Class Action Developments

Courts Move To Control Appointment of Lead Plaintiffs Under PSLRA

The Private Securities Litigation Reform Act of 1995 ("PSLRA") empowers the court to select the lead plaintiff in a securities class action litigation. Although Congress hoped that institutional plaintiffs with substantial financial interests at stake would acquire control over more class actions, that hope has not borne abundant fruit.[1/] An important emerging development, however, is the willingness of some courts to impose stringent requirements on candidates for lead plaintiff status, exemplified by the recent decision of the Northern District of California in Network Associates,[2/] which severely restrained the ability of class counsel to offer an aggregation of unrelated plaintiffs for the lead role. As the law in this area develops, firms representing defendants need to consider what role they should play in the appointment process. There is recent, albeit not abundant, support for the view that defendants as well as contesting plaintiffs' firms should be heard on the question.

1/ See, e.g., In re Cendant Corp. Litig., 182 F.R.D. 144, 148 (D.N.J. 1998).

2/ In re Network Assocs., Inc., Sec. Litig., 1999 WL 1095313, at 6 (N.D. Cal. Nov. 22, 1999). More than two years ago, Professor Coffee wrote that "[t]he most important open question under the lead plaintiff section of the PSLRA is whether unrelated individuals or institutions may aggregate their shares in order to be deemed the 'most adequate plaintiffs.'" John C. Coffee, Jr., Developments Under the Private Securities Litigation Reform Act of 1995: The Impact After Two Years, SC53 ALI-ABA 395, 423 (1997).

3/ In re Donnkenny Inc. Sec. Litig., 171 F.R.D. 156, 157 (S.D.N.Y. 1997).

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Background

The primary objective of the lead plaintiff provisions of the PSLRA "was to prevent lawyer-driven litigation."[3] The court must appoint the lead plaintiff who, in turn, selects and supervises the lead counsel. To effect this end, the PSLRA requires the plaintiff in the first-filed action to publish a notice advising that any member of the proposed class can move to serve as lead plaintiff. After reviewing the applications, the court shall "appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members."[4] The most adequate plaintiff can be a "person or group of persons" and the court shall adopt a rebuttable presumption that the most adequate plaintiff is one who: a) has filed the complaint or made a motion to be lead plaintiff; b) has the largest financial interest in the relief sought by the class; and c) otherwise satisfies the requirements of F.R.C.P. 23.[5]

Plaintiffs' lawyers have taken advantage of the references in the PSLRA to "members" and "group of persons" in order to dilute or circumvent the intent of the legislation.[6] In one common scenario, the lawyer will use the notice provision to create a large group of unaffiliated investors, each of whom has agreed to serve as a representative party. The lawyer aggregates this group, claims that the aggregated group has the largest financial interest in the case, creates a subgroup to represent the larger group, and then argues to the court that the subgroup should act as the lead plaintiff on behalf of the larger group. The subgroup, which lacks organization, coherency, or anything in common other than the lawyer's solicitation, would then supposedly select, control, and supervise this lawyer. However, as noted by the Securities and Exchange Commission, in fact the "net result will be that while the 'group' nominally has a large stake in the litigation, the lawyers will dominate the decisionmaking."[7]

Cases

No court has yet designated a large aggregation of unrelated investors as the lead plaintiff, but treatment of smaller subgroups of investors derived from a larger group has been inconsistent. Courts have approached this situation in three different ways, leading to different conclusions.

1) Any Small Group of Investors Is Permissible. In some cases, courts have appointed subgroups of unrelated investors as the lead plaintiff without examining how the group was formed or its ability or willingness to control the litigation.[8] In all of these cases, the courts appear to have been influenced by the

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[4] 15 U.S.C.A. § 78u-4(a)(3)(B)(i) (West 1997) (emphasis added).

[5] Id. at § 78u-4(a)(3)(B)(iii) (emphasis added).

[6] The Network Assocs. opinion provides an excellent overview of these issues.

[7] In re the Baan Co. Sec. Litig., 186 F.R.D. 214, 224 (D.D.C. 1999) (attached SEC amicus brief).

[8] See In re Advanced Tissue Sciences Sec. Litig., 184 F.R.D. 346 (S.D. Cal. 1998); Chill v. Green Tree Fin. Corp., 181 F.R.D. 398 (D. Minn. 1998); In re Informix Corp. Sec. Litig., No. C-97-1289-SBA (N.D. Cal. Oct. 17, 1997) (available at <http://securities.stanford.edu/decisions/informix/97cv01289/079.html>).

claimed financial interest of the larger group in determining who would be allowed to advance a subgroup as the lead plaintiff. It is questionable whether these courts have met their responsibility under the PSLRA to ensure that litigation is not controlled by class counsel.

2) Certain Small Groups of Investors Are Permissible. On the other hand, a number of courts have only allowed a group of investors to act as lead plaintiff if the group can demonstrate that it is capable of performing the lead plaintiff function.[9/] This position has the support of the Securities and Exchange Commission ("SEC"), which has filed a series of amicus briefs stating that courts should require groups to describe their members, including any pre-existing relationships; explain how the group was formed and how its members will function collectively; and describe the mechanism that its members and the proposed lead counsel have established to communicate with one another about the litigation.[10/] The court in Network Associates found that based on the SEC's criteria, "[a]rtificial aggregation . . . should never be allowed for any purpose, including to serve as lead plaintiff or to sponsor a subgroup as lead plaintiff."[11/] The position taken by these courts is more faithful to the policy goals of the PSLRA than are the decisions permitting aggregations of unrelated plaintiffs.

3) Narrow Definition of Group. One court recently has suggested that the word "group," as used in the PSLRA, has a very limited definition. In Aronson v. McKesson HBOC, Inc., the court held that "group" should be defined as "a small number of members that share such an identity of characteristics, distinct from those of almost all other class members, that they can almost be seen as being the same person."[12/] The Aronson court suggested that this type of group could include a partnership, multiple subsidiaries of the same corporation, or members of a family.[13/] The definition of "group" utilized by the Aronson court would make it impossible for any group of unrelated investors, or even certain groups of related investors, to be appointed as lead plaintiff. It remains to be seen whether other courts will follow this approach.

Although courts have taken varying approaches, the trend in the case law appears to be against the appointment of groups of unrelated investors as lead plaintiffs, especially if the group was created by would-be class counsel. It has become widely accepted that courts should prevent lawyers from using this device to maintain control over securities class actions in contravention of the PSLRA. The requirements advocated by

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[9/] Switzenbaum v. Orbital Sciences Corp., 187 F.R.D. 246, 251 (E.D. Va. 1999); In re Milestone Scientific Sec. Litig., 183 F.R.D. 404, 418 (D.N.J. 1998); Ravens v. Iftikar, 174 F.R.D. 651, 662-63 (N.D. Cal. 1997).

[10/] See In re Baan, 186 F.R.D. at 218-35 (appending SEC brief)); In re Network Assocs., 1999 WL 1095313, at *7 - *10 (overview of SEC's position).

[11/] 1999 WL 1095313, at *10.

[12/] Aronson v. McKesson HBOC, Inc., No. C 99-20743 RMW (N.D. Cal. Nov. 2, 1999) (available at <http://securities.stanford.edu/decisions/mck/99cv20743/991102or.html>).

[13/] Id. Although the Aronson court stated that its holding was based on the Telxon decision, the court in Telxon only observed that the group should be a cohesive unit and that a number of "bonds or preexisting relationships could satisfy this requirement." In re Telxon Corp. Sec. Litig., 1999 WL 826076, at *18 n.35 (N.D. Ohio 1999).

the SEC are likely to be adopted by additional courts.

Challenging the Appointment of a Lead Plaintiff

There is a split of authority on the issue of whether a defendant has standing to oppose the appointment of a lead plaintiff. In Milestone Scientific, the court held that a defendant may not object to the adequacy or typicality of the proposed lead plaintiff at the appointment stage of the case.[14/] The court relied on the plain language of the PSLRA, which states that after a court adopts a presumption of most adequate plaintiff, only other members of the purported class may conduct discovery as to adequacy or introduce evidence to rebut that presumption.[15/]

Other courts, however, have held that the provisions of the PSLRA cited by the Milestone Scientific court assume that the court has already made a determination that the party is presumptively the most adequate plaintiff.[16/] The statute does not limit what a court can consider in determining whether to apply the presumption. Accordingly, these courts have held that "permitting defendants to make a limited, facial challenge to a plaintiff's motion for appointment of lead plaintiff does not disrupt the statutory framework . . . . Rather it is consistent with the goal of alleviating the abuses of the class action device in securities litigation."[17/] As a practical matter, a court can sidestep this split of authority by noting that regardless of any objection by the defendant, the PSLRA requires a judicial examination of whether the proposed lead plaintiff is appropriate, and there is no reason why the courts should refuse to review and consider a point simply because it is raised by a defendant.[18/] Certainly courts have found the amicus briefs of the Securities and Exchange Commission to be useful in reaching decisions. While courts cannot assume that defendants will be as disinterested as the SEC, neither will the quality of the decision-making be enhanced by sole reliance on the briefs of plaintiffs -- especially since the whole conceptual framework of the lead plaintiff provisions is that the nominal plaintiffs and would-be class counsel may have different and conflicting interests.

Reasons For Challenging the Appointment of Lead Plaintiff

A defendant might want to file an opposition to the appointment of lead plaintiff for several reasons. First, an opposition brief may clarify for the court its broad responsibilities under the PSLRA's lead plaintiff section. The judge should take an active role in ensuring that the appointment process is not

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[14/] 183 F.R.D. at 414 n.14.

[15/] Id. (citing 15 U.S.C. § 78u-4(a)(3)(B)(i) and 15 U.S.C. § 78u-4(a)(3)(B)(iii)(II)). See also Greebel v. FTP Software, Inc., 939 F. Supp. 57, 60 (D. Mass. 1996).

[16/] See King v. Livent, Inc., 36 F. Supp. 2d 187, 190 (S.D.N.Y. 1999); Howard Gunty Profit Sharing v. Quantum Corp., No. 96-20711 SW, (N.D. Cal. Feb. 6, 1997) (available at <http://securities.stanford.edu/decisions/quantum/96cv20711/015.html>).

[17/] Howard Gunty, No. 96-20711 SW, (N.D. Cal. Feb. 6, 1997) (available at <http://securities.stanford.edu/decisions/quantum/96cv20711/015.html>).

[18/] Wenderhold v. Cylink Corp., 188 F.R.D. 577 (N.D. Cal. 1999).

manipulated by plaintiffs' counsel. Second, the statute heavily favors the lead plaintiff's choice of lead counsel.[19/] A successful challenge to a potential lead plaintiff will affect the ability of its counsel to take the lead in the litigation. Finally, the selection of a sophisticated and attentive lead plaintiff may increase the possibility of a successful resolution to the litigation. For example, an institutional investor may be more inclined to limit pre-trial proceedings and settle a case, or may have less patience for wasteful and costly discovery battles; however, it also may be less inclined to accept settlement terms that do not provide substantial benefits for the class.

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If you would like a copy of the opinions or have any questions, please call Bruce E. Coolidge (202) 663-6376, Laura Ahearn (202) 663-6418, or Lyle Roberts (202) 663-6877

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[19/] 15 U.S.C.A. § 78u-4(a)(3)(B)(v) (West 1997) (the "most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class").