CHRISTOPHER LOMETTI
212.838.7797
clometti@cohenmilstein.com
V-CARD

RICHARD E. LORANT
202.408.3622
rlorant@cohenmilstein.com
V-CARD

SECURITIES LITIGATION 101:

SELECTING A LEAD PLAINTIFF: HOW COURTS DECIDE WHICH PARTY SHOULD REPRESENT THE PROPOSED CLASS

When it comes time to determine which plaintiffs will act as representatives for all class members, lawsuits brought under the U.S. federal securities laws are unlike any others. That's because securities class actions are subject to the Private Securities Litigation Reform Act of 1995 (the PSLRA), a law that created a process to select the lead plaintiffs based on objective criteria including the size of their financial interest in the case.

Under the law, the lead plaintiff is a key player in a securities class action, acting as a fiduciary on behalf of the entire class and responsible for selecting lead counsel, signing off on litigation strategy and tactics, approving proposed settlements, and negotiating attorneys' fees.

Prior to the PSLRA's enactment in 1996, judges often assigned the role of lead plaintiff to the first party to file a securities lawsuit in their court or based on their knowledge of the law firm representing the plaintiff. This created a perceived "race to the courthouse," in which specialized attorneys filed complaints soon after stock drops, sometimes relying on a stable of clients with small stock holdings in many publicly traded companies. These practices also raised criticisms that too many shareholder lawsuits were "lawyer driven," since plaintiffs' attorneys usually had far larger stakes in the outcome than the small investors who often brought the lawsuits.

SECURITIES CLASS ACTIONS ARE SUBJECT TO THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (THE PSLRA), A LAW THAT CREATED A PROCESS TO SELECT THE LEAD PLAINTIFFS BASED ON OBJECTIVE CRITERIA INCLUDING THE SIZE OF THEIR FINANCIAL INTEREST IN THE CASE.

To remove any advantage for early filers, the PSLRA[1] directs judges to apply a rebuttable presumption to appoint the movant with the largest financial interest in the litigation, if the movant is also "typical" and "adequate" as defined in Rule 23 of the Federal Rules of Civil Procedure.[2] When naming the lead plaintiff, the court also approves lead plaintiffs' choice of lead counsel.

1 The PSLRA has provisions dealing with many aspects of securities litigation, notably creating an automatic stay of discovery designed to protect defendant companies from documentary "fishing expeditions" until a judge decides whether the case is properly pled; raising pleading standards to require plaintiffs to show a strong inference that defendants had knowingly acted wrongly; and providing defendants with a "safe harbor" against liability for forward-looking statements. We will leave those for a future installment of Securities Litigation 101.

2 Rule 23 requires that the lead plaintiff's legal claims are typical of the class, broadly meaning that they arise from the same event and are based on the same legal theory, and that the movant is adequate, meaning its interests do not conflict with those of the class and it has enough experience and resources to vigorously represent the class and oversee counsel.

To help potentially harmed investors learn about new lawsuits and give them time to step forward, the law requires plaintiffs who filed the shareholder lawsuit to publish within 20 days a public notice containing certain information, including the claims asserted, the purported class period, the court where it was filed, the fact that any class member can serve as lead plaintiff, and the deadline for filing lead plaintiff motions. With the growth of the internet, these "PSLRA notices" have evolved from newspaper advertisements to online news releases beamed instantly around the world. Purported class members have 60 days from the first PSLRA notice to file a lead plaintiff motion with the court.

Though the PSLRA is mute on how to calculate financial interest, courts generally have looked at total class period purchases, net class period purchases, net class period expenditures, and most importantly losses, as calculated on a last-in-first-out (LIFO) or first-in-first-out (FIFO) basis. Since movants sometimes group together to file joint lead plaintiff petitions, the courts often consider whether to allow such a group to aggregate its losses in a single motion. The courts typically decide whether to permit such aggregations on a case-by-case basis. While the PSLRA does not provide any guidance about groups, the courts have considered factors such as the group's size, whether group members knew each other before filing the motion, whether they have discussed how they plan to work together on the case, their experience as lead plaintiffs, and their choice of counsel.

WHEN CONGRESS ENACTED THE PSLRA, IT SOUGHT TO EMPOWER INSTITUTIONAL INVESTORS, REASONING THAT THEY WOULD HAVE LARGER LOSSES–MORE "SKIN IN THE GAME"–AND THAT THEIR SIZE, STAFFING, LEVELS, AND SOPHISTICATION WOULD GIVE THEM BETTER TOOLS TO FULFILL THEIR FIDUCIARY DUTIES TO ABSENT CLASS MEMBERS, INCLUDING OVERSIGHT OF THE ATTORNEYS.

When Congress enacted the PSLRA, it sought to empower institutional investors, reasoning that they would have larger losses—more "skin in the game"—and that their size, staffing, levels, and sophistication would give them better tools to fulfill their fiduciary duties to absent class members, including oversight of the attorneys. In that respect, the law certainly worked. Institutional investors, rarely involved in shareholder lawsuits prior to 1996, now are appointed lead plaintiffs in roughly half of all newly filed federal securities class actions; even in smaller cases where individual investors act as lead plaintiffs, the PSLRA's lead plaintiff mechanism ensures an orderly, fact-based selection process. The increased involvement of institutional investors has in turn benefited all shareholders. Numerous academic studies have shown that shareholder class actions led by institutional investors are more likely to succeed than those led by individuals. Cases with institutional lead plaintiffs settle for more money and pay lower attorneys' fees than other cases, even when controlling for the fact that institutions tend to file larger cases. ■

Christopher Lometti is Of Counsel to Cohen Milstein. Richard E. Lorant is the firm's Director of Institutional Client Relations. They are members of the firm's Securities Litigation & Investor Protection practice group.