovery (minus costs) and substantial corporate governance reforms.<sup>230</sup> These reforms included “a process for election of a shareowner-nominated director, enhanced standards for director independence, a mandated holding period for option shares acquired by executives, shareowner approval of any stock option repricing, and that incentive compensation take into consideration UnitedHealth's performance as compared to its peer group.”<sup>231</sup> Current and future shareholders likely benefited from such reforms, but selling shareholders did not. Unless one assumes that UnitedHealth agreed to these corporate governance reforms in exchange for nothing, it follows that the reforms were obtained in exchange for a reduction in compensation for the shareholder class.<sup>232</sup>

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<sup>228</sup> See, e.g., Todd Henderson, *Governance at Gunpoint*, U. CHI. L. SCH. FAC. BLOG (Sept. 12, 2006, 11:26 AM), [http://uchicagolaw.typepad.com/faculty/2006/09/governance\\_at\\_g.html](http://uchicagolaw.typepad.com/faculty/2006/09/governance_at_g.html) (noting the merits of governance reform through litigation and deliberation).

<sup>229</sup> See, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 201, 247 (3d Cir. 2001) (stating defendant issuer may have agreed to corporate governance changes “as a way to show investors that it was addressing the situation that allowed the fraud to occur in the first place, thus trying to make itself more attractive”).

<sup>230</sup> See Notice of Pendency and Settlement of Class Action, Exhibit A1 at 15–16, *In re UnitedHealth Grp. Inc. PSLRA Litig.*, No. 0:06-CV-01691-JMR-FLN (D. Minn. Dec. 22, 2008); *UnitedHealth Group Agrees to Resolve Federal Securities Class Action Lawsuit*, UNITEDHEALTH GRP. (July 2, 2008), <http://www.unitedhealthgroup.com/newsroom/news.aspx?id=92f1c380-fcfc-4228-85bf-9b6ffdd11921>.

<sup>231</sup> Press Release, CalPERS, CalPERS, UnitedHealth Group Reach \$895 Million Settlement in Class-Action Case—Includes Landmark Corporate Governance Reforms (July 2, 2008), available at <http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-archive/pr-2008/jul/unitedhealth-reach-settlement.xml>.

<sup>232</sup> Cf. *Cendant*, 264 F.3d at 219, 246–47 (noting objector's grievance that the lead plaintiff negotiated a settlement including corporate governance changes that would only benefit class members that continued to hold Cendant stock after revelation of the fraud, and ultimately rejecting the objection because the objector failed to present evidence that corporate governance reform was exchanged for reduced compensation).

In addition to raising concerns about the compensation of sell plaintiffs, the tradeoff between compensation and corporate governance reform raises concerns about another threshold purpose of securities class actions: deterrence of fraud.<sup>233</sup> In theory, the purpose of securities class actions is not only to compensate investors for their losses, but to punish the perpetrators of the fraud in the hopes that such punishment will deter other actors from engaging in it.<sup>234</sup> Deterrence is attained when the individual perpetrators of the fraud and the corporation itself are forced to pay a price that leaves the perpetrators worse off financially than they were prior to the fraud.<sup>235</sup> Such deterrence discourages individuals from committing fraud and incentivizes the corporate defendant to institute methods and procedures for preventing the fraud in the first place.<sup>236</sup>

While corporate governance reform is admirable to the extent it improves company value and helps prevent and detect future frauds, when it is being exchanged for lower damages payments it may not only be unfair to sell plaintiffs but may raise concerns about underdeterrence. First, corporate governance reform that halts ongoing fraud and enhances the detection of future fraud only ensures that defendants must stop the scheme. Securities litigation is supposed to be a deterrent, not an amnesty program.<sup>237</sup> Second, not all corporate governance reforms arising from securities litigation directly target the fraud itself.<sup>238</sup> Some enhance shareholder value in other ways. For example, increasing oversight by the audit committee might directly enhance fraud detection and deterrence, but shifting from staggered to annually elected boards of directors would seem to have at most a tenuous connection to fraud and thus little deterrent effect.

Moreover, while holding shareholders, even individual holding shareholders, may benefit from corporate governance improvements, institutional shareholders disproportionately benefit from such improvements. For example, as noted in the UnitedHealth litigation mentioned above, it is not uncommon for lead plaintiff institutions to seek

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<sup>233</sup> John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1545–48 (2006) (discussing compensatory and deterrence rationales).

<sup>234</sup> *See id.* at 1547 (“But if the securities class action fails as a mechanism for compensation, it can still perform admirably as a form of deterrence.”).

<sup>235</sup> *See id.* at 1548 (“In principle, if insiders face an expected penalty that exceeds their expected gain, this should be sufficient to remove any incentive for them to inflate the corporation’s stock price.”).

<sup>236</sup> In practice, optimal deterrence is rarely obtained in securities class actions. In particular, the deterrence function is often inhibited because settlements are often paid by directors’ and officers’ liability insurers and not by the perpetrators personally. *See, e.g., id.* at 1567–70 (discussing the way in which officer insurance and indemnification negatively affect the deterrence function).

<sup>237</sup> *See id.* at 1547.

<sup>238</sup> *See* Press Release, CalPERS, *supra* note 231 (including “incentive compensation [that] take[s] into consideration UnitedHealth’s performance” among the listed corporate governance reforms).



the establishment of a shareowner nominating committee for director elections.<sup>239</sup> Typically such committees are comprised of shareholders who own some minimal threshold of the company's stock, usually enough to ensure that they will be institutional investors.<sup>240</sup> Such investors may find themselves appointed to the committee. While all investors likely benefit from an increased shareholder voice within the corporate management structure, the institutions that actually obtain a seat on such committees disproportionately benefit and therefore may be inclined to trade monetary compensation in exchange for such reform. As argued below, appointment of an individual seller as co-lead plaintiff would embed a voice for maximizing recovery within the lead plaintiff structure and push the balance of protected interests back towards the underrepresented individual sell plaintiffs.

3. *Mergers and Acquisitions: Institutional Investors with Equity in Both the Target and the Bidder.*—In state-level transactional class actions, the bulk of which historically took place in Delaware,<sup>241</sup> the plaintiff shareholder class generally brings an action alleging that the company's board failed to obtain a sufficient price for the company's shares in a friendly merger or other fundamental corporate transaction, or failed to respond adequately to a hostile bid.<sup>242</sup> Such cases may also allege that a controlling shareholder violated its fiduciary duties to minority shareholders by “cash[ing] out the minority at an unfair price, or through unfair dealings.”<sup>243</sup> They may allege self-dealing by management either in management buyouts or sales to a friendly third party.<sup>244</sup> Class actions may also arise in hostile bidder or second bidder situations (when a second

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<sup>239</sup> *See id.*

<sup>240</sup> *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010) (authorizing the SEC to promulgate rules regarding proxy access); Facilitating Shareholder Director Nominations, Release Nos. 33-9136, 34-62764, IC-29384, 75 Fed. Reg. 56,668, 56,782–87 (Sept. 16, 2010) (allowing a shareholder group holding at least 3% of total voting power to access management proxies and nominate up to 25% of the board, gaining additional benefits and voice).

<sup>241</sup> *See e.g.*, John Armour, Bernard S. Black and Brian Cheffins, *Delaware's Balancing Act 1* (Nw. Univ. Law Sch. Law & Econ. Research Paper No. 10-04, July 2011), available at <http://ssrn.com/abstract=1677400> (stating shareholder lawsuits against Delaware corporations have historically been filed in Delaware). *But see* John Armour, Bernard S. Black and Brian R. Cheffins, *Is Delaware Losing Its Cases?* 5 (Nw. Univ. Law Sch. Law & Econ. Research Paper No. 10-03, Mar. 25, 2011), available at <http://ssrn.com/abstract=1578404> (noting the recent trend away from corporate law litigation in the Delaware Court of Chancery).

<sup>242</sup> Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 173–75 (2004) (analyzing acquisition cases including friendly, hostile, arm's length, and control-shareholder transactions).

<sup>243</sup> *Id.* at 173–74 (finding it especially likely when the controlling shareholder owns more than 50% of the company).

<sup>244</sup> *Id.* at 174 (“The MBO cases raise conflict-of-interest claims because of the potential for the target company's board of directors to give its managers special preferences in a sale of control.”).

bidder emerges after management has announced a friendly acquisition deal).<sup>245</sup>

The process of selecting transactional lead plaintiffs in Delaware is similar, but not identical, to the federal process under the PSLRA. Delaware judges assess: (1) “the ‘quality of the pleading’ that appears best able to represent the interests of the shareholder class and derivative plaintiffs;” (2) “the relative economic stakes of the competing litigants in the outcome of the lawsuit (to be accorded ‘great weight’);” (3) “the willingness and ability of all the contestants to litigate vigorously on behalf of an entire class of shareholders;” (4) “*the absence of any conflict between larger, often institutional, stockholders and smaller stockholders;*” (5) “the enthusiasm or vigor with which the various contestants have prosecuted the lawsuit;” and (6) “competence of counsel and their access to the resources necessary to prosecute the claims at issue.”<sup>246</sup> *TCW Technology Ltd. Partnership v. Intermedia Communications, Inc.* established this standard for selecting lead plaintiffs, formulating the economic stakes test as one that evaluated the “greatest economic stake in the outcome of the lawsuit.”<sup>247</sup> In so doing, the *TCW Technology* court noted that this test “give[s] recognition to large shareholders or significant institutional investors who are willing to litigate vigorously on behalf of an entire class of shareholders, provided no economic or other conflicts exist between the institutional shareholder and smaller, more typical shareholders.”<sup>248</sup> Approximately 40% of all transactional class actions that have been filed in Delaware since *TCW Technology* have been led by institutional investors.<sup>249</sup>

State-level transactional class actions present yet another forum for the tensions between institutional and individual investors. Institutional investors hold billions of dollars in diversified assets. Consequently, they will often own shares in both the bidder and target companies.<sup>250</sup> This presents potential conflicts, particularly in the context of a change-in-control transaction in which the target board is obligated to maximize the price for target shareholders.<sup>251</sup> As a lead plaintiff, an institutional investor

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<sup>245</sup> *Id.* (noting that hostile-bidder situations make up only about 10% of acquisition litigation).

<sup>246</sup> *Wiehl v. Eon Labs*, No. Civ.A. 1116-N, 2005 WL 696764, at \*1–2 (Del. Ch. Mar. 22, 2005) (emphasis added) (footnote omitted).

<sup>247</sup> *TCW Tech. Ltd. P’ship v. Intermedia Commc’ns, Inc.*, No. 18336, 2000 WL 1654504, at \*4 (Del. Ch. Oct. 17, 2000).

<sup>248</sup> *Id.* (establishing standard for selection of lead plaintiffs favoring institutional investors similar to PSLRA) (emphasis added).

<sup>249</sup> *Webber*, *supra* note 7, at 7–8.

<sup>250</sup> Miguel A. Ferreira, Massimo Massa & Pedro Matos, *Shareholders at the Gate? Institutional Investors and Cross-Border Mergers and Acquisitions*, 23 REV. FIN. STUD. 601, 638 (2010) (stating that some institutional investors hold both target and bidder shares).

<sup>251</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 185 (Del. 1986) (beginning a line of cases enforcing a duty to get the best price for the shareholders once the company is up for sale).

should typify the class of target shareholders and zealously advocate on their behalf.<sup>252</sup> The institution must strive to maximize the price paid for the class's shares by the acquirer, augment disclosures, and create an open bidding process in the hope that the class will benefit from a bidding war.<sup>253</sup> But as shareholders in the acquiring company, institutional investors' interests may run counter to these objectives. The dollars they win as members of the target class are dollars they lose as an acquirer shareholder, and vice versa. If the institutional investors' stake in the acquirer is greater than their stake in the target, their net financial incentive is to lower the bidding price, not increase it. Moreover, where more than one bidder or potential bidder exists for the target, an institutional lead plaintiff with ownership stakes in these bidders or potential bidders might seek remedies that either expand or restrict the bidding process. The institution might take into account its ownership stake in the bidders rather than focusing solely on its ownership stake in the target.

This conflict has been raised in the Delaware Chancery Court. For example, in a recently filed brief in *Police & Fire Retirement System of the City of Detroit v. Yahoo! Inc.*, a competing lead plaintiff challenged the Police and Fire Retirement System of the City of Detroit's (Detroit P&F) application for appointment as lead plaintiff in a shareholder class action brought against Yahoo!'s board.<sup>254</sup> Yahoo!'s shareholders claimed that the board breached its fiduciary duties by rejecting Microsoft's offer to pay a 62% premium for Yahoo!'s shares.<sup>255</sup> The Plumbers and Pipefitters Local Union No. 630 Pension–Annuity Trust Fund (P&P) argued that Detroit P&F should be disqualified as the lead plaintiff representing Yahoo!'s shareholders because it also owned shares in Microsoft.<sup>256</sup> In defense of its application, Detroit P&F responded that the court had never held “that a proposed representative plaintiff is subject to disqualification due to an equity interest in a potential acquirer.”<sup>257</sup> It further argued that adopting such a rule would “exclude every multi-billion dollar investment fund from

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<sup>252</sup> DEL. CH. CT. R. 23(a)(3)–(4), available at <http://courts.delaware.gov/forms/download.aspx?=39138>.

<sup>253</sup> See *Revlon*, 506 A.2d at 185 (creating a duty for the board to get the best possible price for the shareholders once the company is up for sale); see also *Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110, 1120–21 (Del. 1994) (regarding duties of a controlling shareholder); *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (reinforcing the *Revlon* duty via auction).

<sup>254</sup> Memorandum of Law in Further Support of the Detroit Funds' Motion for Consolidation, Appointment of Lead Counsel and in Opposition to the Plumbers & Pipefitters Competing Motion at 1, *Police & Fire Ret. Sys. of Detroit v. Yahoo! Inc.*, No. 3561, 2008 WL 2213692, at \*1 (Del. Ch. Mar. 3, 2008) [hereinafter Memorandum of Law].

<sup>255</sup> See *Aaron ex rel. Yahoo! Inc. v. Yang*, No. C-08-05438 RMW, 2009 WL 1689707, at \*1 (N.D. Cal. June 15, 2009), *aff'd sub nom. Congregation Beth Aaron ex rel. Yahoo! Inc. v. Yang*, 400 Fed. App'x 252 (9th Cir. 2010).

<sup>256</sup> Memorandum of Law, *supra* note 254, at 1.

<sup>257</sup> *Id.* at 1.

participating” in litigation in Delaware cases involving two or more public companies.<sup>258</sup> The court appointed Detroit P&F lead plaintiff without commenting on the conflict.<sup>259</sup> There is nothing in the record indicating that the court required disclosure of Detroit P&F’s stake in Microsoft. Without such disclosure, it is difficult to discern how one could assess whether there was “any conflict between larger, often institutional, stockholders and smaller stockholders.”<sup>260</sup>

As Detroit P&F pointed out, because of broad shareholdings by institutional investors, a per se rule barring investors that maintain an equity position in a bidder would de facto disqualify institutions from serving as lead plaintiffs.<sup>261</sup> But intermediate positions exist between barring such investors from serving as lead plaintiffs and ignoring the conflicts they present. For example, one seemingly straightforward solution might be to require institutional investors to disclose their stakes in actual bidders—e.g., Detroit P&F disclosing its shares in Microsoft. From this, a simple calculation would follow (subject to the complexities of calculating derivatives exposure). What is the lead plaintiff applicant’s financial interest in the bidder relative to the target? An institution whose financial interest in the bidder exceeds its interest in the target should simply be barred from serving as the lead plaintiff because its financial interests directly conflict with those of the class. One would hope that an institutional lead plaintiff that finds itself in this situation would not seek a lead plaintiff appointment that would be against its own interests and thereby create a conflict between the fund’s duties to its beneficiaries and its duties to the shareholder class as lead plaintiff.

It is worth pausing here to investigate why a fund might ever seek a lead plaintiff appointment to represent a class of shareholders with whom the fund’s interests are in direct conflict. The reasons range from the sinister to the merely negligent. One reason could be that the board members of the fund retain some private benefit from bringing the litigation even if the suit runs counter to the fund’s interests. For example, politicians serving on a fund’s board might win favorable publicity by using the fund’s lead plaintiff status to win concessions from the bidder in favor of the target, particularly if the target is located within the politician’s constituency and employs voters. Politicians might also bring an action if they have received a campaign contribution from the plaintiffs’ lawyers interested in bringing the case, although recent empirical work suggests these concerns are

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<sup>258</sup> *Id.* at 1–2.

<sup>259</sup> See *Police & Fire Ret. Sys. of Detroit v. Yahoo! Inc.*, No. 3561 (Del. Ch. Mar. 5, 2008), available at [http://www.blbglaw.com/cases/00071\\_data/Yahoo-SignedOrderofCons.03-05-08.pdf](http://www.blbglaw.com/cases/00071_data/Yahoo-SignedOrderofCons.03-05-08.pdf) (consolidating three cases and appointing Detroit P&F as lead plaintiff).

<sup>260</sup> *Hirt v. U.S. Timberlands Serv. Co.*, No. Civ.A. 19575, 2002 WL 1558342, at \*2 (Del. Ch. July 3, 2002).

<sup>261</sup> Memorandum of Law, *supra* note 254, at 1.

overblown.<sup>262</sup> On the more sinister end of the spectrum—in what is an admittedly improbable but still possible scenario—an institutional investor could obtain lead plaintiff status for the purpose of thwarting the litigation. This would be a blatant violation of the fund’s fiduciary duty to the class of shareholders it is supposed to represent. Nevertheless, with no required disclosure of the fund’s holdings in the bidder, the risk of exposure would seem low, and if the stakes were high enough for the institutional investor, it might conclude on a cost–benefit basis that obtaining the lead plaintiff appointment would be worth the risk. Investors have exhibited similarly mercenary behavior in the realm of empty voting, in which investors with no financial interest in a bidder, but with a voting interest, campaign for the bidder to pay maximum price for the target company in which the investor’s true financial interest actually lies.<sup>263</sup> In the empty-voting scenario, the investor voting in favor of the high price deceptively appears to have the same interests as its fellow investors, when in fact their interests are opposed.<sup>264</sup> In the empty-voting scenario, though, the investor owes no duty to its fellow investors,<sup>265</sup> whereas a fund that obtained a lead plaintiff appointment would owe a fiduciary duty to fellow investors as class representative.<sup>266</sup> The mere existence of the duty would presumably make the lead plaintiff scenario less likely than the empty-voting scenario, but many cases settle with no change in the offer price and a handful of relatively meaningless disclosures of little material interest to shareholders. The mere presence of an unattractive settlement for the target’s shareholders is unlikely to raise suspicions about a lead plaintiff willfully underlitigating a case.

Another more benign but nevertheless troubling reason why a fund would seek to represent a class of target shareholders when its ownership stake in the bidder or bidders exceeds its stake in the target is simple negligence. The fund may not examine its ownership stake in the bidder or bidders because it does not have to. There have been prior examples of such

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<sup>262</sup> Webber, *supra* note 96, at 2080 (“[P]oliticians and political control negatively correlate with lead plaintiff appointments in securities class actions.”).

<sup>263</sup> See Hu & Black, *supra* note 13, at 830 (“Empty voting on the acquirer’s side by the target’s shareholders, employed if the vote is likely to be close, could reduce whatever constraint the vote requirement now instills on the acquiring firm.”); Shaun P. Martin & Frank Partnoy, *Encumbered Shares* 34 (Univ. of San Diego Sch. of Law Legal Studies Research Paper Series, Research Paper No. 05-23, Oct. 2004), available at <http://ssrn.com/abstract=621323> (“[M]illions of target shares . . . come to be owned by encumbered shareholders with a single incentive: to ensure that the deal is approved, regardless of its merits.”).

<sup>264</sup> See Hu & Black, *supra* note 13, at 894 (suggesting that such empty voting would constitute the same breach of fiduciary duties as classic vote buying).

<sup>265</sup> *Id.* at 893–95 (finding no duty between investors).

<sup>266</sup> 7 NEWBERG ON CLASS ACTIONS § 22:5, at 37 (4th ed. 2002) (“The lead plaintiff owes a fiduciary duty to all members of the proposed class to provide fair and adequate representation and actively to work with class counsel to obtain the largest recovery for the proposed class consistent with good faith and meritorious advocacy.”).

negligence on the part of funds.<sup>267</sup> As in the “thwarting” example above, such negligence might also constitute a breach of fiduciary duty to the class, or to the institution’s own shareholders or beneficiaries.

Even in the most typical scenario, where an institution whose interest in the target exceeds its interest in the bidder and thus benefits from increasing the share price, the institution’s incentives are neither as strong nor as pure as a shareholder invested only in the target. The institution will still be protective of its ongoing investment in the bidder. Here, an institutional lead plaintiff bears a closer resemblance to the institutional “holding” lead plaintiff in a PSLRA suit, presenting similar conflicts of interest that can hamper the interests of the entire class.

A simple procedure to remedy these conflicts follows from this basic example. The court should calculate a lead plaintiff’s actual financial interest by subtracting its holdings in the bidder from its holdings in the target. Thus, if institution *A* maintains a \$10 million investment in the target and a \$5 million investment in the bidder, its financial interest is \$5 million. If institution *B* invests \$7 million in the target and \$1 million in the bidder, its financial interest is \$6 million. If institution *C* invests \$12 million in the target and \$15 million in the bidder, its financial interest is -\$3 million. Under current Delaware practice, the preferred lead plaintiff would be institution *C*.<sup>268</sup> Under the proposal here, institution *B* should be selected.<sup>269</sup>

While this procedure is straightforward in the situation of a target with one bidder (again, subject to the complexities of derivatives exposure), it becomes more complex when multiple bidders are involved. In that case, the institutional lead plaintiffs’ interests may vary substantially depending on the bidder: Institution *A* may have a \$5 million stake in one bidder and a \$1 million stake in another. A further degree of complexity is added if one includes potential bidders—bidders who have expressed some interest but have not made a bid or may otherwise be obvious bidders for the target.

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<sup>267</sup> See, e.g., Cox & Thomas, *supra* note 85, at 412 (finding that large financial institutions frequently do not make claims on money owed from class action litigation).

<sup>268</sup> See TCW Tech. Ltd. P’ship v. Intermedia Commc’ns, Inc., No. 18336, 2000 WL 1654504, at \*4 (Del. Ch. Oct. 17, 2000) (“[T]he Court should give weight to the shareholder plaintiff that has the greatest economic stake in the outcome of the lawsuit.”).

<sup>269</sup> Institution *B* might also offer more benefit to the class than an institution with the same financial interest—\$6 million—but no investment in the bidder. For example, one of the chief complaints in state-level transactional litigation is that the target board has exchanged its approval and recommendation of the merger for seats on the board of the bidder or the post-merger entity. See, e.g., *In re Atlas Energy Res., LLC, Unitholder Litig.*, No. 4589-VCN, 2010 Del. Ch. LEXIS 216, at \*46–47 (Del. Ch. Oct. 28, 2010) (attacking the independence of a target company’s board members on the grounds that they were promised seats on the board of the surviving company); *Krim v. ProNet, Inc.*, 744 A.2d 523, 525 (Del. Ch. 1999) (asserting that the target board breached its duty of loyalty in approving a merger because several directors would receive seats on the acquirer board if the merger were finalized). A significant shareholder in the bidder would have some leverage to maximize price or open up the process to other bidders or at least put pressure on the bidder to disclose its financial arrangements with target directors or officers.

Without analyzing every possible permutation, it is clear that there is a point of diminishing returns to this inquiry when its complexity and inconvenience could outweigh its benefits in producing a conflict-free lead plaintiff. In such circumstances, the court should use its discretion to fashion a solution that is suitable to the particular case, whether that be a group of lead plaintiffs or the selection of the lead plaintiff with the largest net financial interest at the time of application, regardless of what bidders may subsequently step forward. Still, the potential complexity of such an inquiry should not lead courts to avoid it altogether. In many instances the inquiry will not be complex at all.

As is discussed below, appointment of an individual co-lead plaintiff who is invested only in the target would significantly improve the typicality and adequacy of the lead plaintiff group.

#### IV. POTENTIAL SOLUTIONS TO CONFLICTS BETWEEN INSTITUTIONAL AND INDIVIDUAL INVESTORS

The conflicts outlined above place federal district court judges in a bind, caught between two competing congressional commands: (1) to appoint an institutional investor lead plaintiff and (2) to abide by Rule 23.<sup>270</sup> This Article argues that, in practice, courts have followed the first command at the expense of the second. The best way for federal district judges to harmonize both commands is to appoint a qualified individual investor as co-lead plaintiff with an institutional investor. Judges should only opt for subclasses on motion from one of the co-lead plaintiffs in the unlikely event that the co-leads simply cannot agree about what is in the best interests of the class they represent. This same solution applies to Delaware Chancery Court judges and indeed any state court system which articulates a preference for institutional investor lead plaintiffs. Such judges are similarly caught between this preference and state versions of Rule 23.

##### *A. Appointment of an Individual Co-lead Plaintiff with an Institutional Lead Plaintiff*

The PSLRA grants courts the authority to appoint as lead plaintiff a “person or group of persons.”<sup>271</sup> Such authority has been used to appoint small lead plaintiff groups that jointly apply for the job.<sup>272</sup> It has also been

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<sup>270</sup> See generally 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (2006) (creating the “most adequate plaintiff” rule that favors institutional investors); H.R. REP. NO. 104-369, at 34 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 733 (noting that Congress “intend[ed] that the lead plaintiff provision will encourage institutional investors to take a more active role in securities class action lawsuits”).

<sup>271</sup> § 78u-4(a)(3)(B)(iii)(I); see also *In re Oxford Health Plans, Inc. Sec. Litig.*, 182 F.R.D. 42, 49 (S.D.N.Y. 1998) (noting that the PSLRA “expressly contemplates the appointment of more than one plaintiff”).

<sup>272</sup> See, e.g., *Johnson v. Pozen Inc.*, No. 1:07CV599, 2008 WL 474334, at \*3 (M.D.N.C. Feb. 15, 2008) (appointing an individual and a fund as co-lead plaintiffs to provide diversity in representation).

used to join separate applicants as co-lead plaintiffs.<sup>273</sup> Delaware courts have similarly appointed lead plaintiff groups consisting of both co-applicants and competing applicants.<sup>274</sup> I have found some instances in which courts have appointed individual and institutional co-lead plaintiffs with the explicit goal of combining the representative qualities of each to craft one typical and adequate lead plaintiff group. In *Johnson v. Pozen Inc.*, the court stated that “proposed Co-Lead Plaintiffs have argued persuasively that an institution/individual Co-Lead Plaintiff structure will provide a diversity of representation and also protect the interests of the class at class certification in the event that either [the individual] or the Pension Fund later leaves the action for whatever reason.”<sup>275</sup> In *Plumbers & Pipefitters Local 51 Pension Fund v. First Bancorp.*, the court similarly appointed individual and institutional co-lead plaintiffs, noting:

[W]hile the Pension Fund has the expertise to prosecute the litigation in the manner contemplated by the PSLRA . . . the small size of its loss may diminish its incentive to carry out that function vigorously. Also, there are special defenses that may be raised against the Pension Fund different from those that may be raised against [the individual co-lead plaintiff appointees].<sup>276</sup>

It is noteworthy that in both *Johnson* and *Plumbers & Pipefitters*, the lead-plaintiff applicants with the largest financial interest in the relief sought by the class happened to be individual investors, so the courts appointed institutional co-lead plaintiffs.<sup>277</sup> Still, the rationales discussed, particularly

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<sup>273</sup> *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. LaBranche & Co., Inc.*, 229 F.R.D. 395, 419 (S.D.N.Y. 2004) (“Other courts have determined that the interests of a proposed class will be served best by the appointment of co-lead plaintiffs or multiple lead plaintiffs who did not move initially as a group.”); *Miller v. Ventro Corp.*, No. 01-CV-1287, 2001 WL 34497752, at \*11–12 (N.D. Cal. Nov. 28, 2001) (appointing separate movants as co-lead plaintiffs in order to ensure adequate representation).

<sup>274</sup> *See, e.g., Nierenberg v. CKx Inc.*, No. 5545–CC, 2011 WL 2185614, at \*1–2 (Del. Ch. May 27, 2011) (appointing a co-applicant group as lead plaintiff); *In re Allion Healthcare Inc. S’holders Litig.*, No. 5022–CC, 2011 WL 1135016, at \*1 (Del. Ch. Mar. 29, 2011) (noting appointment of competing applicants as co-lead plaintiffs).

<sup>275</sup> 2008 WL 474334, at \*3; *see also In re Cable & Wireless, PLC, Sec. Litig.*, 217 F.R.D. 372, 375–77 (E.D. Va. 2003) (exercising discretion to appoint institution co-lead plaintiff with individual investor because individual had purchased defendant issuer’s American Depositary Receipts on NYSE, whereas institution could represent purchasers of defendant issuer’s common stock on London Stock Exchange); *Bell v. Ascendant Solutions, Inc.*, No. 3:01-CV-0166, 2002 WL 638571, at \*5 (N.D. Tex. Apr. 17, 2002) (observing that the inclusion of an institutional investor with two individual investors helps to “improve[] diversity of experience” for the class); *Laborers Local 1298 Pension Fund v. Campbell Soup Co.*, No. Civ.A. 00-152 (JEL), 2000 WL 486956, at \*3 (D.N.J. 2000) (“The Court also considers it desirable to have both an institutional investor, like Connecticut, and individual investors, like DeValle and Green, included as lead plaintiffs since each may bring a unique perspective to the litigation.”); *Yousefi v. Lockheed Martin Corp.*, 70 F. Supp. 2d 1061, 1071 (C.D. Cal. 1999) (“The Court also finds that with the appointment of one lead plaintiff who is an individual private investor and one lead plaintiff that is an institutional investor, the lead plaintiffs will represent a broader range of shareholder interests than if the Court appointed an individual or an institutional investor alone.”).

<sup>276</sup> 409 F. Supp. 2d 482, 483 (S.D.N.Y. 2006).

<sup>277</sup> *Id.*; *Johnson*, 2008 WL 474334, at \*3.



in *Plumbers & Pipefitters*, fit the reverse scenario as well, with an institution that has the largest absolute loss but one that is trivial relative to its asset size, though it seems no court has chosen to apply this reasoning in such a circumstance.

The procedure for selecting the individual co-lead plaintiff should mimic that for selecting lead plaintiffs generally. A court should conduct the lead plaintiff contest, where applicable, on two tracks. The first track would be for the selection of the institutional lead plaintiff, the second for selection of the individual. This sequence should be observed in order to select an individual co-lead plaintiff who complements the institutional lead plaintiff, not the other way around. The sequence maintains fidelity to Congress's preference for the selection of institutional investor lead plaintiffs.

As to the procedure for the individual lead plaintiff selection, the court should first establish which applicants have the largest absolute financial interest in the relief sought by the class. The most straightforward way to analyze this would be to determine which applicant incurred the largest loss in the fraud after disclosure of all relevant securities. This procedure alone would ensure an individual co-lead plaintiff with a significant stake in the case. And it is likely that this stake relative to the individual's net worth or total portfolio is greater than that of the institution's loss relative to its total portfolio.<sup>278</sup> Courts wishing to delve deeper should then consider the losses of the leading individual candidates relative either to their total assets or their total investment portfolios. The selection process need not be overly formalistic or rigid. The court could identify the individuals with the largest absolute losses (compared to other individuals) and look to the size of these losses relative to the individuals' overall portfolio or net worth.<sup>279</sup> The purpose of this inquiry would be to enable the court to refine its choice among competing individual lead plaintiff applicants by determining which of these individuals with the most substantial absolute losses have incurred losses that are sufficiently material to motivate them to monitor class counsel. Individuals with high relative losses can be counted on to serve as motivated lead plaintiffs who will push their lawyers and the defendants to maximize monetary recovery for the class<sup>280</sup> and may well be sophisticated enough for the job, as discussed in the survey of the financial literature

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<sup>278</sup> See e.g., *In re Del Monte Foods Co. S'holders Litig.*, C.A. No. 6027-VCL, 2010 WL 5550677, at \*6–7 (Del. Ch. Dec. 31, 2010) (selected as lead plaintiff a pension trust that owned 25,000 shares worth \$475,000 and representing 0.07% of its assets under management instead of a European asset manager for private and institutional clients that held 1,899,900 shares worth \$36 million and representing 0.02% of its assets under management.)

<sup>279</sup> Individuals who may be sensitive to disclosing their net worth or the size of their portfolios may request confidential treatment of this information.

<sup>280</sup> See generally Nicholas Barberis & Richard Thaler, *Survey of Behavioral Finance*, in 1 HANDBOOK OF THE ECONOMICS OF FINANCE 1053, 1067–72 (G.M. Constantinides et al. eds., 2003) (noting the effect narrow framing has on individual preference and evaluation of utility).

above.<sup>281</sup> Courts could measure the applicants' sophistication by requiring them to submit affidavits offering some brief biographical background, similar to what institutional investors and their lawyers currently present,<sup>282</sup> along with their certifications attesting to the purchases. In most cases, the individual investor should not have traded in derivatives of the stock, should be a sell plaintiff and not a hold plaintiff, and therefore, should be very interested in maximizing the damage payment to shareholders. At the state transactional level, the individual should not hold stock in the bidder. These restrictions should rule out few individuals, as they are attributes more commonly associated with institutional investors.

Once the individual and institution are selected, the court should then determine whether the combined lead plaintiffs comply with the Rule 23 requirements that they be typical and adequate class representatives. If the court finds that the co-lead plaintiffs fail the test, it can drop any of the co-lead plaintiffs, or all of them, and begin the process again. As with the current PSLRA procedure, once the presumptive co-lead plaintiffs are established, other members of the plaintiff class may overcome the presumption by demonstrating that the co-lead plaintiffs "will not fairly and adequately protect the interests of the class; or . . . [are] subject to unique defenses that render such plaintiff incapable of adequately representing the class."<sup>283</sup> The objective is for the individual investor, in looking out for her own best interests, to be looking out for those of the individual investor class members as well. The institutional and individual investors would jointly select lead counsel or select their respective counsel as co-lead counsel.

This procedure should ensure a more robust airing of the views of all class members in lead plaintiff decisions made on their behalf. Selecting the right individual co-lead plaintiff would improve the motivation and possibly the sophistication of the lead plaintiff group. The right individual co-lead plaintiff would reduce concerns about whether the lead plaintiff group is typical and adequate.<sup>284</sup> For derivatives trading, an individual co-lead plaintiff would reduce concerns about hidden gains or hidden offset losses in the lead plaintiff group. An individual who did not trade in derivatives

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<sup>281</sup> See discussion *supra* Part II.

<sup>282</sup> See, e.g., *In re Bank of America Corp. Sec., Derivative & Emp't Ret. Income Sec. Act (ERISA) Litig.*, 258 F.R.D. 260, 271 (S.D.N.Y. 2009) (referencing the high level of experience possessed by proposed lead counsel); *Se. Penn. Transp. Auth. v. Rubin*, No. 6323-VCN, 2011 Del. Ch. LEXIS 67, at \*4 (Del. Ch. Apr. 29, 2011) (explaining that where all lead counsel applicants "have successfully served as lead or co-lead counsel in varying numbers of complex cases," the applicants cannot be distinguished and selected based on that prior experience); see also *In re Molson Coors Brewing Co. Sec. Litig.*, 233 F.R.D. 147, 151 (D. Del. 2005) (noting that lead plaintiff applicant explained its qualifications by stating that "[it] has been appointed lead plaintiff or co-lead plaintiff in four securities class actions, and has never been rejected on adequacy grounds" (internal quotation marks omitted)).

<sup>283</sup> 15 U.S.C. § 78u-4(a)(3)(B)(iii)(II) (2006).

<sup>284</sup> See discussion *supra* Part III.A.

could insulate an otherwise attractive lead plaintiff group from attacks on its institutional members who might have reliance problems. Even if such attacks are successful in disqualifying the institutional lead plaintiff, the presence of the individual lead assures continuity of representation for the class both in terms of the individual lead plaintiff and the lead counsel. Conversely, to the extent that courts find that the presence of an individual, non-derivatives-trading investor “cures” the typicality and adequacy issue for a co-lead plaintiff group that includes a derivatives trader, this might attract the participation of large institutional investors that might otherwise not apply to be a lead plaintiff or might otherwise opt out and bring a separate action because of the potential conflicts caused by its derivatives trading. Such investors are the type Congress had in mind in adopting the lead plaintiff provisions of the PSLRA in the first place.<sup>285</sup>

Regarding conflicts over compensation versus corporate governance reform between holding and selling plaintiffs, the individual co-lead plaintiff could restore the voice of selling plaintiffs into the settlement process. Such a voice might not only improve monetary compensation for the class but could also aid in preserving the deterrence function of the class action. Likewise, an individual co-lead plaintiff would ensure that a member of the lead-plaintiff group in a state-level transactional class action has an equity stake in the target alone and not the bidder. While conflicts created by an institutional owner of both the target and the bidder(s) could be alleviated through disclosure of the applicants’ holdings in the bidder as outlined in Part III.B.3 above, appointment of an unconflicted individual co-lead creates added assurance that the interests of the lead plaintiff group are properly aligned with the class, particularly when the presence of multiple bidders greatly complicates the relative-stakes analysis for institutional investors. And unlike the use of subclasses, an individual–institutional co-lead plaintiff allows individual class members to benefit from the sophistication and experience of the institutional lead plaintiffs without subordinating their interests to them or exposing both subclasses to divide-and-conquer strategies by defendants, as discussed below. In addition, this procedure facilitates a larger role for individuals in securities class actions without marking a return to the pre-PSLRA days, when individual lead plaintiffs obtained the position by winning the race to the courthouse rather than on the basis of their investment in the defendant company. Unlike those individuals, the individuals for which this Article advocates as co-lead plaintiffs have a genuine stake in the outcome and every incentive to monitor class counsel.

A risk of this co-lead plaintiff approach is that the conflicts described above could result in irreconcilable differences within the group.<sup>286</sup>

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<sup>285</sup> S. REP. NO. 104-98, at 11 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 690.

<sup>286</sup> Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1174 (2011) (noting potential intragroup conflicts including “an inability to reach consensus, arbitrary choices

Individual demands for maximum compensation could conflict with institutions' ongoing investments in the issuer or their desire for corporate governance reform. In some instances, subclasses may be inevitable, as discussed below. But there should be few such cases.

First, courts should be reluctant to create subclasses given that they contravene Congress's intention that institutional investors should lead the class.<sup>287</sup> Second, institutional investors often seek both monetary compensation and corporate governance reform, and a restructuring of settlements to place increased emphasis on the former should not trigger extensive institutional resistance as long as it does not place the institutions' ongoing investment in the issuer at risk. Because many settlements are covered not by the corporation alone but by directors' and officers' insurance policies, and occasionally by contributions from underwriters and professionals too,<sup>288</sup> a conflict in which the institutions would actually be opposed to monetary compensation and only willing to accept corporate governance reform should be rare. Third, it is possible, if not likely, that the addition of individual investor co-lead plaintiffs would not lead to a net decrease in corporate governance reform in exchange for greater compensation but will lead to increased compensation alongside corporate governance reform. Individual investors are more sympathetic in the eyes of the public than large institutional investors.<sup>289</sup> In the rare instance in which these cases go to trial, individual investors are often presented to the jury because they make more sympathetic witnesses.<sup>290</sup> Presenting such investors before the judge, defense counsel, or the defendants may strengthen the emotive if not the legal case for monetary compensation, giving the defendants a preview of what the trial might be like and influencing the primary actors in favor of additional monetary compensation. Institutional investors are rarely positioned to make persuasive, sympathetic arguments that they were meaningfully harmed by the fraud, if not debilitated by it; monetary compensation arguments made by institutional investors look like stalking horses for the "true" motive of maximizing pay for their lawyers.

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through group voting, and strategic behavior through withholding consent" (citing SCOTT E. PAGE, *THE DIFFERENCE: HOW THE POWER OF DIVERSITY CREATES BETTER GROUPS, FIRMS, SCHOOLS AND SOCIETIES* 256–57 (2007)).

<sup>287</sup> H.R. REP. NO. 104-369, at 34 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 733 (noting that Congress "intend[ed] that the lead plaintiff provision will encourage institutional investors to take a more active role in securities class action lawsuits"); *see also* *Gluck v. Cellstar Corp.*, 976 F. Supp. 542, 549 (N.D. Tex. 1997) ("The best way for the Court to effectuate the purposes of the Reform Act is to appoint [a] sole Lead Plaintiff.").

<sup>288</sup> David M. Gische, *Directors and Officers Liability Insurance*, FINDLAW, <http://library.findlaw.com/2000/Jan/1/241472.html> (last visited Mar. 24, 2012).

<sup>289</sup> *See generally* David M. Herszenhorn, *Big Banks, U.S. Cities, Common Space: In Louisville, an Illustration of How Lines Can Blur*, N.Y. TIMES, June 11, 2010, at B1 (noting the existence of "loose rhetoric pitting Wall Street against Main Street").

<sup>290</sup> *See* Shapiro, *supra* note 29, at 208.

And as discussed below, the creation of subclasses exposes shareholders to divide-and-conquer exploitation by defendants. Rational shareholders should recognize the dangers of such exposure and make every effort to work within the co-lead plaintiff structure.

Finally, this proposed procedure offers all of the benefits enumerated above at minimal cost to courts in terms of added workload. In fact, there are strong reasons to believe that it will actually reduce burdens on the court. In the most likely scenario, the additional up-front investment of court time may be measured in minutes. Instead of reviewing a set of lead plaintiff application papers from institutional investors alone, courts will also review such applications from individuals. Institutional and individual investors may even apply jointly for the co-lead plaintiff position, thereby adding no additional briefs to the file. As with many current lead plaintiff fights, the outcome may be decided on the briefs alone. The papers will state the individual co-lead plaintiff applicant's losses and provide some background information about the applicant and the selected counsel. The court may wish to assess these losses relative to the applicant's total portfolio or assets by requesting that information in advance. Lead plaintiff application hearings, to the extent they occur, tend to last half a court day at the most. There is no reason to believe that the procedure propounded here will add materially to the efforts courts undertake anyway.

Moreover, co-lead plaintiffs have become increasingly prevalent in securities and transactional class actions. For example, in a hand-collected dataset of all 453 Delaware class and derivative actions filed from October 2003 to December 2009, 44% of all cases contained at least two co-lead plaintiffs, nearly a quarter were led by three or more plaintiffs, and nearly 10% were led by five or more plaintiffs.<sup>291</sup> Thirty percent of all cases led by an institutional investor were led by more than one such investor.<sup>292</sup> Nearly a quarter of all cases contained at least one institutional and one individual lead plaintiff, albeit an individual who was not selected according to the procedure outlined here.<sup>293</sup> In short, courts are already well-practiced in selecting co-lead plaintiffs. Nor is there any reason to believe that cohesive groups of multiple lead plaintiffs result in underperformance.<sup>294</sup> In the early years following passage of the PSLRA, plaintiffs' lawyers attempted to aggregate very large groups of investors (sometimes numbering in the thousands) for purposes of meeting the largest financial interest test.<sup>295</sup>

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<sup>291</sup> Data on file with author and the Northwestern University Law Review.

<sup>292</sup> *Id.*

<sup>293</sup> *Id.*

<sup>294</sup> *But see* Burch, *supra* note 286, 1111–12 (2011) (arguing that “lead plaintiff groups have performed poorly historically”).

<sup>295</sup> *See, e.g., In re Network Assocs., Inc., Sec. Litig.*, 76 F. Supp. 2d 1017, 1019 (N.D. Cal. 1999) (facing competing lead plaintiff applications from one group consisting of more than 1725 investors, 10

Some commentators expressed understandable concern that these large, aggregated groups of lead plaintiffs would ineffectively monitor class counsel, undermining a primary goal of the PSLRA.<sup>296</sup> This practice of aggregating very large numbers of lead plaintiffs into lead plaintiff groups has all but disappeared.<sup>297</sup> But there is little to suggest that a single lead plaintiff is superior to a small group, especially for the types of cases discussed here. Cox and Thomas conclude that single individual lead plaintiffs outperform groups in “bottom-tier cases,” but that groups of individuals outperform single individual lead plaintiffs in “top-tier cases” (where the tiers are based on the market capitalization of the defendant).<sup>298</sup> As I noted earlier, the conflicts presented here are particularly problematic in top-tier cases in which it is more likely that an institutional investor will obtain a lead plaintiff appointment.

Of course, it is true that more applications by more parties may lead to more conflicts at the lead plaintiff selection stage. But what the court saves in time on the back end may more than compensate for the additional up-front investment. By obtaining a more representative lead plaintiff group, courts may substantially reduce objections to the typicality and adequacy of the class representatives at the settlement hearing. They may also be spared the ordeal of having to select an entirely new lead plaintiff group or new lead counsel because the selected lead plaintiff finds itself subjected to unique defenses.

In short, my proposal favoring appointment of individual co-lead plaintiffs will not materially increase the burdens on courts but will instead likely reduce that burden.

### *B. Subclasses of Institutional and Individual Plaintiffs*

Federal Rule of Civil Procedure 23(c)(5) grants courts the discretion to create subclasses, stating that “[w]hen appropriate, a class may be divided

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of whom were applying for appointment as lead counsel, and another consisting of “over 100 institutions and thousands of individuals”).

<sup>296</sup> See, e.g., Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 54 (2001) (noting concerns regarding the use of aggregation to unite large numbers of unrelated investors into a lead plaintiff group); see also R. Chris Heck, Comment, *Conflict and Aggregation: Appointing Institutional Investors as Sole Lead Plaintiffs Under the PSLRA*, 66 U. CHI. L. REV. 1199, 1218–19 (1999) (“[A]ggregation shifts control of securities fraud litigation from investors to their attorneys.”).

<sup>297</sup> Paul Dutka, Joshua S. Amsel & Carrie E. Davenport, *Strange Bedfellows: Appointing Lead Plaintiffs Under the PSLRA*, BUS. & SEC. LITIGATOR (Mar.–Apr. 2006), available at <http://www.weil.com/news/pubdetail.aspx?pub=8470> (criticizing the aggregation of large lead plaintiff groups and noting recent judicial rejections of such groups).

<sup>298</sup> Cox et al., *supra* note 5, at 1632–34; see also Cox et al., *supra* note 174, at 375 tbl.6 (showing that the mean and median ratio of recoveries to provable losses is higher for groups of individual lead plaintiffs than for single individual lead plaintiffs).

into subclasses that are each treated as a class under this rule.<sup>299</sup> There is little precedent construing the rule, and the academic commentary on it has been sparse.<sup>300</sup> Courts create subclasses when certain class members “require specialized or distinct treatment,”<sup>301</sup> whether such distinct treatment refers to claims or remedies.<sup>302</sup> Here, both individual and institutional investors have largely the same interests in prevailing on liability issues.<sup>303</sup> Primarily, it is conflicts over remedies that set them apart. Probably the purest way to solve these conflicts is to separate individual and institutional investors into subclasses.

As noted above, the *Cendant* court suggested that subclasses may be a way to cope with conflicts between selling and holding plaintiffs.<sup>304</sup> This is one small logical step away from suggesting subclasses for individual and institutional investors, as the subclass of sell plaintiffs may be primarily composed of individual investors, whereas the subclass of hold plaintiffs conversely may be composed mostly of institutional investors. Still, even *Cendant* shied away from appointing subclasses for selling and holding plaintiffs on the grounds that if such a conflict were itself disqualifying, it would undercut Congress’s intention that institutions obtain lead plaintiff appointments.<sup>305</sup> Without something more, the sell–hold conflict alone failed to justify subclasses. Yet it may be the case that conflicts over derivatives trading or corporate governance reform could tip the balance in favor of subclasses, at least under *Cendant*. (The sell–hold distinction is meaningless in the context of state-level transactional litigation, although it bears some resemblance to the situation where the institution is invested in both the target and the acquirer.)

The *Cendant* court’s reluctance to grant subclasses in the face of strong conflicts between sell and hold plaintiffs—conflicts that were particularly acute because the defendant issuer went bankrupt—demonstrates how strongly courts weigh Congress’s intention that institutional investors lead the plaintiff class.<sup>306</sup> The co-lead plaintiff approach honors that intention while subclasses cut against it, as they leave institutional lead plaintiffs in a

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<sup>299</sup> FED. R. CIV. P. 23(c)(5).

<sup>300</sup> See e.g., Scott Dodson, *Subclassing*, 27 CARDOZO L. REV. 2351 (2006) (detailing the lack of jurisprudence on subclassing in class action litigation).

<sup>301</sup> *In re Prudential Ins. Co. Am. Sales Practices Litig.*, 148 F.3d 283, 316 (3d Cir. 1998).

<sup>302</sup> 1 Alba Conte & Herbert B. Newberg, *NEWBERG ON CLASS ACTIONS* § 3:32, at 454–55 (4th ed. 2002) (noting that class members may have a common interest in prevailing on liability but competing interests in seeking relief and that such conflict may be resolved through subclasses).

<sup>303</sup> *In re Gemstar–TV Guide Int’l, Inc. Sec. Litig.*, 209 F.R.D. 447, 453 (C.D. Cal. 2002) (“However, [e]very class member shares an overriding common interest in establishing the existence and materiality of misrepresentations.” (alteration in original) (quoting *Blackie v. Barrack*, 524 F.2d 891, 910 (9th Cir. 1975))).

<sup>304</sup> *In re Cendant Corp. Litig.*, 264 F.3d 201, 244 n.25 (3d Cir. 2001).

<sup>305</sup> *Id.* at 243–44 & n.25.

<sup>306</sup> See *id.* (giving Congress’s intent great weight).

position where they are only representing other institutions. Because subclasses cut against Congress's intent to see institutional investors leading class actions, the burden should be high on any party seeking such a remedy, which should only be utilized in extreme circumstances. For example, in a case in which damages are a particularly high percentage of the issuer's total assets—such that even a relatively moderate rate of recovery for investors would harm the company—and where another conflict such as derivatives trading is present, the interests of institutional and individual investors might diverge so greatly that they could not be harmonized without running afoul of typicality and adequacy requirements.

Moreover, even if subclasses did not run afoul of Congress's intention that securities class actions be led by institutional investors, they may be a cure worse than the disease. The sophistication of institutional investors as lead plaintiffs is not in dispute. Their frequent access to in-house counsel; their repeat relationships with the lead plaintiffs' law firms; their management of billion-dollar portfolios; their role as repeat market players; their widespread relationships with other investors, with the companies they invest in and with Wall Street; and their roles as fiduciaries for their beneficiaries leave them well-placed to act as fiduciaries for the shareholder class.<sup>307</sup> Securities class actions featuring institutional investor lead plaintiffs recover more for shareholders than securities class actions led by individual investors,<sup>308</sup> although it is difficult to discern whether this is because the institutions are better at litigating these cases or because they simply "cherry pick" the best ones. It may well be the case that individual investors would fare better overall under the status quo than under a regime in which they recover damages as part of a separate subclass of individual investors.

The argument of this Article is that investors' interests are optimized in a co-lead plaintiff structure. The key from the point of view of individual investors is to harness the benefits of an institutional lead plaintiff while mitigating the disadvantages. Subclasses deprive individual investors of both the advantages and disadvantages of institutional lead plaintiffs. Moreover, because Congress expressed a preference that lead plaintiffs be sophisticated and motivated, subclasses similarly deprive institutional investors of the benefits of highly motivated individual investors with

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<sup>307</sup> See generally Cheng et al., *supra* note 5, at 356–62 (using a database from 1996 to 2005 and controlling for case determinants of having an institutional lead plaintiff, finding that institutional investors, including public pension funds, decrease the probability of a case being dismissed, increase monetary recoveries, and improve the independence of boards at defendant companies); Cox et. al., *supra* note 5, at 1589 (studying the benefits of institutional lead plaintiffs).

<sup>308</sup> Cox et. al., *supra* note 5, at 1592, 1631–32 (finding that "the presence of an institutional lead plaintiff improves the settlement size, even holding constant estimated provable losses, firm market capitalization, the length of class period, and the presence of an SEC enforcement action," and concluding that the presence of "[i]nstitutional lead plaintiffs . . . increase settlement size, all other things being held constant").



relatively high losses. Rule 23(b)(3) merely requires that questions of law or fact common to the class predominate and that the class action device be superior to individual actions, not that the claims should be uniform or that the class action device be flawless.<sup>309</sup> The Supreme Court has noted that securities class actions readily satisfy the predominance standard.<sup>310</sup>

Finally, as a strategic matter, subclasses allow defendants to “divide and conquer” the plaintiffs.<sup>311</sup> There are numerous potential permutations of how defendants could exploit subclasses. They could offer comparatively generous terms to the first settling subclass while threatening to deploy maximum litigation resources against the second. They could exploit competition between the subclasses’ respective plaintiffs’ law firms, consenting to higher fees for one subclass or the other. Subclasses empower defendants to impose asymmetrical costs on competing groups of shareholders, which invariably improves the defendants’ settlement position. A united shareholder front presents a more daunting challenge and will likely result in more favorable settlements for the shareholders. Subclasses may be a cure that is more harmful than the conflicts of interest they are designed to remedy.

Still, the conflicts addressed in this Article are serious enough that subclasses should not be ruled out as a possible solution. Courts should be reluctant, but not unwilling, to create them. The co-lead plaintiff structure is preferable for the reasons outlined above. That co-lead plaintiff structure is enhanced by the remote but real possibility that courts could impose subclasses if necessary. The threat that either institutions or individuals could obtain subclasses ought to keep either side (more likely institutions) from attempting to impose their own priorities on the co-lead plaintiff group at the expense of the other. Such an arrangement should help ensure that the costs individuals or institutions impose on each other in negotiations over remedies will remain lower than the costs imposed on each by subclasses. Should either side conclude that the costs of the co-lead plaintiff arrangement exceed that of subclasses, one would expect that a subclassing motion would follow. The co-lead plaintiff offers an intermediate step between the status quo and the imposition of subclasses—one that ought to solve the typicality and adequacy problem. Courts may always resort to subclasses if the co-lead plaintiff arrangement fails. In order to give the co-lead structure an opportunity to succeed, courts should be reluctant to impose subclasses in the absence of a motion by a co-lead plaintiff calling for this remedy in light of irreconcilable conflicts within the lead plaintiff group.

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<sup>309</sup> FED. R. CIV. P. 23(b)(3).

<sup>310</sup> *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 625 (1997) (“Predominance is a test readily met in . . . cases alleging . . . securities fraud . . .”).

<sup>311</sup> Burch, *supra* note 286, at 1134 (noting risk of creating subclasses with no settlement leverage).

*C. Should Individual Co-lead Plaintiffs Be Represented by Separate Counsel?*

A lingering question for courts will be whether the individual co-lead plaintiffs should be represented by separate counsel or by the same counsel as the institutional lead plaintiffs.<sup>312</sup> Institutional investors themselves often serve as co-lead plaintiffs in couples or groups of other institutional investors represented by co-lead counsel; the notion of multiple lead counsel does not depart greatly from current practice.<sup>313</sup> Attorneys representing both institutional and individual investor co-lead plaintiffs would have incentives to cater to the interests of each. Because the attorneys' fees are based on the dollar recovery and not on corporate governance reform, the attorneys' incentives align well with individual investors seeking to maximize recovery.<sup>314</sup> But because attorneys are repeat players and institutions have the potential to be repeat players,<sup>315</sup> the attorneys might prioritize institutional interests in the hope of attracting future business or to prompt referrals to other institutions. The attorneys' calculation would balance increased attorneys' fees in the present case versus the value of future institutional business and referrals. Some of this calculation could depend on which institution(s) the attorneys happen to represent in any given case. Among institutional investors that have obtained lead plaintiff appointments, a substantial portion have done so just once.<sup>316</sup> This could be because the fund has no intention of participating again, but was drawn to the lead-plaintiff role because of unique circumstances pertaining to a particular case, or it could be that the fund will become a repeat player in the future. Some funds have obtained as many as nine appointments.<sup>317</sup> A law firm representing the latter type of fund might be more inclined to slant its representation towards the

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<sup>312</sup> See, e.g., Judith Resnick, *Money Matters: Judicial Market Interventions Creating Subsidies and Awarding Fees and Costs in Individual and Aggregate Litigation*, 148 U. PA. L. REV. 2119, 2169 (2000) (noting that lawyers may not adequately represent the conflicting interests among different class litigants); see also Nancy J. Moore, *Ethics Matters, Too: The Significance of Professional Regulation of Attorney Fees and Costs in Mass Tort Litigation—A Response to Judith Resnick*, 148 U. PA. L. REV. 2209, 2215–23 (2000) (discussing class counsel's ethical obligations in representing conflicted class members); Charles Silver & Lynn Baker, *I Cut, You Choose: The Role of Plaintiffs' Counsel in Allocating Settlement Proceeds*, 84 VA. L. REV. 1465, 1483–84 (1998) (discussing the extensive role played by class counsel in allocating settlement proceeds).

<sup>313</sup> See Webber, *supra* note 96, at 2051.

<sup>314</sup> See Weiss & Beckerman, *supra* note 1, at 2059 (noting attorneys typically receive 20%–30% of the monetary recovery).

<sup>315</sup> 15 U.S.C. § 78u-4(a)(3)(B)(vi) (2006) (allowing any plaintiff to serve as lead plaintiff no more than five times in a three-year period).

<sup>316</sup> See, e.g., Webber, *supra* note 96, at 2048, 2056 (finding that seventy-eight public pension funds obtained lead plaintiff appointments between 2003 and 2006). In unpublished results based on the same data used for the paper cited here, I find that just forty-three of these funds served in a lead plaintiff role more than once.

<sup>317</sup> *Id.* at 2056.

institution than would a firm representing an institution it expects will not become a repeat player. On the other hand, a once-only institutional lead plaintiff might incline an attorney to maximize recovery subject to the probability that the institution could become a meaningful source of referrals or a repeat player itself. In part, the law firm's assessment may depend on whether the institution in question has submitted to portfolio monitoring by the firm.

One way to cope with attorneys serving more than one master would be to appoint separate counsel for individual and institutional investors. Attorneys representing the individual co-lead plaintiff would, in theory, act based on the priorities of that plaintiff. But the underlying question remains: what are the attorneys' incentives? This leads to the crucial issue of how they will be paid. If we assume that counsel for the individual co-lead plaintiff will be compensated for its work on behalf of the individual investors alone, then the potential recovery for such attorneys in many cases could be too small to attract quality counsel.<sup>318</sup> In Delaware, courts weigh the "competence of counsel and their access to the resources necessary to prosecute the claims at issue" in selecting lead plaintiffs in the first place,<sup>319</sup> and federal courts similarly consider the competence of proposed lead plaintiff's counsel in selecting a lead plaintiff.<sup>320</sup>

Conversely, high attorneys' fees commanded by individual investor counsel would be removed from the pockets of institutional investor counsel. The downside risks of separate counsel include the possibility of either poor quality legal work for individual investors or a net increase in attorneys' fees paid by the class as institutional counsel demand higher compensation to make up for fees earned by individual counsel. Arguably, such higher fees could be worth the cost of improved representation, particularly if it results in increased compensation for the class. However, in general, courts will not want to see lawyers collecting an even greater share of class recoveries than they already do.

Depending on the case, such concerns about the zero-sum nature of attorneys' fees may be exaggerated. The absolute value of fees in the blockbuster cases that plaintiffs' lawyers bring to compensate for the costs of shepherding a portfolio of class actions through the almost-insuperable barriers of pretrial securities litigation practice—such as the bar on discovery prior to a ruling on the motion to dismiss and the highest pleading

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<sup>318</sup> See Weiss & Beckerman, *supra* note 1, at 2094 (arguing that individual investor recoveries constitute a small percentage of total dollar recoveries in securities class actions).

<sup>319</sup> *Hirt v. U.S. Timberlands Serv. Co.*, No. Civ.A. 19575, 2002 WL 1558342, at \*2 (Del. Ch. July 3, 2002) (citing DEL. CH. CT. R. 23(a); see *Youngman v. Tahmouh*, 457 A.2d 376, 379–80 (Del. Ch. 1983)).

<sup>320</sup> See, e.g., *In re MicroStrategy Inc. Sec. Litig.*, 110 F. Supp. 2d 427, 438 (E.D. Va. 2000) ("[A] district court should approve plaintiff's choice of lead counsel based solely on that counsel's competence, experience, and resources . . .").

standard in contemporary civil procedure—may be high enough to bear further subdivision among additional counsel without damaging anyone’s desire to take the job.

Alternatively, individual and institutional counsel could be compensated based upon the recovery for the class as a whole and not just their particular clients. The difficulty here is that one might question how separate counsel would add value if they will be responding to the same incentives as the institutional counsel, balancing recovery in the current action against the potential to attract institutional clients in a future action.

Ultimately, the factors outlined above—the proportional share of individual investor damages, the incentives of institutional counsel in any particular case, and the total dollar size of the potential recovery—are case specific and best known to the trial judge. Rather than impose a one-size-fits-all solution, trial court judges should exercise their discretion in deciding whether to appoint separate counsel for the individual co-lead plaintiff.<sup>321</sup>

#### CONCLUSION

Judges in securities and transactional class actions must balance two vital commands: appointment of an institutional investor lead plaintiff—the purpose of the “largest financial interest” provision of the PSLRA and the practice followed in Delaware—and appointment of a typical and adequate class representative as required by Rule 23.<sup>322</sup> Although these commands have been portrayed as being in concert with one another, this Article argues that they frequently conflict. Institutional investors’ derivatives trading, their practice of retaining equity in the defendant company even after the fraud has been exposed, their use of litigation to pursue corporate governance reforms, and, in state-level transactional cases, their maintenance of equity in both target and bidder companies create incentives that at times diverge from those of individual investor class members. In many instances, appointment of institutional lead plaintiffs strains Rule 23 requirements that a lead plaintiff be both a typical and adequate class representative.

While the status quo is unsatisfactory from the perspective of individual shareholders, total elimination of these conflicts by dividing

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<sup>321</sup> See Andrew S. Gold, *Experimenting with the Lead Plaintiff Selection Process in Securities Class Actions: A Suggestion for PSLRA Reform*, 57 DEPAUL L. REV. 447, 448–49 (2008) (advocating judicial experimentation with the lead plaintiff selection process).

<sup>322</sup> 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (2006) (“[T]he court shall adopt a presumption that the most adequate plaintiff . . . is the person or group of persons that—(aa) has either filed the complaint or made a motion . . . [to be appointed lead plaintiff]; (bb) in the determination of the court, has the largest financial interest in the relief sought by the class; and (cc) otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.”); *TCW Tech. Ltd. P’ship v. Intermedia Commc’ns, Inc.*, No. 18336, 2000 WL 1654504, at \*4 (Del. Ch. Oct. 17, 2000) (adopting a similar standard).

shareholders into subclasses of institutional and individual plaintiffs would contravene the intent of the PSLRA, deprive individual investors of the benefits of institutional lead plaintiffs, and allow defendants to “divide and conquer” plaintiff shareholders. The sensible course for vindicating individual investor rights is for courts to appoint a sophisticated and motivated individual investor to serve as co-lead plaintiff with institutional investors. Courts should select such plaintiffs based on their financial interest in a case, similar to the way institutional lead plaintiffs are selected now. An individual co-lead plaintiff would be a voice for individual class members, not to disrupt corporate governance reforms or other settlement-worthy objectives, but to remind institutions and the court that for some class members the only remedy for their injuries is money.