Why are a growing number of European institutional investors taking a leading role in shareholder litigation?

Dispelling the myths and explaining the benefits

Darren J Check, Esquire

Robin Winchester, Esquire

Schiffrin & Barroway LLP

Class action litigation is a powerful procedural tool to hold corporate wrongdoers accountable for malfeasance. This is often the case when there are securities violations, because individual losses will likely be dwarfed by class-wide losses. This procedural tool serves a useful social function because it provides remedies for all persons in a definable class who have suffered as a result of the same alleged conduct.

Despite the significant increase in the number of US institutional investors that have become much more active in prosecuting securities class actions since the passage of the Private Securities Litigation Reform Act (PSLRA) of 1995, a law enacted by the US Congress to accomplish, among other things, an increased involvement by institutional investors in securities class actions, institutional investors based outside of the US have largely refrained from seeking leadership roles in securities fraud class actions. Recently, however, courts in the US have appointed a growing number of foreign institutional investors as lead plaintiff in class actions. The reasons for the reluctance on the part of foreign institutional investors to seek leadership roles in securities fraud class actions are varied, but it is clear that many non-US-based institutional investors are not aware that they have the ability to assert claims in the US or simply do not have a sufficient level of understanding or comfort with the process and responsibilities. While these reasons are understandable, this article will explain why it is important for non-US institutional investors to step forward and protect their investments.

The PSLRA and lead plaintiff appointment process

Enacted in 1995, the PSLRA was intended to reform federal securities litigation. The US Congress passed the law to curb what it had identified as "abusive litigation". It was argued that, often, where a stock price dropped dramatically and suddenly, plaintiffs sought to prove fraud by hindsight through extensive "fishing expedition" discovery, and lawyers would "race to the courthouse" to file complaints in a jurisdiction expected to be most favourable to preside over the case.

The perceived "race to the courthouse" and lawyers' alleged use of "token plaintiffs" effectively ended with the enactment of the PSLRA, which requires the presiding court to adopt a rebuttable presumption that the most adequate plaintiff to represent a class is that which suffered the largest financial loss. To shift control of securities class actions from the lawyers to the plaintiffs, certain provisions were enacted to increase the likelihood that institutional investors would serve as lead plaintiffs because Congress believed that institutional investors with large amounts at stake would represent the interests of the class more effectively than class members with small amounts at stake.

The PSLRA provides very specific procedures for appointing a lead plaintiff in a securities class action. Once the initial notice of an action is disseminated, potential class members have 60 days to file a motion to be appointed lead plaintiff. The initial notice, and the 60-day period that follows, is intended to alert potential class members and to provide them with time to measure their losses and consider seeking appointment as a lead plaintiff.

Once all potential lead plaintiffs have filed their lead plaintiff motions the court will appoint a single plaintiff or a small group of plaintiffs as the 'lead plaintiff'. This selection is based primarily on which plaintiff or plaintiff group has suffered the largest financial losses. As discussed above, the PSLRA creates a rebuttable presumption that the plaintiff with the largest financial interest in the security that is the subject of the action should be appointed as lead plaintiff. This framework was established to encourage courts to appoint institutional investors as lead plaintiffs, as institutions typically hold large positions in publicly-traded companies. While nearly all courts allow small groups of plaintiffs to come together and represent the class together, the size of these groups generally does not exceed five members so that they are able to work together in an efficient manner. The court will typically approve the lead plaintiff's selected attorneys as lead counsel.

Once appointed, the lead plaintiff oversees the litigation primarily by monitoring the progress of the action and the efforts of counsel. Specifically, a lead plaintiff will review and comment on important filings and other documents pertaining to the prosecution of the action. Lead counsel is responsible for litigating the action and keeping the lead plaintiff well informed so that the lead plaintiff can effectively monitor all progress and provide comments and suggestions. Additionally, the lead plaintiff will have an opportunity to be active in all negotiations relating to the size of the financial recovery, the make-up of the consideration (ie, cash and stock, cash and options, etc), the proposed plan of allocation for distribution of the recovery to the class, and any corporate governance demands aimed to protect shareholders from future frauds.

The seven lead plaintiff myths

MYTH 1 – There is no reason or advantage to be a lead plaintiff because institutions receive the same return when, and if, the case resolves positively for the plaintiffs.
Reality: One of the leading misconceptions with regard to securities class actions is that there are no advantages to being the lead plaintiff. While taking on this role requires careful consideration, it is important to note that the majority of investors do not understand what is entailed. Indeed, most believe that it is much more burdensome than it truly is and don't fully understand the benefits. However, one of the biggest benefits to being a lead plaintiff is the opportunity to secure a larger recovery for class and, in turn, the lead plaintiff itself. For instance, the lead plaintiff has a strong voice when negotiating the settlement of the class action, and the clout of a sophisticated institutional investor cannot be overstated in these situations. Another advantage for an institution to serve as a lead plaintiff is its ability to reduce attorneys' fees. The recent trend is that attorneys' fees by percentage have been dramatically reduced as institutional investors have stepped forward to serve as lead plaintiffs. Institutional investors are able to establish more competitive contingent fees with counsel, sometimes below the benchmark set by many courts. As a result, the class benefits by a return of a larger portion of the settlement. It is important to note that, even if counsel and the lead plaintiff agree on an appropriate fee, this must still be approved by the court as fair and reasonable.

MYTH 2 – The lead plaintiffs may be held financially liable if the case is unsuccessful.
Reality: There is *no* financial risk in serving as a lead plaintiff. Lead counsel advances all costs and expenses incurred in the prosecution of the case and is reimbursed only if there is a successful settlement or judgment on behalf of the class. There is never a time when the lead plaintiff would have to pay anything out of its own pocket. Furthermore, the lead plaintiff is not responsible for the legal costs or expenses of the defendants in the event that a case does not resolve favourably for the plaintiff class.

MYTH 3 – There is a large time and resource commitment in being a lead plaintiff.
Reality: Lead counsel does all of the legal work and advances all of the costs and expenses associated with the litigation. The lead plaintiff monitors the progress of the litigation by reviewing important documents. While it is true that the lead plaintiff may need to produce documents and have a representative available to answer certain questions at deposition, the time commitment is not burdensome. Furthermore, the benefits to serving in this role outweigh any work that is required.

MYTH 4 – The lead plaintiff will receive unwanted media publicity.
Reality: A common question asked of investors is, "Who is the lead plaintiff in the Enron case?" The Enron case is one of the most widely publicised class actions ever and we have yet to meet an investor who can name the lead plaintiff. The truth is that most lead plaintiffs have as much or as little publicity as they seek. Indeed, in some instances institutional investors seek publicity to demonstrate to their constituents that they actively fight corporate fraud and are fulfilling their obligations to protect and preserve their funds' assets.

MYTH 5 – The lead plaintiffs will have to make frequent trips to the US.
Reality: The lead plaintiff is generally not required to attend most hearings, though institutional clients should consider attending the important hearings which may have a positive impact on the court. There is always the possibility that a representative plaintiff will be required to sit for a deposition during which defendants attempt to obtain information from the lead plaintiff. These depositions tend not to be burdensome as we generally are able to schedule them at a time convenient to the plaintiff.

MYTH 6 – There is no need to seek to be a lead plaintiff because another institution will step forward anyway.
Reality: While a growing number of institutions are seeking to be lead plaintiffs in class actions, those investors that have become active have begun speaking out against 'free riders' – institutional investors which rarely or ever serve as lead plaintiff, yet always participate in securities class recoveries. There is no risk in filing a lead plaintiff motion; indeed, one can always withdraw a motion once it is determined that another qualified institutional investor (with greater financial losses) has stepped forward. However, a substantial risk does exist when an institutional investor with substantial losses elects not to file a lead plaintiff motion and, instead, allows other smaller (perhaps individual) investors to assume the lead plaintiff role and select their own counsel, the quality of which the institution with a great deal at stake may not be confident in. In fact, some commentators have gone so far as to suggest that institutional investors may have a fiduciary duty to assume the role of lead plaintiff, or, at the very least, make an informed decision on why not to not serve, when they sustain losses as a result of securities fraud.[1]

MYTH 7 – Non-US-based investors cannot serve as a lead plaintiff.
Reality: We now live in a global economy and courts in the US have continually recognised that non-US-based investors, many of which have very substantial holdings in US securities, are adequate lead plaintiffs with just as much right to seek leadership positions in these cases as US-based investors. ■

Darren Check is a partner at Schiffrin & Barroway and serves as the firm's director of institutional relations, working with clients around the globe on issues regarding shareholder litigation and corporate governance.
Robin Winchester serves in Schiffrin & Barroway's lead plaintiff department, which involves working with clients, litigation strategy and lead plaintiff issues.

Schiffrin & Barroway, LLP, comprised of over 50 attorneys, has specialised in prosecuting complex class action litigation for nearly 20 years. As a leader in shareholder litigation and corporate governance, S&B has recovered billions of dollars on behalf of our clients and the classes they represent. S&B has developed a worldwide reputation for excellence, focusing primarily on the prosecution of securities fraud, transactional, derivative and ERISA/401k litigation brought against public companies, their officers and directors, and advisers. S&B has actively and successfully represented public and Taft-Hartley pension funds, mutual fund managers, investment advisers, insurance companies, hedge funds and individual investors from around the world in this important role. S&B's website www.sbclasslaw.com is available in 17 languages for your convenience and we invite you to visit it to learn more about the firm, our people, and the work that we do.

• Corporate governance • Helping fulfil fiduciary obligations
• Shareholder litigation • Portfolio monitoring services

[1] See Elliot J Weiss and 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, 2098-2109 (1995).