AN ASSESSMENT OF THE LEAD PLAINTIFF PROVISION OF THE PRIVATE SECURITIES LITIGATION REFORM ACT AND POTENTIAL CHANGES IN ITS APPLICATION

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INTRODUCTION

One of the primary goals of the Private Securities Litigation Reform Act ("PSLRA") was to allow plaintiffs who have the largest stake in securities class actions to take an active role in these cases. The Act specifies that no more than 90 days after notice is sent to the class in a securities class action,

> the court shall consider any motion made by a purported class member in response to the notice . . . and 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.[1]

In short, the PSLRA lead plaintiff provision was designed to put securities class actions in the hands of plaintiffs with the largest stake in the case. To date, though, this provision has largely failed. Specifically, institutional investors often fail to claim money easily available from class action settlements. In addition, private institutions generally have not taken up the invitation of the PSLRA to serve as lead plaintiffs in securities class action cases.[2] The PSLRA *has* attracted one class of lead plaintiff who has served with favorable results: public pension

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1. 15 U.S.C. § 78u-4(a)(3)(B)(i) (2000).

2. Stephen J. Choi, Jill E. Fisch & A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869, 902 (2005).

funds.[3] Given these positive outcomes when this one type of institutions has served as lead plaintiff, the time has come to consider a better way that other institutions, too, might be urged to take a role as lead plaintiffs in securities class action suits.

In a large proportion of securities class actions, institutions have failed even to participate in the claims process after settlement of the suit.[4] As a result, billions of dollars from class action settlement funds have been passed over by institutions for failure to file simple forms. The issues of institutional claims in the recovery process and of institutional duty to act as lead plaintiff are closely linked. The failure to collect settlements shows a deep bias of investing institutions against the use of securities class actions as a mechanism for maximizing returns—one that no doubt also affects their participation as lead plaintiffs.

Recent literature showing that the PSLRA has not had the intended results raises the question of what can be done to strengthen the PSLRA and to allow it to fulfill the ambitions of its drafters. Certain changes, mostly related to better compensation, could make the lead plaintiff provision more effective at a relatively low cost and possibly without major legislative changes. Changes in the law of fiduciary duty to force service as lead plaintiff are attractive in principle but are simply not feasible when considered in practice.

I.
THE ORIGINS AND GOALS OF THE LEAD PLAINTIFF PROVISION

The lead plaintiff provision was largely modeled on an influential 1995 paper by Elliot Weiss and John Beckerman. In the paper, they attempted to illuminate new ways in which monitoring of class action suits by those with the largest stake

3. *See generally* Michael A. Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* (St. John's Univ. Legal Stud. Res. Paper Series, Paper No. 06-0055, 2006), *available at* http://ssrn.com/abstract=938722.

4. James Cox & Randall 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 (2005) (documenting the failure of institutions to claim settlements based on a survey of fund administrators) [hereinafter *Letting Billions Slip*].

could be encouraged.[5] Weiss and Beckerman thought that the presence of a designated lead plaintiff could take securities litigation out of the hands of plaintiffs' attorneys and place it in the hands of investors with a large stake in the outcome.[6] By adopting this proposal, the drafters of the PSLRA hoped to take advantage of the general rise in institutional investor interest in corporate governance; indeed, class action participation can be conceptualized as a radical form of intervention in corporate governance.[7] The hope was that monitoring by interested plaintiffs with a large stake and expertise in the field would reduce the occurrence of strike suits without chilling the progress of meritorious suits. Moreover, such regulations would put a larger portion of settlement money in the hands of plaintiffs rather than those of their attorneys.

Indeed, the lead plaintiff provision of the PSLRA was one among several proposals aimed at controlling plaintiffs' attorneys who were seen as driving securities litigation to the detriment of injured classes. One of the primary goals was to make securities class actions resemble typical client-driven litigation. For example, Jonathan Macey and Geoffrey Miller suggested that entire class action claims be auctioned off to the highest bidder.[8] The proposal essentially entailed a settlement for the class in which their claim was completely purchased by an entrepreneurial attorney, investor, or the defendant himself.[9] If any party but the defendant won the auction, the suit would progress with that party in sole control and entitled to the full proceeds of the action; if the defendant won, he would pay his bid to the class as a settlement.[10] Though this particular pro-

5. *See generally* Elliot Weiss & John Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).

6. James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1588 n.3 (2006) (discussing Weiss & Beckerman, *supra* note 5).

7. Weiss & Beckerman, *supra* note 5, at 2126 (institutional investors "have the knowledge and financial sophistication necessary to serve as effective litigation monitors. Their stake in the outcome of the class action would give them an incentive to do that job well.").

8. Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 6 (1991).

9. *See generally id.*

10. *Id.* at 108.

posal was not adopted in the PSLRA, the lead plaintiff provision was adopted with many of the same goals. It is against this historical background that the lead plaintiff provision must be measured.

The important insight behind the lead plaintiff scheme was that in most securities class actions, at least one institutional actor has a substantial stake. Weiss and Beckerman found that the largest claimant in the average securities class action has a stake of more than 13% of the total damages suffered by the class.[11] With such a sizeable stake, they suggested that institutions would be likely to step in to reduce the agency costs associated with attorney control of class action litigation if given the opportunity. Institutions could be trusted to monitor plaintiffs' attorneys on behalf of the class because of their strong incentive to maximize their own recovery. This would provide a suitable alternative to plaintiffs with a smaller stake who were hand-picked by plaintiffs' attorneys.[12]

Under the PSLRA, the lead plaintiff is appointed by the court from the group of possible lead plaintiffs who motion the court for appointment. There is a rebuttable presumption that the most suitable lead plaintiff is the petitioner whom the court finds to have the largest stake in the litigation. He must also meet the typicality requirements of Rule 23.[13] Once appointed, a lead plaintiff is responsible for selecting class counsel, negotiating fees with counsel, overseeing counsel, and generally overseeing the progress of the class litigation.[14] In theory, a lead plaintiff with a large stake in a class action should behave more like a litigant in a standard lawsuit, driving the progress of the litigation and taking many important decisions out of the hands of class counsel.

II.
THE FAILURE OF INSTITUTIONS TO ACT AS LEAD PLAINTIFF

Common experience and a number of studies have shown that very few private institutions have chosen to act as lead plaintiffs in securities class action suits since the 1995 passage

11. Weiss & Beckerman, *supra* note 5, at 2056.
12. *Id.* at 2060-61.
13. 15 U.S.C. § 78u-4(a)(3)(B)(iii) (2000).
14. *See In re* Cendant Corp. Sec. Litig., 404 F.3d 173, 198 (3d Cir. 2005).

of the PSLRA.[15] Through 2001, only 5-10% of securities class actions had an institutional lead plaintiff.[16] There is some evidence that more institutions have stepped forward since that time, but there is almost no doubt that the PSLRA is still not fulfilling its goals.[17]

The one type of institution that has acted more frequently as lead plaintiff since the passage of the PSLRA is the public pension fund.[18] When the Act was passed, Congress primarily envisioned mutual funds as the large institutions that would serve as lead plaintiff.[19] They have almost never done so.[20]

III.
Assessing the Effectiveness of Institutions as Lead Plaintiffs

There is some statistical evidence that monitoring by institutions can have the effects Congress intended. All other factors being equal, institutional lead plaintiffs have a statistically significant positive impact on the size of settlements won for the class relative to the estimated losses suffered by the class.[21]

Nonetheless, the literature assessing the success of institutions as lead plaintiffs is not unequivocal, partly because so few institutions have actually chosen to act as lead plaintiff.[22] James Cox and Randall Thomas studied the effects of the lead

15. Choi, Fisch & Pritchard, *supra* note 2, at 902 (finding that before and after 1995 "[l]evels of overall institutional participation remain relatively consistent.").

16. Cox & Thomas, *supra* note 6, at 1590.

17. *Id.* at 1590 n.11.

18. Choi, Fisch & Pritchard, *supra* note 2, at 902 ("[W]e find that the PSLRA has had an effect on the participation of only one type of institution—the public pension fund. Public pension fund participation as lead plaintiff has increased substantially since 1995 and continues to increase. Beyond the public pension fund, however, institutional participation remains unchanged.")

19. Panel Discussion, *The Private Securities Law Reform Act: Is it Working?*, 71 Fordham L. Rev. 2363, 2369 (2003).

20. Choi, Fisch & Pritchard, *supra* note 2, at 894.

21. Cox & Thomas, *supra* note 6, at 1631 (when comparing institutional lead plaintiffs to other lead plaintiffs, finding that "[f]or each 1% increase in Provable Losses, the Settlement Amount increases 0.26 percent. If there is an institution as lead plaintiff, the settlement amount increases an *additional* 0.04 percent.").

22. *Id.* at 1629.

plaintiff provision generally.[23] Rather surprisingly, their paper found that the overall ratio of settlement size to provable losses has actually declined since the passage of the PSLRA in 1995.[24] In other words, relative to the legal environment before the passage of the law, the post-PSLRA era has not been more favorable to injured classes. They did find that institutional lead plaintiffs generate better returns than other lead plaintiffs but also found that the increased recovery was not as large as expected.[25] Cox and Thomas theorized that the improved returns might partly be the result of "cherry-picking" by financial institutions that chose to become involved only in stronger cases.[26]

Another major study conducted on the effects of the lead plaintiff provision came from Stephen Choi, Jill Fisch, and Adam Pritchard.[27] This study predated the Cox and Thomas study and reached many of the same results. Choi, Fisch, and Pritchard also drew a distinction between private and public institutions. Public institutions, they found, had a higher level of participation in securities class actions since the passage of the PSLRA.[28] They found that recoveries were larger in cases where public institutions served as lead plaintiff.[29] They did not find any significant effect on attorneys' fees in these cases.[30] Their results for private institutions, however, were not encouraging. They found no statistically significant correlation between the presence of private institutions and higher

23. *See generally id.*

24. *Id.* at 1634 ("[P]rovable loss ratios have significantly declined in the post-PSLRA period from their pre-PSLRA level for both categories of institutional investors and the individuals").

25. *Id.* at 1636 ("We find that institutional lead plaintiffs add value for shareholders, although perhaps not as much as was expected by the architects of PSLRA's lead plaintiff provision. . .This is disappointing and facially inconsistent with institutional lead plaintiffs' beliefs that they can double or triple recoveries overall.").

26. *Id.* at 1630 ("[A]n institutional investor is more likely to become a lead plaintiff for cases against large capitalization firms, with bigger estimated losses, and when the SEC has filed a parallel action").

27. *See generally* Choi, Fisch & Pritchard, *supra* note 2.

28. *Id.* at 902.

29. *See id.* at 902.

30. *See id.* at 902-03 ("[W]hen we control for the size of the case, institutional participation—even pension fund participation—does not correlate with lower attorney fee awards").

recoveries.[31] They also noted that the private institutions that have participated as lead plaintiff since 1995 generally have been smaller institutions, and they theorized that the failure of large institutions to step into the role may account for the lack of positive results.[32] These small institutions stand in contrast to the large mutual funds envisioned as lead plaintiffs at the time that the Act was passed.[33] There is little doubt that large private institutions have not often been chosen to act as lead plaintiffs since the passage of the PSLRA.[34]

Michael Perino also studied cases where public pension funds have acted as lead plaintiff finding that these cases had larger settlements relative to the measure of potential damages.[35] Unlike Choi, Fisch, and Pritchard, he found that attorney fees requested and granted were both lower than in cases without institutional lead plaintiffs.[36] Perino suggested that institutional participation is most likely in the largest cases "where the benefits of monitoring are most likely to outweigh costs."[37] This conclusion is logical but also suggests that measures ought to be taken to reduce costs and make participation economical in more cases.

All three studies have observed at least some positive effect from the participation of institutional lead plaintiffs in securities class actions. The main caveat to this finding is the suggestion (from Cox and Thomas as well as Choi, Fisch, and Pritchard) that the increased recovery may be partly attributa-

31. *Id.* at 894.

32. *Id.*

33. *See id.*

34. *Id.* at 880.

35. Perino, *supra* note 3, at 21-25 (finding increased recovery when public pension funds act as lead plaintiff).

36. *Id.* at 29-32 (finding that "results suggest that public pension fund participation does reduce fees, either because institutions are sophisticated consumers of legal services or because of increased competition for institutional representation"); Michael A. Perino, *Markets and Monitors: The Impact of Competition and Experience on Attorneys' Fees in Securities Class Actions* 21 (St. John's Univ. Legal Stud. Res. Paper Series, Paper No. 06-0034, 2006), *available at* http://www.ssrn.com/abstract=870577 ("The mean fee in cases with public pension fund plaintiffs (.1998) [19.98%] was significantly lower than cases with other types of lead plaintiffs (.2713) [27.13%].").

37. Perino, *supra* note 3, at 32.

ble to institutional lead plaintiffs' selection of cases with stronger indicia of fraud.[38]

There may also be value to institutional participation beyond increased recovery and lower attorney fees. Institutional participation can serve as a signal to courts that major investors support the litigation and have chosen to devote resources and reputation to it. This can be an indication to the court that the litigation is built on a solid foundation.

Moreover, if the participation of institutions were to become commonplace, the lack of an institutional lead plaintiff would become a suspicious circumstance suggesting that highly interested investors do not believe that the suit has merit. The refusal of institutions with a large stake to serve as lead plaintiff could serve as an important indicator to courts considering securities cases that investors thought a given case lacked merit.

There is also clear value in giving practical effect to the lead plaintiff provisions of the PSLRA to determine whether the lead plaintiff provision is actually capable of meeting its promise and meeting the public policy goals clearly laid out by Congress. In Weiss and Beckerman's original plan, the lead plaintiff provision was part of a larger proposal to encourage institutions to take an active role in litigation by aligning their incentives with the larger investor class.[39] Without adopting other portions of Weiss and Beckerman's proposal, particularly the promise of compensation, the lead plaintiff provision is empty; it merely adds to the cost and complexity of securities litigation without providing any discernable benefits. Weiss and Beckerman also proposed that under certain circumstances, liability for failure to serve as lead plaintiff might be appropriate.[40] Unlike compensation, this part of the original proposal appears to be almost impossible to implement given the evidence provided by the experience of the lead plaintiff provision to date.

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38. Choi, Fisch & Pritchard, *supra* note 2, at 900-01.
39. *See* Weiss & Beckerman, *supra* note 5, at 2126-27.
40. *Id.* at 2125.

IV.
Reasons for the Failure of Institutions to Participate as Lead Plaintiffs

Why, we must ask, have institutions—particularly private institutions—so clearly failed to act as lead plaintiffs? What can be done to induce institutions to take up the invitation of the PSLRA lead plaintiff provision?

To date, institutional lead plaintiffs are not rare because they are eliminated by courts in the lead plaintiff selection phase, but rather because institutions fail even to petition to serve as lead plaintiff. There is evidence that courts have generally favored institutional lead plaintiffs since the passage of the PSLRA.[41] Still, there are several possible factors that could lead courts to reject suitable institutional lead plaintiffs. These possible court biases will be mentioned briefly but will not be fully explored here.

One such factor suggested by Choi, Fisch, and Pritchard is that courts may sometimes favor a single private investor or "lead plaintiff groups" that aggregate the claims of individual investors over an institutional lead plaintiff because they may better meet the Rule 23 requirement of typicality necessary for class action suits.[42] Another legal reason for the lack of institutional lead plaintiffs might be the "professional plaintiff" provisions of the PSLRA which are designed to prevent repeated service as lead plaintiff.

Of greater interest to this paper are the endogenous reasons that institutions fail ever to become involved in securities class actions. The reasons fall broadly into two categories: 1) a cost-benefit analysis shows that serving as lead plaintiff is ineffective for investors, and 2) agency costs prevent institutions from serving as lead plaintiff even when it would be effective for them to do so.

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41. Cox & Thomas, *supra* note 6, at 1618-19 (surveying 129 cases where lead plaintiff status was disputed and finding that in the "vast majority" of cases where institutions petitioned to serve as lead plaintiff, courts "found in their favor").

42. Choi, Fisch & Pritchard, *supra* note 2, at 902.

A. *Costs*

At the present time, relatively little compensation is given to lead plaintiffs. Given the difficulty of serving in this role, it is easy for institutions to decide that acting as lead plaintiff is not an effective use of their resources—particularly given the uncertainty of increased recovery. A policy of generous compensation for the costs incurred by those acting as lead plaintiff would have the potential to change this situation.

Under the Act as it is currently applied, most lead plaintiffs are compensated for the direct costs of the suit such as the costs of travel or deposition time. The costs of acting as lead plaintiff in a securities class action, however, go far beyond these directly measurable costs.[43] Other costs are difficult to quantify but still arise as a result of assuming the lead plaintiff role. These costs are not often accounted for by the courts. Institutional investors are likely to consider all of these potential costs and balance them against the potential for increased recovery when deciding whether to petition the court to act as lead plaintiff.

Courts have frequently refused to compensate for non-pecuniary costs at their full market value.[44] For example, one of the largest costs for lead plaintiffs is the time spent by their professional staff managing the suit.[45] Courts have hesitated to grant full market-rate compensation for this lost time even though it is a cost which should be relatively easy to quantify.[46]

Costs other than time lost are far more difficult to measure and are even less likely to be fully compensated. For instance, lead plaintiffs expose themselves to costly discovery requests from defendants in a securities action. Defendants are allowed to seek information about the lead plaintiffs in order to challenge their suitability for the role based on a lack of

43. Cox & Thomas, *supra* note 6, at 1606 (surveying the costs associated with lead plaintiff service).

44. Cox & Thomas, *supra* note 6, at 1606 & n.82 (citing, among others, State of Wis. Inv. Bd. v. Bartlett, No. 17727, 2002 Del. Ch. LEXIS 42, at *22-*23 (Del. Ch. 2002); Cook v. Niedert, 142 F.3d 1004, 1016 (7th Cir. 1998)).

45. Cox & Thomas, *supra* note 6, at 1607 ("A number of our survey respondents identified monitoring costs as an important issue in their decisionmaking process, although their estimates of the total time involved ranged widely from 40 to 100 hours to as much as 250 to 1000 hours.").

46. *Id.* at 1606.

typicality.[47] Lead plaintiffs may also be forced to reveal proprietary information about their business and investing activities, placing them at a competitive disadvantage.[48] This is one of the major reasons cited by institutions for avoiding service as lead plaintiff.[49]

Lead plaintiffs may also lose business and antagonize their peers by taking on such a public role in a securities action. Many mutual funds manage large amounts of money (particularly retirement fund monies) for public companies of the sort that are likely to be targeted in securities suits.[50] Managers may hesitate to take an active role in litigation for fear that they will be viewed as having "taken the wrong side" and will be unable to compete for business from these companies.[51]

If the managers of an institution judge that the costs are too high or that the same recovery could come from another lead plaintiff's efforts, they will be unlikely to seek out the position of lead plaintiff. This situation is only made worse by the fact that the courts have taken such a limited view of the compensation allowed under the PSLRA.

B. *Compensation*

There are at least two possible alternative schemes of calculating payments for service as lead plaintiff. One would be incentive rewards that specifically grant the lead plaintiff a larger portion of the increased recovery that he helps to win for the class. The second would be to compensate for all costs of lead plaintiff service.

The PSLRA explicitly provides for an award of "reasonable costs and expenses . . . directly relating to the representa-

47. Jill Fisch, *Class Action Reform: Lessons From Securities Litigation*, 39 ARIZ. L. REV. 533, 544 (1997) (defendants will seek discovery to challenge typicality of institutional investor as class representative, or to investigate institution's trading behavior which might bear on the institutions involvement in the suit).

48. Cox & Thomas, *supra* note 6, at 1603.

49. OFFICE OF THE GEN. COUNSEL, U.S. SEC. & EXCH. COMM'N, REPORT TO THE PRESIDENT AND CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 51 (1997), *available at* http://www.sec.gov/news/studies/lreform.txt.

50. *See* Choi, Fisch & Pritchard, *supra* note 2, at 881.

51. *Id.* at 881 (citing WILLIAM M. O'BARR & JOHN M. CONLEY, FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING (1992)).

tion of the class."[52] It is widely agreed that the PSLRA does not allow compensation in the form of a reward for class representatives.[53] In fact, most courts currently interpret the statute to grant compensation only for immediately quantifiable costs.[54]

Compensation is particularly important in the PSLRA context. Theodore Eisenberg and Geoffrey Miller argue that class action lead plaintiffs might choose to serve for a number of reasons, including the "psychic benefits such as the pleasure of having their name on the 'marquee,' being catered to by counsel, or participating in an interesting and stimulating activity" as well as the potential for increased recovery to be shared among all members of the class.[55] In the securities litigation context, though, institutional investors are likely to be concerned primarily with whether they will recuperate the costs of serving as lead plaintiff.[56] The "psychic benefits" are less significant for institutions in securities suits than for many other litigants. With the notable exception of politically moti-

52. 15 U.S.C. § 78u-4(a)(4) (2000).

53. Richard A. Nagareda, *Restitution, Rent Extraction, and Class Representatives: Implications of Incentive Awards*, 53 U.C.L.A. L. REV. 1483, 1484 (2006).

54. For a survey of decisions on the subject of lead plaintiff compensation, see Swack v. Credit Suisse First Boston, LLC, No. 02-11943-DPW, 2006 WL 2987053, at *3-4 (D. Mass. Oct. 4, 2006) (comparing decisions from a number of courts and refusing compensation for the lead plaintiff and requiring that "the representative plaintiff should document the value of any lost opportunities-such as lost employer-granted vacation time, lost sales commissions, or missed business opportunities-and costs paid in relation to the litigation"); *In re* Merrill Lynch Research Reports Sec. Litig., No. 02-CV-3176-JFK, 2007 WL 313474, at *25 (S.D.N.Y. Feb. 1, 2007) (denying compensation to lead plaintiff for failure to show "any actual expenses incurred, or wages or business opportunities she lost, as a result of acting as lead plaintiff" despite plaintiff's showing that she spent significant time during her work day overseeing the litigation which took her away from her duties as CEO); *In re* AMF Bowling, 334 F. Supp. 2d 462, 470 (S.D.N.Y. 2004) (denying lead plaintiffs any compensation because "[n]either claims any out-of-pocket expense. There is no assertion that either lost time at work or gave up employer-granted vacation time. Neither cites to lost sales commissions nor missed business opportunities.").

55. Theodore Eisenberg & Geoffrey Miller, *Incentive Awards to Class Action Plaintiffs: An Empirical Study*, 53 U.C.LA. L. REV. 1303, 1305 (2006).

56. *Id.* at 1347 ("The large-scale investors that Congress hoped to have serve as class representatives after the PSLRA may be the investors most sensitive to recovering their opportunity and other costs if they do serve").

vated participation by public institutions,[57] the motivations that might, for instance, drive an activist to seek to have his name "on the marquee" for a civil rights action are not applicable for institutions in securities actions. To the contrary, private institutions participating in a securities suit face reputational risks among their peers and clients.[58] Moreover, most managers of large financial institutions hardly need leadership in a class-action suit to be "catered to" by counsel. Institutional lead plaintiffs will be best attracted by changing the economics of lead plaintiff service so that they are more likely to profit monetarily.

If lead plaintiffs were awarded a larger portion of recovery either as an incentive reward or to cover their expenses, other class members would benefit from the increased overall recoveries that are to be expected from institutional lead plaintiffs' participation. This, in turn, would allow better compensation results for all class members. These increased recoveries would increase the potential costs of securities fraud suits for defendants and provide a stronger deterrent effect.

1. *Incentive Awards*

Under the PSLRA, a lead plaintiff who gains a significantly better settlement for the class through his monitoring will be granted no benefits beyond the increased recovery available to the entire class. Considering its goal of *encouraging* participation as lead plaintiff, this is an odd incongruity in the PSLRA. Weiss and Beckerman's original proposal envisioned incentive awards as a way to attract institutional investors.[59] However, Congress feared that incentive awards would encourage "pay-to-play" practices in which attorneys seek selection as class counsel by promising lead plaintiffs that they will request a larger lead plaintiff award from the court at the conclusion of the suit.[60] There was a belief that "'bounty pay-

57. Perino, *supra* note 3, at 11 (noting that some public pension funds become involved as lead plaintiff where "participation could lead to valuable publicity for the fund's political overseers").

58. *See supra* pp. 684-85; *infra* p. 693.

59. Weiss & Beckerman, *supra* note 5, at 2124.

60. Nagareda, *supra* note 55, at 1489.

ments or bonuses' prior to the PSLRA 'encouraged the filing of abusive cases.'"[61]

A statutory prohibition strips the courts of valuable flexibility in awarding lead plaintiffs in order to prevent a practice that could be better curtailed by vigilant judges.[62] No such bounty can be granted to the lead plaintiff without an order of the court in any case. In order to better comport with the PSLRA's focus on attracting lead plaintiffs, these abuses should be managed by careful court oversight of incentive awards rather than by a blanket ban. As Nagareda rightly notes, the PSLRA's refusal to grant incentive awards to lead plaintiffs is at "cross-purposes" with provisions meant to encourage participation by institutional lead plaintiffs.[63]

If increases in recovery from monitoring are equally shared among all members of the class, an institutional lead plaintiff will rationally hope that another capable lead plaintiff steps in to do the work of monitoring for them so that they can benefit without committing time and effort to the litigation.[64] Cox and Thomas refer to one attorney who says, "the first question his clients ask before considering undertaking a lead plaintiff position is whether any other institution is willing to do it."[65]

If offered an incentive for capable monitoring, institutions would stand to benefit uniquely from serving as lead plaintiff in the suit; it would no longer be rational merely to

61. *Id.* at 1489 n.28 (citing H.R. REP. NO. 104-369, at 33 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 732).

62. Eisenberg & Miller, *supra* note 57, at 1347 (concluding after an empirical survey of incentive awards that "Courts' general performance in this area seems to support continued discretion to grant or deny incentive awards based on the facts of each case. A flat rule such as the PSLRA's ban on payments to class representatives not only is not clearly supported but may be counterproductive").

63. Nagareda, *supra* note 55, at 1489.

64. In this situation, the class member may be better off staying on the sidelines in hopes that someone else will incur the costs of representing the class . . .But even if a class member does come forward, the costs and benefits outlined above do not create incentives for efficient representative participation because the named plaintiff gains only a fraction of the value added by his or her efforts on behalf of the class.

Eisenberg & Miller, *supra* note 54, at 1306.

65. Cox & Thomas, *supra* note 6, at 1606.

hope for another capable lead plaintiff to do the necessary work to improve recovery. Given the benefits of the participation of institutional investors as lead plaintiff, securities litigation under the PSLRA is a particularly appropriate setting to allow incentive awards. Such an incentive award need not be large relative to the increased recovery. Incentive awards in securities suits before the PSLRA and in other class action contexts are generally a small fraction of the recovery.[66] A significant benefit could be conferred on the lead plaintiff while still increasing the recovery of other members of the class. Though a move to incentive awards would be likely to improve institutional participation in securities class actions, it would clearly require revisions to the PSLRA statute.

2. *Full Compensation*

Full compensation for the direct costs of service as lead plaintiff is allowed by the PSLRA without any changes to the current statutory scheme. The statute need not be read to circumscribe direct costs narrowly. The semantics of any change in interpretation are important. Costs such as corporate secrets revealed in discovery, the opportunity cost of time spent overseeing the suit, lost business, and damage to an institutional reputation can all be classified as direct and compensated under the PSLRA. However, if these same costs are viewed as indirect, they will be excluded from compensation by the clear statutory language.

For example, Cox and Thomas have suggested that "indirect costs" could be compensated at "some multiple of the actual amount attributed to the damages."[67] They suggest that this method of compensation could be analogous to the "lode star" method used to calculate attorneys' fees in class action suits, noting:

> Just as the class counsel is rewarded for such factors as the uncertainty of the suit, the skill and experience devoted to the suit's prosecution, and the ultimate outcome, we believe similar considerations should justify awarding to the institutional

66. Eisenberg & Miller, *supra* note 57, at 1308 ("In the ninety cases in which sufficient data were reported, the total incentive award to all representative plaintiffs constituted, on average, 0.16 percent of the class recovery.").
67. Cox & Thomas, *supra* note 6, at 1637.

lead plaintiff an award greater than the costs directly attributable to the suit.[68]

Many of the factors that Cox and Thomas mention need not be characterized as indirect. Courts could choose to acknowledge that the oversight of the suit and the extraordinary inconveniences of being subject to discovery are direct costs of the suit even where they cannot be immediately quantified.

Some courts have already taken this approach using the same factors mentioned by Cox and Thomas but in so doing, have characterized these factors as direct costs of the suit. In In re *Xcel Energy, Inc., Securities, Derivative & "ERISA" Litigation*, the district of Minnesota stated:

> In granting compensatory awards to the representative plaintiff in PSLRA class actions, courts consider the circumstances, including the personal risks incurred by the plaintiff in becoming a lead plaintiff, the time and effort expended by that plaintiff in prosecuting the litigation, any other burdens sustained by that plaintiff in lending himself or herself to prosecuting the claim, and the ultimate recovery.[69]

In this case, even with the strictures of the PSLRA in place, $100,000 was awarded to the lead plaintiff group.

Note the differences between the language of the In re *Xcel* court and that of Cox and Thomas. The underlying test used by both is essentially the same, but the language used to characterize the test is very different. Cox and Thomas characterize the added costs as "indirect" whereas the In re *Xcel* court carefully notes that the reward is "compensatory"[70] implying that these costs are, in fact, direct and fall under the purview of compensation allowed by the PSLRA. The In re *Xcel* court reached the same desirable result of full compensation as Cox and Thomas while carefully remaining within the language of the PSLRA. This approach should be a model to other courts considering lead plaintiff compensation.

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68. *Id.* at 1637-38.

69. *In re* Xcel Energy, Inc. Sec., Deriv., & "ERISA" Litig., 364 F. Supp. 2d 980, 1000 (D. Minn. 2005) (citing Denney v. Jenkens & Gilchrist, 230 F.R.D. 317 (S.D.N.Y. 2005)). Note that *Denney* actually discusses *incentive* awards and is not analyzed in the PSLRA paradigm.

70. *Id.* ("granting *compensatory* awards to the representative plaintiff in PSLRA class actions") (emphasis added).

To comply with the statute, payments should not be characterized as an incentive for exceptional monitoring or service, but rather a way of ensuring that the actual costs of service as lead plaintiff are fully compensated.[71] In rulings to date, there is a vague distinction between compensatory awards and incentive awards for lead plaintiffs. Many awards that are characterized by courts as incentive awards (for non-securities or pre-PSLRA cases) are in fact a means of compensating class representatives for non-pecuniary costs incurred during the lawsuit.[72] Costs such as reputational risk, the possibility of antagonizing important clients, the opportunity cost of time spent on the suit, and the potential for damage to the firm's standing among its peers may not be easily quantifiable pecuniary damages, but they are direct costs of the suit deserving of compensation. Once this fact is recognized, more generous compensation can be granted without changes in the PSLRA. Cox and Thomas' "lode star approach" can be justified as compensation for those costs which are direct but not easily quantifiable.

Expanded compensation has the distinct advantage of being relatively easy to implement and requires only a change of tack by courts to recognize that the *actual* costs of taking a leading role in a securities class action far exceed the immediately quantifiable costs usually awarded under the current interpretation of the PSLRA. Though this is a broad reading of the language of the statute, it is neither an unfounded one nor a completely novel one as it has been adopted by some courts already.[73]

A policy of full compensation would signal to potential lead plaintiffs that they could expect their service as lead plaintiff would be cost-effective. Institutions assessing whether to serve as lead plaintiff would have far fewer costs to balance

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71. *Cf.* see Swack v. Credit Suisse First Boston, LLC, No. 02-11943-DPW, 2006 WL 2987053, at *4 (D. Mass. Oct. 4, 2006) (rejecting *In re Heritage Bond Litig.*, No. 02-1475 DT, 2005 WL 1594403 (C.D. Cal. June 10, 2005) for its suggestion that courts have the discretion to grant incentive awards in PSLRA cases).

72. *Cf.* Eisenberg & Miller, *supra* note 57, at 1308 ("We find support for the hypothesis that some incentive awards are designed to reimburse some or all of the representative plaintiff's nonpecuniary costs").

73. *See In re* Xcel Energy, Inc., 364 F. Supp. 2d 980; *cf. In re* Heritage, 2005 WL 1594403.

against the potential benefits of increased recovery. This change would fall short of the more optimal solution of actually giving incentive awards to attract lead plaintiffs but would be far easier to implement since it could function within the current statutory scheme.

C. *Conflicts of Interest*

Unfortunately, proper compensation for service as lead plaintiff alone is unlikely to overcome completely the resistance among private institutions to participate in securities class actions. Class action settlements can provide a case study in such conflicts. The costs of collection are far lower than the costs of lead plaintiff service and the returns far more certain, yet institutions often fail to collect available monies from class action settlements.[74] There are many possible causes for this failure to collect, some of which are benign. However, fund managers often do not file claims against corporations for fear of "antagoniz[ing] potential clients for their services."[75] Financial institutions depend on the corporations, banks, and accounting firms for business both as investing clients and for other services provided by financial sector firms.[76] A private institution seen as a "litigious" investor runs the risk of creating a stigma that will drive potential clients away from the firm.

Anti-class action feeling may be as prevalent among mutual funds themselves as among their clients. Indeed, mutual funds are relatively frequent targets of class action suits based on the securities laws. A cursory survey of the case law shows that since the passage of the PSLRA, Janus, Fidelity, and Dreyfus, three of the largest mutual fund management companies,

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74. *See generally* Cox & Thomas, *supra* note 4.

75. *Id.* at 441.

76. Cox & Thomas, *supra* note 6, at 1609 ("Banks, mutual funds, and insurance companies — three of the five largest classes of financial institutions — are each vendors of financial services and products. Their customers include the corporations and accounting firms who are the grist of securities class actions"); Choi, Fisch & Pritchard, *supra* note 2, at 881 ("[A] substantial component of business for the major mutual funds involves managing retirement accounts for publicly traded issuers. Unlike litigation recoveries, the fees associated with these services go directly to mutual fund managers. Fund managers might reasonably be concerned that active litigation participation would hurt their ability to compete for this business from managers of public companies") (citation omitted).

have each been defendants in multiple securities class action suits.[77] It is no surprise then that these companies would view securities class action suits with some skepticism.

Moreover, the cultural affinity between money managers and other typical securities lawsuit defendants raises doubt as to whether institutional investors' incentives are fully aligned with those of their clients when assessing whether, or how extensively, to participate in a securities class action.[78] Money managers may sometimes shy away from serving as lead plaintiff in order not to sully their own reputations among their peers. The phenomenon can be compared to the biases noted by numerous scholars in the area of executive compensation. Where outside directors from a similar corporate culture sit on a board committee to determine the compensation of a company's CEO, his pay is likely to be higher.[79] Similarly, we might expect that financial industry figures will hesitate to take the lead in a lawsuit against people and institutions in the same field or in other closely related fields.[80]

The unwillingness of investors to become involved in securities class actions is at least partially responsible for the lack of settlement collection in securities cases. The fact that settlement collection has nearly no costs and a clear benefit makes it a perfect example of the general reluctance of institutions to become involved in any way in securities class actions. If institutions are unwilling to take easy actions for a guaranteed re-

77. *See e.g. In re* Fidelity/Apple Sec. Litig., 986 F. Supp 42 (D. Mass. 1997); *In re* Fidelity/Micron Sec. Litig., 964 F. Supp. 539 (D. Mass. 1997); Bildstein v. Dreyfus/Laurel Funds, Inc., Fed. Sec. L. Rep. (CCH) ¶ 90,473 (S.D.N.Y. Mar. 30, 1999); Kircher v. Putnam Fund Trusts, 126 S. Ct. 2145 (2006); *In re* Mutual Funds Inv. Litig., 384 F. Supp. 2d 845 (D. Md. 2005).

78. *See* Fisch, *supra* note 48, at 548 (observing that "institutions have traditionally maintained the ability to act through informal contacts with issuers in ways not subject to public view").

79. *Cf.* Lucian Ayre Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (assessing the indirect forms of control by corporate managers over their own compensation).

80. *See* Cox & Thomas, *supra* note 6, at 1609-10 ("[T]here is only the thinnest social divide between executives of banks, insurance companies, and mutual funds and executives of industrial firms. These are groups of individuals who understand one another and who are aware of the price to be incurred by fail-ing to honor that understanding.").

turn, it is certainly no surprise that they would not take the necessary efforts to serve as lead plaintiff.

For the sake of comparison, it is also illustrative to consider public pension funds, one class of institutional investor that has responded to the PSLRA's call for lead plaintiffs with a large stake in litigation.[81] Public pension funds are faced with the same costs and compensation outlook as private institutions when deciding whether to take on the lead plaintiff role. Still, public pension funds have chosen to act as lead plaintiffs far more often than private institutions since the passage of the PSLRA.[82] There are many possible reasons for the differing behavior of public and private institutions. Some public institutions have chosen to become involved in large securities fraud cases for the political and publicity benefits.[83] Another potential difference is that private fund managers are judged by their performance as money managers. Because of the lengthy delays in recovery from class actions, those recoveries may not be fully reflected in measures of manager performance.[84] Even so, neither of these explanations is completely satisfying given the gains which are possible through participation as lead plaintiff.

Conflicts of interest in the lead plaintiff decision are much more difficult to overcome than a failure of incentives. A change in compensation alone may not be sufficient motivation to prompt change. The most obvious way to rectify this problem would be to impose a duty upon financial institutions to take part in securities class actions under certain circumstances. Such a duty would be owed to the investors in the fund who would be able to sue to recover for damages when fund managers failed to maximize returns from securities class actions.

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81. *See* Choi, Fisch & Pritchard, *supra* note 2, at 902; Perino, *supra* note 3, at 11.

82. *See generally* Perino, *supra* note 3.

83. *Id.* at 11 (noting that "At the same time, the publicity concerning Enron, WorldCom, and other corporate scandals undoubtedly led some institutions to seek a greater role in securities class actions, either as a means of enhancing their deterrent impact or because participation could lead to valuable publicity for the fund's political overseers").

84. *See* Choi, Fisch & Pritchard, *supra* note 2, at 880-81 ("Because of the time lag between the fund's trading and the resolution of litigation, litigation recoveries may not be fully reflected in performance figures").

A duty to become involved in class actions could be defined at a variety of levels. Institutions might have a duty to collect settlement money from suits where it is cost-effective. This option has been described at length in studies of institutional failure to collect class action settlements.[85] To solve the lead plaintiff problem, the duties of care and loyalty might require institutions to consider serving as lead plaintiffs in order to maximize the recovery available to their investors. Weiss and Beckerman countenanced this kind of liability in the original proposal which gave rise to the PSLRA.[86] It was not integrated into the legislation.

V.
POTENTIAL DUTIES TO ACT IN SECURITIES CLASS ACTIONS

Weiss and Beckerman's original proposal suggested that under the common law of trusts, the duty to care would sometimes be breached where a clear benefit was available to institutions in leading a suit and they did not seize that benefit.[87] If the system guaranteed full compensation (or incentive awards) to lead plaintiffs and the involvement of an institution as lead plaintiff would significantly increase recovery as compared to the other possible lead plaintiffs, the fiduciary duty might require that institution to petition to serve as lead plaintiff.

Defining such a duty would not be easy. Important factors would include the size of the institution's stake in the suit vis-à-vis its overall size, the size of its stake vis-à-vis other investors, and the availability of suitable alternative lead plaintiffs on whom the institution could expect to "free-ride." For an institution to be required to serve as lead plaintiff, it would certainly have to be among the largest stakeholders in the potential securities suit. This would still not indicate that the stake was substantial; as Professor Pritchard points out, even seemingly large losses by institutions as a result of securities

85. Cox & Thomas, *supra* note 4, at 440-42.

86. Weiss & Beckerman, *supra* note 5, at 2113-18 (surveying the common law of trusts and ERISA law and concluding that fiduciary duty might require service as lead plaintiff where the benefits clearly exceed the costs).

87. *Id.*

fraud are a very small percentage (less than .1%) of total assets held by mutual funds.[88]

The responsibility of a trustee to pursue claims is analogous to that of a corporate director.[89] The general rule, as pointed to by Weiss and Beckerman, is laid out by Judge Cardozo in *General Rubber Co. v. Benedict*: a trustee must take "the same care of its property that men of average prudence take of their own property."[90] Specifically, trustees can be held responsible for "a negligent failure to prosecute enforceable rights."[91] This would leave plaintiffs the challenge of showing that in a given case, the involvement of their institution as lead plaintiff would have been likely to increase recovery substantially and that a reasonable investor would have taken on the role as lead plaintiff in order to do so. Though a difficult burden for a potential plaintiff to meet, this inquiry would be precisely the right one. If standards of compensation are changed so that an institution can expect to be compensated fully, the duty of care would require that due consideration be given to service as lead plaintiff where that institution holds the largest stake in the suit.

To date, no lawsuits have been brought for failure to petition to serve as lead plaintiff. One can imagine the allegations necessary for a successful suit: a plaintiff who had money invested with a mutual fund, for example, would be required to show that 1) the mutual fund had the largest (or nearly the largest) stake in the suit, 2) the potential damages were significant with respect to the overall size and returns of the mutual fund, 3) the fund's participation could have been reasonably expected to increase recovery when compared with other potential lead plaintiffs, and 4) the institution failed to petition the court to serve as lead plaintiff.

This proposal for a duty is appealing in the abstract. Unfortunately, it is unlikely to have either a meaningful or a wide-reaching effect. Perhaps most damningly, there are strong indications in the Congressional record that the lead plaintiff provision was not intended to create new fiduciary duties. In fact, the PSLRA Conference Report states that "the most ade-

88. A.C. Pritchard, *Who Cares?*, 80 WASH. U. L.Q. 883, 883-84 (2002).
89. Weiss & Beckerman, *supra* note 5, at 2114.
90. *Id.* (citing General Rubber Co. v. Benedict, 109 N.E. 96 (N.Y. 1915)).
91. *Id.* (citing *In re* Greenberg's Estate, 267 N.Y.S. 384 (Sur. Ct. 1933)).

quate plaintiff provision does not confer any new fiduciary duty on institutional investors and the courts should not impose such a duty."[92]

Even if state courts were to choose to disregard this statement with respect to state fiduciary responsibility law, the cases where it can be clearly said that an institutional investor has passed up significant certain gains are simply too few. There are too many mitigating factors that an institution could use to claim that its decision—even if a bad one—was defensible.

It would be virtually impossible to show that a given institution would have garnered a better recovery than the actual lead plaintiff. Though it might be statistically provable that monitoring by institutional lead plaintiffs increases recoveries generally (though even here the evidence is imperfect)[93], it is not clear what proof could be used to show that recovery would have been increased in a specific case. Particularly where a court has approved a settlement and attorney compensation, an investor would be hard pressed to show that the recovery was insufficient or unreasonable.

Moreover, institutions would sometimes be correct in the assertion that even with full compensation, it is at least as cost-effective to allow another party to do the work of monitoring and to focus on the expertise of institutional investors: investing.[94] This problem is even more acute where there is more than one large institutional investor in the class. The institution sued can simply argue that they hoped to see one of the other large institutions take on the role of lead plaintiff. A rational individual investor would have hoped for precisely the same outcome.

The hurdles to proving that an institution was negligent in its failure to petition to serve as lead plaintiff are virtually insurmountable. There are simply too many ambiguities present to determine whether the institution actually would have benefited from the decision. In too many cases, the reasonable

92. H.R. CONF. REP. NO. 104-369 (1995), Joint Explanatory Statement of the Committee of Conference—The "Private Securities Litigation Reform Act of 1995," reprinted in 141 CONG. REC. H13691 (daily ed. Nov. 28, 1995).

93. *See supra* pp. 6-10.

94. *See* Pritchard, *supra* note 91, at 884 ("Perhaps money managers have more important things to worry about. For example, money managers may spend their time investigating companies so as to avoid investing in fraudulent firms.").

man standard would not show that an institution clearly ought to have taken on the burdens of service as lead plaintiff.

A more plausible suit could be brought where an investor could show that his institution's failure to become involved in a securities class action was primarily the result of an explicit conflict of loyalties.[95] One could imagine a case in which an institution failed to become involved in securities litigation primarily because one of the defendants was a major client. Such an occasion is likely to be quite rare, but where such a conflict arises, it is desirable that courts enforce a duty to act for the benefit of investors in the institution and not for the institution itself.[96] These cases would be clearer and easier to resolve than duty of care cases. Such a model would parallel the close scrutiny to which courts subject corporate board decisions where a director has a personal interest in the decision and the corporate decision is thus not covered by the business judgment rule.[97]

VI. CONCLUSION

This paper has surveyed recent developments in academic literature regarding the PSLRA and has considered a number of proposals to encourage institutional participation as lead plaintiff. Some of these proposals were associated with the PSLRA before the law was even passed but have not been adopted. Because of the failure of the lead plaintiff provision to date, these proposals ought to be reconsidered. There is at least some evidence to show that the lead plaintiff provision *could* work if other measures were adopted to encourage institutional participation.

A more complete scheme of compensation for lead plaintiffs would be an excellent first step to encourage participation. When the PSLRA was passed, Congress feared that plain-

95. *See* Weiss & Beckerman, *supra* note 5, at 2118.

96. *Id.*

97. *Cf.* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (the business judgment rule's "protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.").

tiffs' attorneys would use compensation to manipulate lead plaintiffs. However, by limiting compensation, the PSLRA discourages many potential lead plaintiffs. A statutory change creating a system of incentive awards for lead plaintiff performance would be likely to attract many of the sorts of institutional lead plaintiffs envisioned at the time of the enactment of the PSLRA. Such a change would need to be accompanied by vigilant court monitoring of "pay-to-play" practices but could have positive results.

Even without a change in the statute, a change in the interpretation of the PSLRA could significantly improve compensation for lead plaintiffs. The strict reading of the PSRLA adopted by many courts has limited compensation to easily measurable pecuniary costs even though it is clear that the direct costs of lead plaintiff service are much greater. The courts could remedy this under the current statute by adopting a more liberal scheme for compensation not based on incentive awards, but rather premised on the reality that costs incurred by an institutional lead plaintiff go well beyond the directly measurable ones. Litigants could aid in this process by providing reasoned estimates of the costs of lost business and lost time as a result of leadership of the suit.

If a more complete compensation scheme were adopted, institutions would no longer be able to claim costs as reason not to serve as lead plaintiff. In such a system, investors could expect involvement as lead plaintiffs where their institution stood to make great gains from a suit. Unfortunately, this expectation is probably not judicially enforceable under the law of fiduciary duty. Even where institutional investors would be the best potential lead plaintiff, they would have several ways to "opt-out." They could point to the potential to gain free benefits from the actions of other lead plaintiffs or the uncertainty of increased recovery on account of their participation. The difficulty of proving actual damages would generally make a suit by investors untenable.

The lead plaintiff provision need not be doomed by the lack of an enforceable duty. Although the gains associated with institutional lead plaintiffs may not be as large as was once hoped, investors can still benefit significantly from their presence in these suits. The successes of the current system in attracting public institutional investors to monitor suits should not be overlooked. If an enhanced compensation scheme caused at least some additional private institutions to serve as lead plaintiffs, the lead plaintiff provision might regain some of its luster. It may not be possible to have a perfect lead plaintiff system, but with increased compensation the lead plaintiff provision could yet prove its worth.