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SELECTING LEAD COUNSEL IN THE MIDST OF JUDICIAL CHAOS

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What Happens After You Say "I Do"

Many large investors have begun to develop procedures for determining when they should seek to be appointed lead plaintiff in securities class actions. However, once a decision to file for lead plaintiff is made, attention must be turned to selecting lead counsel and deciding how lead counsel should be compensated. Some courts have even intertwined the lead plaintiff and lead counsel decisions by rejecting lead plaintiff candidates that failed to use a lead counsel selection process acceptable to the court.

This article describes some of the conflicting conclusions that have been reached by the federal courts on approving lead counsel and offers observations about lead counsel selection from the perspective of one institutional investor's chief legal counsel.

The Importance of Being Earnest

Over the last five years, the State of Wisconsin Investment Board (SWIB) has received almost $30 million from class action claims in 100 lawsuits *in addition* to the cases where SWIB served as lead plaintiff. This is the natural result of being a large investor (the tenth largest public pension fund in the country) with a broadly diversified stock portfolio. Most other institutional investors also have significant financial interests in securities class action litigation where they are passive claimants.

In the aggregate, the amounts involved in class action lawsuit recoveries and legal fees are staggering. National Economic Research Associates (NERA) estimates that class action recoveries between 1991 and mid-1999 totaled almost $11 billion. The subsequent Cendant settlement alone recouped $3.2 billion for investors. NERA data also shows that plaintiffs' attorney fees paid by class members have averaged about 31 percent, despite indications from the experience of SWIB and other lead plaintiffs in using competitive lead counsel fee negotiations that class legal fees could be cut by one-half to one-third from current averages. In fact, if SWIB's competitive fee setting practices had been replicated by all lead plaintiffs, SWIB might have *saved as much as $6 million in legal fees* on its 100 passive claim recoveries over the last five years. Such savings alone would have more than offset SWIB's total direct legal fee expenditures during the same period on all other matters.

Hundreds of millions of dollars of these essentially invisible legal fees are awarded on behalf of investors in class actions each year. This was not lost on Congress when it enacted the Private Securities Litigation Reform Act of 1995 (Reform Act). In addition to the creation of provisions authorizing lead plaintiffs to choose lead counsel (subject to approval of the court), the Reform Act also limited fee awards to a "reasonable percentage" of the recovery. Interpretation of this limit has resulted in a plethora of recent court decisions on appointment of lead counsel. Lead plaintiffs should be familiar with the potential challenges presented by these decisions.

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Playing When the Rules Keep Changing

Unfortunately, federal judges have been unable to agree on what legal principles should apply to court oversight of lead counsel selection. For example, courts have reached the following diverse conclusions:

- Where no institutional investor sought to serve as lead plaintiff, a Northern District of California court found that all lead plaintiff candidates in the *Quintus Securities Litigation* were incapable of adequately negotiating a fee agreement with lead counsel and ordered a competitive bidding process through which the court itself would select lead counsel;

- The *Comdisco Securities Litigation* court in the Northern District of Illinois decided an institutional investor lead plaintiff cannot insist on appointment of its selected law firm as lead counsel and *must accept* the lowest responsible bidder;

- In the *Cendant Securities Litigation* in the District of New Jersey, the district court ordered an auction for lead counsel but allowed the lead plaintiffs' selected firms to match what the court thought was the most favorable bid—this decision, however, was subsequently reversed by the Third Circuit Court of Appeals, as discussed further on page 4;

- The *Network Associates II* court in the Northern District of California tied the lead plaintiff and lead counsel decisions together, reasoning that a lead plaintiff candidate's ability to negotiate a reasonable fee agreement with lead counsel should be taken into consideration when determining whether that candidate could adequately represent the class and be appointed as lead plaintiff;

- In the District of South Dakota, the *IBP Securities Litigation* court refused to order an auction for appointment of lead counsel and deferred to the lead plaintiff's pick but required submission of an affidavit from the lead plaintiff, explaining how its lawyers were selected and what fee arrangements had been made;

- In the *Razorfish Securities Litigation* in the Southern District of New York, the court rejected an auction system for choosing lead counsel, emphatically concluding that the Reform Act does not allow it to arrange a "shot-gun marriage" between the lead plaintiff and strangers that submit the lowest bid. Instead, after finding the fee proposal of lead plaintiff's selected firm excessive, the court allowed the firm to submit a more competitive proposal that was subsequently found to be reasonable.

Confused? So is the federal judiciary. Earlier this year, the Federal Court of Appeals for the Third Circuit appointed a Task Force on Selection of Class Counsel and charged it with developing recommendations for selection and compensation of lead counsel. The Task Force held three public hearings in Philadelphia this spring and is expected to issue a report at the end of the year. I presented the following observations on selection of lead counsel in testimony to the Task Force.

Problems Faced by Courts in Selection of Lead Counsel

From my involvement as the lead plaintiffs' supervising attorney in four separate class actions, I view selection of lead counsel as one of the most important decisions made in a case. In addition, I believe that most institutional investor lead plaintiffs are in a better position to make that decision than the court. This is a view that was shared by Congress when it passed the Reform Act. The Congressional Conference Committee Report on the Reform Act stated that "increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions."

Retention of the plaintiffs' attorney in a class action requires careful consideration of a number of things, such as fees, reputation, responsiveness to the client, expertise on issues involved in the matter, knowledge of the judge and other counsel in the litigation, trial experience, command of the facts, analysis of the case, litigation plan, ability to cover expenses, understanding of corporate governance principles, and potentially a host of other factors. Judges are not in a position where they can balance these different considerations without sacrificing their objectivity and taking on an advocacy role for the plaintiffs. Moreover, judges do not have the same inherent interests on many of these issues as the plaintiffs. For example, a judge with a crowded calendar might prefer lead counsel with a reputation for settling cases rather than a firm known for its ability to win at trial. More importantly, a judge is not going to know whether lead plaintiff and counsel will be able to get along and work well together.

Some courts have tried to deal with this disconnect by focusing primarily on the level of fees that would be sought by lead counsel candidates. Introduction of competitive forces on class action fees is important. Indeed, it can substantially increase payments ultimately received by class members. But fees are only part of the picture. The plaintiffs' primary interest is in obtaining the best "net" recovery. Class members would be better served by a law firm that did not submit the lowest bid, if that firm can obtain a higher recovery net of the fee.

In addition, it is not always clear which fee proposal will be the most favorable. This was aptly illustrated by the Cendant case, where the district court approved its own fee arrangement that resulted in a fee that was at least $76 million larger than would have been awarded under the schedule that had been negotiated by lead plaintiffs, though the size of the Cendant

recovery also exceeded lead plaintiffs' initial expectations by over $2 billion.

However, the biggest problem created by court selection of lead counsel is that it undermines the ability of the lead plaintiff to supervise lead counsel. When lead counsel is selected by the judge and knows that fees will be set by the judge, there can be less incentive for them to be responsive to the client. Given the potentially divergent economic interests and risk tolerance levels of class members and lead counsel (maximizing payments to the class versus obtaining the largest fee), this lack of accountability to the lead plaintiff can seriously affect how a case is handled and the ultimate result.

Courts could avoid these issues and implement intent of the Reform Act by extending some level of deference to lead counsel selection decisions made by lead plaintiffs, much like the courts defer to boards of directors under what is called the "Business Judgment Rule." While the courts have a role to play under the Reform Act in evaluating and approving the lead counsel selection, it is not to become a surrogate lead plaintiff.

In the Cendant appeal, decided just last month, the Third Circuit Court of Appeals agreed. After finding that the district court correctly appointed three institutional investors to serve jointly as lead plaintiff, the Third Circuit reversed the lower court's decision to auction the lead counsel position to the lowest bidder, explaining that the Reform Act gives lead plaintiff the power to select and retain lead counsel.

The Third Circuit is the first appellate court to consider judicial intervention in lead plaintiffs' selection of counsel under the Reform Act. According to the Third Circuit, courts have a limited role in the counsel selection process and should defer to lead plaintiff's selection, even when lead plaintiff selects counsel or negotiates a retainer agreement that is different than what the court would have done. Judicial intervention, therefore, should be limited to instances when lead plaintiff's selection of counsel poses a threat to the interests of the class or evidences a disregard for lead plaintiff's duties. Where lead counsel is selected without conflict of interest and in good faith, with reasonable efforts made to select competent counsel under a competitive compensation arrangement, the courts should uphold that selection.

Indeed, the Third Circuit observed that Congress intended to encourage institutional investors to serve as lead plaintiff, believing that they would do a better job at counsel selection, retention and monitoring than judges have traditionally done. This goal of encouraging participation by institutional investors would be undermined, according to the Third Circuit, if courts can easily take away decisions concerning lead counsel selection from institutional investors.

Guidelines for Lead Counsel Selection Procedures

In light of the above, lead plaintiffs would be well-served to focus on principles like the following, if they want to minimize chances of judicial intervention in lead counsel selection and compensation:

- Include a process for selecting lead counsel in your lead plaintiff procedures;
- Establish a record to justify the basis for your lead counsel recommendation to the court, including compensation arrangements;
- Provide some mechanism for evaluating competitive market fees in each case, whether by soliciting proposals from law firms or comparing the lawsuit to similar cases where competitive fee levels were established;
- Remember that the goal is to obtain the best "net" outcome for the class and balance qualitative factors (e.g., experience, reputation, case analysis) with quantitative fee considerations;
- Insulate lead counsel selection decisions from political manipulation by including independent participants in the process where such concerns are present; and
- Consider the different methods for setting fees (e.g., negotiated at the beginning or end of the case, set on an increasing or decreasing schedule as the amount of recovery rises, set at a single percentage regardless of recovery amount) and be ready to explain why you think your method is appropriate.

SWIB generally uses a process that involves solicitation of competitive proposals from several law firms and review by a panel with representatives of portfolio management staff, the Chief Legal Counsel, outside case review counsel, and the Attorney General. While we have not placed limits on the types of fee proposals SWIB will consider, we have generally concluded that a pre-negotiated fee schedule that goes up as the amount of recovery increases best aligns the interests of counsel with members of the class. If you would like to view SWIB's procedures, they are posted at: http://www.swib.state.wi.us/class.asp.

While even the best process cannot guarantee that a lead plaintiff's choice for lead counsel will be approved in the current judicial environment, use of a principled process should both increase the chances of approval and ultimately enhance the litigation recovery for the entire class.

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