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INSTITUTIONAL INVESTORS AND SECURITIES CLASS ACTIONS

By Dan L. Goldwasser[1]

When Congress enacted the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), it tried to wrest control of securities class actions from the plaintiffs' bar by providing a mechanism for replacing nominal plaintiffs with lead plaintiffs that would take an active role in the litigation process. To this end, the Reform Act requires that attorneys filing a suit covered by the Reform Act give notice of the suit to all potential class members and give those persons an opportunity to replace the originally named plaintiffs as the lead plaintiff. To further enlist the participation of institutional investors, the Reform Act creates a presumption that the person with the largest interest in the lawsuits is the best person to serve as lead plaintiff.

At the time the Reform Act was being debated by Congress, the plaintiffs' bar argued against these provisions claiming that institutional investors would not accept this role. Their arguments, however, were largely ignored as a result of obvious self-interest. The experience of the past two years, however, has shown that the plaintiffs' bar was correct as institutional investors have only offered to serve as lead plaintiff in approximately 10% of the securities class actions filed since the adoption of the Reform Act. Moreover, on each of these occasions, the institutional investor was a governmental pension fund and not a mutual fund or private pension fund. This is clearly indicative that Congress may have overlooked some important economic factors in adopting this regulatory framework.

Why the Funds Have Abstained

There are a number of reasons why mutual funds have

chosen to decline Congress' invitation to become active in securities class action litigation. Unfortunately, these factors are likely to keep most mutual funds on the sidelines, although (as more fully discussed below) there are roles which mutual funds can play in this class of litigation.

Perhaps the main reason why mutual funds have chosen to abstain is because of the possibility of interfering with their investor-investee relationships. The primary business of mutual funds is to invest their depositors' money productively and thereby generate a high return for depositors. To accomplish this (their primary) goal, the managers of mutual funds (other than index funds) closely monitor the activities of the companies in which they invest and maintain close relationships with the managements of those companies. A mutual fund that joins in class actions against an investee company runs a very serious risk that it might destroy the lines of communication between investee companies and its fund managers, thereby adversely impacting its investment decisions. Thus, active participation in a class action litigation could have a negative impact on the fund's primary mission.

Secondly, fund managers often are in a state of constant communication with the managements of companies in which they invest. As a result, they frequently learn information about an investee enterprise not generally known to the public or at least are better able to evaluate public announcements of investee companies from a broader perspective. Accordingly, misstatements and omissions by an investee enterprise which may be material to the public at large may not be material in terms of the total mix of information that has been made available to an institutional investor. In this respect, such an institutional investor may not be an adequate representative of the class of injured plaintiffs. Even so, the courts have tended to overlook such issues where institutional investors have been opposed in their efforts to become the lead plaintiff on the theory that the express provisions of the Reform Act should take precedence over the requirements of Federal Rule 23.

Moreover, the base of knowledge accumulated by an institutional investor might provide a basis for claiming that the institution actually traded on "inside information," with the result that the institution would not only be an

inappropriate class representative, but also runs the risk of being named as a co-defendant.[2] Thus, what may have started out as a well-intentioned effort to recoup investment losses could end up as a source of even greater losses. The damages that could result from an insider trading claim go far beyond any assessment or settlement of the claim and the attendant legal fees. It could also result in the fund's having to defend civil charges brought by the SEC or state regulatory authorities or corresponding criminal charges. On top of these potential consequences is the added possibility that the adverse publicity could cause depositors to withdraw their investments from the institution and thereby further weaken it.

A third impediment to institutional investors' serving as lead plaintiffs is their lack of expertise in managing litigation. While institutional investors do occasionally become involved in legal disputes, it is hardly a widespread activity and most institutional investors simply do not maintain a cadre of individuals who are qualified to oversee, much less manage, complex litigation. Moreover, to do so would present a substantial diversion of the fund's resources away from its primary mission of managing investments.

Members of the plaintiffs' bar go one step further, arguing that not only do institutional investors not have the expertise to manage a class action, but also that their experience and training makes them peculiarly unfit to pursue securities litigation. Specifically, they argue that fund managers work from information which they subject to a variety of analyses in order to derive insight as to the investee company's future operations. On the other hand, class action plaintiffs are invariably forced to work from a dearth of information, being forced to rely upon their instincts regarding human behavior and economic motivation. Thus, the plaintiffs' bar contends that institutional investors would have to change the way they approach problems in order to become successful class action plaintiffs. The courts, however, have not proven responsive to these considerations, finding the presumption in favor of a lead plaintiff with a substantial financial interest in the litigation virtually impossible to rebut.

Irrespective of whether institutional investors have the expertise or instincts to serve as lead plaintiffs, most probably lack the human resources to take on the job of

overseeing a large class action litigation. Such cases could easily absorb countless hours of management time which could undoubtedly be spent more profitably in managing the fund's assets. Thus, if institutional investors were to accept this role, they would probably be required to hire additional persons to carry out this function.

Serving as a class representative also poses some difficult conflicts of interest for a mutual fund. Unlike most individual investors, a mutual fund is likely to have altered its holdings in the company's securities over the class period and may continue to have an interest in the company during the litigation itself. Moreover, its own shareholders are likely to have changed throughout the class period and the period of the litigation, raising the question as to whose interest it is protecting by actively prosecuting a class action litigation. Some even question whether there may not be significant conflicts of interests between the duties owed by a class representative to class members and the duties owed by a fund's management to its current shareholders, particularly if the fund maintains a substantial investment in the corporate defendant. Thus, a desire to avoid legal disputes based upon such conflicts of interests may also militate against active participation in class action cases.

Benefits of Being Involved

Being a lead plaintiff is like being the president of a cooperative apartment or condominium association; it takes a lot of time and effort and you receive no compensation for your services. Moreover, there is little prestige in the job and you become the focal point for a lot of criticism. The rewards, therefore, are largely indirect; namely, much could be lost by allowing someone who is less qualified or conscientious to perform this task. This fact was underscored in the recent $910 million class action settlement against a host of Wall Street firms accused of fixing prices in the NASDAQ market. The institutional investors among the class of plaintiffs were reported to be in line to receive as much as 75% of the settlement proceeds. While there is not a lot of data regarding the results of securities class actions, prominent members of the plaintiffs' bar have reported institutional investors regularly reap more than 50% of class action damage awards.

Settlements of securities class actions are usually in the

range of 20% to 25% of the damages sustained by the class members. Indeed, one of the few studies in this area, the one done by Janet Cooper Alexander which was published in the *Stanford Law Review* (Vol. 43 1991), concluded that the merits of a case have little or no impact on the results achieved. This study involved claims under Section 11 of the Securities Act against approximately 25 high tech companies in the 1980s. Thus, there is some basis for suspecting that the results heretofore achieved by the plaintiffs' bar could be improved upon through proper management of the case.

The members of the plaintiffs' bar argue that the results achievable in a class action are limited by the resources of the defendants and that they achieve the best possible results under the circumstances. While Professor Alexander's study gives some credence to these assertions, there is also some indication that the plaintiffs' bar may not be achieving the maximum results. Certainly, this was one of Congress' principal concerns when it debated the lead plaintiff provisions of the Reform Act.

Many securities class action cases involve CPA firms as co-defendants because such firms have the ability to make sizable contributions to a settlement. The results of the past ten years, however, have revealed that although class actions present aggregate claims which generally far exceed the claims of a single plaintiff, the resulting settlements of these actions were significantly outstripped by the resolutions of claims brought by private litigants. This was particularly true of the FDIC and FSLIC claims arising out of the failures of lending institutions. This represents further evidence that class actions managed solely by the plaintiffs' bar are not maximizing recoveries for class members.

Aside from this essentially anecdotal evidence, there are fundamental factors which suggest that the plaintiffs' bar may not be maximizing recoveries for injured investors. Although it can be argued that plaintiffs' attorneys have an incentive to achieve the best possible results in order to maximize their fees, a close analysis reveals that this may not be the case. For the most part, the courts award the plaintiffs' attorneys a multiple of what the court determines to be the reasonable cost of prosecuting the litigation up to a cap set in relationship to the net recovery after out-of-pocket expenses. The multiple utilized by the courts is based upon the judge's evaluation of the

complexity and difficulty of the case. The cap could be as high as one-third of the net recovery where the recovery is modest; it could be much lower where the recovery is large.

Plaintiffs' counsel's incentive, therefore, is not to achieve the largest recovery, but rather to achieve the largest fee in relationship to the efforts exerted. It can also be argued that plaintiffs' counsel has an incentive not to pursue the defendants too vigorously, especially underwriters and professionals, in the hope that they will live to commit future oversights that will lead to further litigations and further fees. Indeed, by imposing too great a cost on the system, the members of the plaintiffs' bar arguably run the risk of "killing the goose that lays the golden eggs" by inviting legislative and judicial reforms which might negatively impact class action litigation. Thus, it can be argued that plaintiffs' attorneys are encouraged to only litigate their cases to the point that the defendants are willing to make a sizable settlement offer based upon a demonstration that the plaintiffs have a substantial chance of recovering, rather than pursuing the case to the point that the defendants' settlement offer exhausts their resources. This tactic is perhaps evidenced by the fact that few, if any, such settlements require insured directors or officers, CPAs, or law firms to contribute to settlements beyond the deductible amounts under their liability policies.

While it is difficult to estimate to what extent the results could be improved, it is not inconceivable that they could be improved by as much as 25% to 50%.

Not only can the total recovery be increased by forcing the plaintiffs' counsel to litigate harder and longer, but the costs of litigating the case could also be reduced by appropriate oversight and management. It is no accident that the attorneys achieving the highest earnings from their practices are members of the plaintiffs' bar. Both Melvyn Weiss and William Lerach of Milberg, Weiss, Bershad, Hynes & Lerach report earnings that are at least twice as high as any five members of the defense bar. Thus, there can be little doubt that a lot less could be paid to plaintiffs' counsel without fear of detracting from the quality of their representation. This could be achieved by the same type of oversight that most defendants exercise over their counsel. The savings that could be achieved could result in a 20% to 50% savings of legal fees.

In a case in which the damages incurred by an institutional investor are $15 million and this represents 5% of the class, under the current system the total amount collected is likely to total $75 million of which the plaintiffs counsel would likely receive fees of $20 million, providing a recovery to the fund of $2.75 million. With proper management, however, the recovery might be increased to $100 million and the counsel fees might be reduced to $15 million, resulting in a net recovery of $85 million of which the fund would receive $4.25, or an increase of $1.5 million. Thus, there could be a sizable reward to a fund that chooses to take a more active role in class action litigation. The net results could be even greater if several funds did so in concert.

To be sure, the potential dangers of serving as the lead plaintiff have to give every institutional investor pause, especially if it is an active trader and relies heavily on its communications with company managements. On the other hand, the rewards to be achieved by participating in the class action process could result in significant additional recoveries. While virtually all mutual funds have resolved this dilemma in favor of not getting involved, several pension funds have begun to seek designation as lead plaintiff.

Not only could mutual funds benefit from taking a more active role in class action litigation, many would argue that their managers have a fiduciary duty to do so. This is perhaps an overstatement as their duty is only to achieve the best results for their beneficial owners and this requires a balancing of the benefits and risks of taking a more active role. Nevertheless, the fiduciary duty considerations at least require institutional investors to assess taking a greater role in securities class actions and to establish policies for evaluating the extent of their participation on a case-by-case basis.

The Plaintiffs' Bar Perspective

The plaintiffs' bar has mixed emotions about institutional investor involvement. On the one hand, plaintiffs' attorneys can frequently benefit from the financial sophistication and information regarding the issuer and its management that an institutional investor can provide. On the other hand, they fear removal as class counsel by such a lead plaintiff. In this regard, the courts have rejected the possibility of multiple lead plaintiffs and at least one

institutional lead plaintiff has insisted upon a negotiated legal fee, a position that has little appeal to the members of the plaintiffs' bar.

In addition, plaintiffs' attorneys would prefer to litigate the case without further oversight by a sophisticated and highly interested party. These factors, plus the general apathy of institutional investors, have led most members of the plaintiffs' bar to use the notice requirements of the Reform Act as a means of soliciting a multitude of individual investors to support their efforts to represent the class. In this way, they can argue to the court that they represent the holders of hundreds of thousands of shares while at the same time having no substantial shareholders looking over their shoulder.

The plaintiffs' bar has also discovered that this process offers other benefits. Oftentimes, shareholders responding to their solicitations are former employees or suppliers who feel aggrieved by the actions of the defendant company's management and who are anxious to assist plaintiffs' counsel by providing information not otherwise available, such as the existence and nature of internal politics within the company that explains seemingly conflicting actions and offers the keys to the ultimate resolution of the case. In many respects, this development has largely offset many of the impediments to class action litigation erected by the Reform Act.

The plaintiffs' bar is also not eager to welcome an institutional lead plaintiff because of the additional work that such a plaintiff is likely to engender. Whereas, many defense attorneys might be willing to forego taking discovery of an individual lead plaintiff, few would waive an opportunity to fully explore the knowledge of an institutional investor in an effort to uncover that many of the alleged misrepresentations and omissions set forth in the complaint were actually known to the lead plaintiff. Moreover, unlike individual investors, institutional investors are likely to have maintained extensive files on the company which might contain notes of conversations with members of the company's management or securities analysts who have had extensive contacts with management. Thus, an institutional lead plaintiff is not only likely to invite much broader discovery, but may even serve to undermine the plaintiffs' claims.

The fact that institutional investors frequently represent

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more than 50% of the damages incurred by the plaintiff class raises a question as to whether an individual plaintiff who purchased 100 shares during the class period is an appropriate representative of the class. While there seems to be little chance that a court would disqualify such a person as a class representative, there does seem to be a reasonable chance that defendants in a class action involving a company, a large percentage of whose shares are held by institutional investors, could argue that, based upon the much broader range of information made available to institutional investors, such investors can only be represented by an institutional investor. If successful, such an argument could serve to greatly reduce the class' potential damages. On the other hand, it could also compel the participation of a sophisticated and substantial plaintiff that would insist upon litigating the case longer and securing a larger settlement. Thus, while such a strategy does offer the possibility of reducing the potential liability exposure in a securities class action, it is not without downside risks.

Room for Compromise

The economic motives discussed above, however, could prompt one or more institutional investors to play a significant role in class action litigations without accepting the role of lead plaintiff. For example, they could work with the plaintiffs' counsel offering information and financial and market analyses which plaintiffs' counsel must normally obtain from experts at considerable cost. They could also carefully monitor the litigation and raise objections to counsel's fee petition at the conclusion of the case. It is even conceivable that one or more institutions with a large stake in the litigation could even offer to underwrite the litigation costs at negotiated hourly rates. While it is unlikely that many plaintiffs' counsel would accept such an offer, such offers would likely be considered by the court in ruling on fee requests. Thus, the Reform Act might ultimately encourage the participation of institutional investors, albeit in a manner not envisioned by Congress.

While most plaintiffs' attorneys will not welcome supervision from others (especially from an investor that is not designated as lead plaintiff), plaintiffs' counsel must seek court approval for both a proposed settlement and for its fee award. Since an institutional investor has standing to be heard at such hearings, no plaintiffs' counsel can

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afford to wholly ignore an institutional investor that expresses an interest in the litigation, especially one that is willing to limit the risks undertaken by plaintiffs' counsel.

Institutional investors seeking a way to fulfil their fiduciary duties thus might wish to meet with plaintiffs' counsel and discuss the strategy of the case and the case's likely settlement value. The institutional investor could also offer to underwrite the costs of the case, i.e. guaranty the plaintiffs' counsel that they will recover all or a portion of their time charges. In return, the institutional investor would receive the right to monitor, if not manage, the efforts of plaintiffs' counsel. While many plaintiffs' counsel will welcome the opportunity to eliminate the downside risk in bringing the litigation, others may not relish the oversight that such an arrangement would entail. Nor would they be pleased at the prospect of the court's reaction to such an arrangement which is likely to limit their compensation to their time charges. On the other hand, if plaintiffs' counsel declined such an offer, they could face the worst of all possible worlds the possibility of having no guaranteed fee and no possibility of receiving a premium fee. In short, plaintiffs' counsel may have little practical choice in deciding whether to accept such an offer.

The combination of an institutional investor and plaintiffs' counsel could be quite powerful. Perhaps the biggest weakness of class action plaintiffs is their lack of knowledge of what actually took place within the company and the motives underlying inadequate or misleading disclosures. In most cases, institutional investors will have an excellent understanding, not only of the company's operations, but also of the personalities of the company's senior management. This knowledge could undoubtedly enable plaintiffs' counsel to immediately understand how the inadequate disclosures came about and how to fashion an approach to the case. It would also help to avoid a lot of false starts and pursuits of dead-end issues. In short, an extensive knowledge of the facts is invariably more useful than even the best litigator's intuition.

Conclusion

While institutional investors may not be willing to play the role that Congress envisioned for them in the Reform Act, they can still play an important catalytic, if not

substantive, role in securities litigation. By doing so, they can make class action litigation more efficient and enhance the returns for their depositors.

In this way an institutional investor might receive the best of all possible worlds — higher settlements and lower attorneys' fees along with little or none of the exposure associated with serving as the lead plaintiff.

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[2]While the courts have generally denied such inquiries in the context of the appointment of the lead plaintiff, it is by no means clear that they would do so in the context of discovery of the merits of the case.

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