

Commentary:

Individual Suits Beat Class Actions For Institutional, Corporate Investors

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Institutional and corporate investors that join class-action suits in securities fraud cases face the potential of being injured twice: once by the party they are suing and then again by their own law firm.

Plaintiffs' attorneys in securities class actions have a poor record of achieving successful results for their clients. Median settlements in such actions are typically just 2 percent to 10 percent of the plaintiffs' estimated damages, according to "Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2002" from Cornerstone Research. The percentage generally decreases as claimed damages increase. In other words, the more you lose from securities fraud, the lower the percentage of claimed damages you can expect to collect.

One notorious example is the VMS Realty Partnership case, where promoters sold limited partnership interests based upon misleading statements and were sued in a class action. *In re VMS Securities Litigation*, 145 F.R.D. 458 (N.D. Ill. 1992).

In 1995 Gary S. Mendoza, California's commissioner of corporations, testified before Congress: "[D]espite the strong evidence of securities law violations, this case was settled for less than 8 cents on the dollar. While this may have represented a significant recovery for the lawyers, it woefully undervalued the investors' claims. Investors who opted out of the class ... and are now participating in the independent arbitration process are frequently receiving 100 percent of their losses."

Lack of Incentive

The low settlement amount in class actions is a result of the method used by courts to compensate attorneys who prosecute those actions.

Attorneys are often compensated out of the settlement proceeds according to the "lodestar" method, which does not give attorneys an incentive to maximize recovery. Under the lodestar method, the court multiplies the number of hours worked by a reasonable hourly rate and then applies an additional multiplier based on a variety of other factors.

The easiest way for attorneys to increase their fees when representing class-action plaintiffs is to work as many hours as possible on the case. More hours, however, do not necessarily translate into a larger recovery for the client. Lawyers are often rewarded for spending time on costly and unnecessary discovery, which does little to further the clients' interests. There is a disincentive to go to trial, where plaintiffs' attorneys who do not prevail receive no fees at all. That is why class actions rarely go to trial.

Class actions are also rarely settled early, because an early settlement would significantly reduce attorney fees. The longer the plaintiffs' attorneys draw out the case, the more money they will make.

The lodestar method is not always used in class actions, as some judges have moved to other methods, such as a straight percentage. However, even in such cases, the judge uses the lodestar method to crosscheck the reasonableness of the percentage-generated fee.

Securities Litigation Reform

Once a large investor decides to pursue a claim for damages arising from violations of federal securities laws, the investor can either participate as a lead plaintiff in a class action or simply retain its own counsel and pursue its claim against the culpable parties.

The opportunity to serve as lead plaintiff was created by the Private Securities Litigation Reform Act, which was passed by Congress in 1995 to discourage frivolous lawsuits. Among other things, the lead plaintiff can select and dismiss counsel.

According to Stanford University Law School's Joseph A. Grundfest and Michael A. Perino, Congress created the lead-plaintiff provision for several reasons:

- To curb the "race to the courthouse" that previously took place, when the first party to file played the role of lead plaintiff;
- To reduce the use of "professional plaintiffs" by attorneys seeking to file class actions;
- To limit the influence of plaintiffs' attorneys who prosecute class actions; and
- To encourage participation by institutional investors.

As a result of the PSLRA, plaintiffs' counsel now need to attract one or more large claimants to pursue class claims.

However, when institutions have stepped forward to serve as lead plaintiffs, according to Grundfest and Perino, plaintiffs' attorneys have often opposed them, charging, among other things, that the level of sophistication of the institutions makes them atypical of the class as a whole. *Ten Things We Know and Ten Things We Don't Know About the Private Securities Litigation Reform Act of 1995: Joint Written Testimony before the Subcommittee on Sec. of the Comm. on Banking, Housing and Urban Affairs, U.S. Senate (July 24, 1997) (testimony of Joseph A. Grundfest and Michael A. Perino, Stanford University Law School).*

The Contingency Fee Option

Rather than participate in a class action, the institutional investor should consider filing a separate civil suit and retaining counsel on a contingency basis. The interests of such counsel are more directly aligned with the interests of the client because the lawyer maximizes his fee by maximizing recovery.

We can think of no case where serving as lead plaintiff

has any advantage to the institutional investor. The institutional investor has greater control over the process when it is the sole plaintiff in the case. Legal fees and out-of-pocket expenses should be no greater than if the investor participated in a class action, but the recovery, if the case is won, should be far greater than the 2 percent to 10 percent a plaintiff can expect from a class-action case. In addition, the solo-plaintiff approach avoids the expensive procedural steps characteristic of class actions, such as class certification and notification, and attendant delays.

One thing that individual cases have in common with class actions is that they are time-consuming and require a great deal of effort. Whether pursuing individual actions or class actions, institutional and corporate investors should first decide whether they are willing to expend the time and effort necessary to comply with pretrial discovery requests, including the production of documents and depositions of individuals involved in the investment decisions.

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