Legal Backgrounder

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COURT STRIKES BLOW AGAINST LAWYER-DRIVEN SECURITIES SUITS

by

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In *Berger v. Compaq Computer Co.*, 257 F.3d 475 (5th Cir. 2001), the U.S. Court of Appeals for the Fifth Circuit tightened the standard for certifying securities class actions, a decision which may curb the frequency of lawyer-driven cases. The decision announces a stronger test for determining whether the named plaintiffs are adequate representatives for the proposed class. The court held that the plaintiffs had failed to show that they were adequately informed and in control of case management.

The ruling is a watershed on two fronts: First, it rejects the previously lax inquiry into the adequacy of the representatives routinely applied in the Fifth and other circuits,[1] — a test which typically required little or no demonstration of the qualifications of representative plaintiffs, so long as class counsel was sophisticated and the representatives did not have a conflict of interest with the remainder of the class.[2] This

[1] A few previously reported decisions had focused on whether plaintiffs were in actual control of the litigation. *See Efros v. Nationwide Corp.*, 98 F.R.D. 703, 707 (S.D. Ohio 1983) (plaintiff did not speak to counsel until after complaint was filed, didn't know who the expert witness or trial attorneys were, showed "glaring lack of familiarity with facts," and didn't support many of the claims of the attorney); *Darvin v. International Harvester Co.*, 610 F. Supp. 255 (S.D. N.Y. 1985) (plaintiff's inconsistent answers at deposition and lack of familiarity with facts in the complaint rendered him an inadequate representative).

[2] *See In Re Mego Financial Corp. Sec. Litig.*, 213 F.3d 454, 462 (9th Cir. 2000) ("adequacy" satisfied if: (1) plaintiff's counsel is able to prosecute the action vigorously on behalf of the class, and (2) interests of plaintiffs are not antagonistic to the remainder of the class); *Kalodner v. Michaels Stores, Inc.*, 172 F.R.D. 200, 209-10 (N.D. Tex. 1997) (requiring only a general knowledge of their position as plaintiffs and the alleged wrongdoing); HERBERT B. NEWBERG & ALBA CONTE, NEWBERG ON CLASS ACTIONS, (3d ed.) § 3.22 at 3-126, § 3.24 at 3-133–134 and § 3.42 at 3-220-3-232 (1977) (vigorous prosecution test for adequacy applied mainly from the perspective of the competence and experience of class counsel).

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prior line of cases is typified by *Kirkpatrick v. J.C. Bradford & Co*., 827 F.2d 718, 727 (11th Cir. 1987) (downplaying the importance of the class representatives' familiarity with the case because "the economics of the class action suit are often such that counsel have greater financial incentive for obtaining successful resolution of a class suit than do individual class members"). Second, the *Berger* court pointedly rejected relying on the sophistication of the lawyers as a proxy for adequate representation, stating that Congress has made it clear by the passage of the Private Securities Litigation Reform Act ("PSLRA") [3] that it intended to curb abuses resulting from lawyer-controlled securities class action litigation:

> Any lingering uncertainty, with respect to the adequacy standard in securities fraud class actions, has been conclusively resolved by the PSLRA's requirement that securities class actions be managed by active, able class representatives who are informed and can demonstrate they are directing the litigation. In this way the PSLRA raises the standard adequacy threshold.

257 F.3d at 483.

The Facts. Berger sued Compaq and its directors on behalf of all buyers of Compaq stock alleging that the company had artificially inflated its stock price by engaging in "channel stuffing," — a practice of "overselling" products to distributors with the knowledge that the distributors will not be able to sell at retail in the volumes or at the prices of the wholesale transactions. Plaintiffs alleged violations of § 10(b) and 20(a) of the Securities Exchange Act of 1934 and the corresponding rules. Seven members of the putative class moved for certification. Defendants opposed on the ground that plaintiffs had failed to meet their burden under Rule 23(a)(4)[4] that they were directing and controlling the litigation and were otherwise adequate representatives. 257 F.3d. at 478.

The trial court granted certification, stating that "[t]he adequacy of the putative representatives and of plaintiffs' counsel is presumed in the absence specific proof to the contrary." 257 F.3d at 481. The Fifth Circuit reversed and remanded, rejecting the trial court's standard on two counts: (1) the burden was incorrectly placed on defendants and (2) consistent with the mandate of the PSLRA, plaintiffs were required to show that they, not the lawyers, were directing and controlling the litigation. The Fifth Circuit noted that the affect of the PSLRA on class certification was a matter of first impression and proceeded to find in the PSLRA confirmation of its view that adequate representatives must show they are informed and are directing the litigation. 257 F.3d at 483-484.

How much will be required of future class representatives to pass muster under the *Berger* "adequacy" test? The Fifth Circuit gives some broad guidance in its observation that: "[a]lthough, certainly, class representatives need not be legal scholars and are entitled to rely on counsel, plaintiffs do need to know more than that they were 'involved in a bad business deal.' Unoccupied space exists between these positions for the purpose of preserving meaningful consideration of the class representatives' knowledge about, or control of, the litigation." 257 F.3d at 483 (citations omitted).

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[3] Securities Exchange Act of 1934, 21D *et seq.*, as amended, 15 U.S.C.A. § 78u-4 *et seq.*

[4] Rule 23 states that a class may be certified only where the party seeking certification shows all four of the following: (1) [numerousity] the class is so numerous that joinder of all members is impractical; (2) [commonality] there are questions of law or fact common to the class; (3) [typicality] the claims or defenses of the representative parties are typical of the claims or defenses of the class; and (4) [adequacy] the representative parties will fairly and adequately protect the interests of the class. FED. R. CIV. P. 23(a).

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The court in *Berger* had reason to be concerned. In a lengthy footnote citing Compaq's description of the depositions of four of the proposed representatives, the court catalogs the shortcomings of these representatives. The representatives could not explain the basis for the channel-stuffing allegation or why it was evidence of fraud rather than changed market conditions or a mistake of business judgment. The deponents admitted they were relying upon hindsight. None could articulate a reason beyond general speculation, why Compaq's chairman would commit fraud. One representative even disavowed the allegation in the complaint that the chairman had committed fraud to obtain a higher salary. The court found these conflicts between the testimony and the complaint probative of a conclusion that the lawyers, not the representatives, were in control of the suit. 257 F.3d at 480, n. 10.

The Impact of Berger. Does *Berger* portend a trend in other jurisdictions towards a tightening of the "adequacy" standard for class certification? The influential Second and Ninth Circuits, where a substantial portion of securities class actions are filed, are likely to provide the answer.

While no other circuit has yet addressed *Berger's* use of the PSLRA to justify more rigorous scrutiny of the plaintiff's control of the litigation, the recent Second Circuit decision in *Baffa v. Donaldson, Lufkin & Jenrette Securities Corp.*, 222 F.3d 52, 60-62 (2d Cir. 2000) (reversing denial of class certification) may signal reluctance in that jurisdiction to adopt *Berger's* test that class representatives demonstrate that they are active, able litigants who control the litigation.[5]

In *Baffa*, plaintiffs brought a securities class action claim challenging the adequacy of financial disclosure by the issuer in connection with its initial public offering. Plaintiff Robert Baffa purchased defendant's shares on behalf of his son, Brett, placing them in a Uniform Gifts to Minors account. During the litigation, Brett came of age and became the owner of the account. The trial court rejected Brett as an adequate representative because Brett had not demonstrated adequate knowledge of the claims or a sufficient willingness to direct the litigation. The Court of Appeal reversed, finding that Brett had a general knowledge of the claim, had expressed a willingness to consult with his lawyers and experts to manage the claim, and had demonstrated good judgment in understanding the limits of his own experience. 222 F.3d at 62.

The *Baffa* court expressed hostility to the trial court's adequacy test, suggesting that that court focused too much on the familiarity of the class representative with the facts of the case. In this aspect of the holding, the Second Circuit relied on *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 370-74 (1966) (precluding attack on the sufficiency of a verification of a derivative action based upon the ignorance of the declarant). Significantly, the same argument based upon *Surowitz* was made by the plaintiffs in *Berger* and rejected by the Fifth Circuit. On this point, the Fifth Circuit has the better argument.

The *Berger* court correctly noted that, although frequently used for this purpose, *Surowitz* is not properly cited in the context of a Rule 23(a)(4) adequacy determination as authority for the proposition that the prospective class representative's familiarity with the action is not important. *Surowitz* is not a class certification case. *Surowitz* dealt with a totally different issue — whether a plaintiff in a derivative action had properly verified the complaint.[6] The verification requirement for a derivative action has the limited function of affirming that the plaintiff was a shareholder at the time of the filing of the complaint and that the action was not filed for the collusive purpose of conferring jurisdiction on a federal court where it would

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[5]*See Aldina v. Penton Media, Inc.*, 143 F. Supp. 2d 363, 366 (S.D.N.Y. 2001) (following *Baffa*, holding that a representative who understands and is willing to assume role and can describe amount and type of inappropriate conduct is adequate).

[6]Class action claims are direct claims of the individual class members, in this context, their shareholders. Derivative actions are actions brought by a shareholder to enforce the rights of the corporation.

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otherwise have been absent. These interests discussed in *Surowitz* are a far cry from the due process concerns implicated by the Rule 23(a)(4) adequacy requirement for class actions. The class representative must be an adequate representative for absent class members because those who do not opt out will be bound by the class representatives' conduct of the case. The Second Circuit's opinion in *Baffa*, 222 F.3d at 61, glosses over this significant difference and perpetuates a use of *Surowitz* that is not justified and has led to an unduly lenient application of Rule 24(a)(4).

Notwithstanding *Baffa*, several things ought to be clear from the *Berger* decision: (1) plaintiffs ignore the adequacy issue at their peril; (2) courts should be less willing to indulge arguments that attempt to "paper over" the poor command of the case by a proposed representative by diverting the focus to the sophistication of counsel; and (3) plaintiffs should expect to make an affirmative showing that the clients, not the lawyers, are in control of the case.[7]

On the practical side, one can expect that there will be immediate impact from the *Berger* case in the way class certification is prepared and briefed. Defendants will undoubtedly focus on the knowledge and control issues in taking the depositions of class representatives. Plaintiffs can expect to spend greater time preparing representatives for those depositions. While the objectives of *Berger* are good, if all that results is a "cramming" process by which representatives are simply better schooled for their depositions, the goal will not be accomplished. Courts should be more vigilant about the extent to which the class representatives are in control of the litigation to ensure that the purpose behind class actions is met.

Conclusion. The *Berger* decision is a welcome articulation of a clear standard for the Rule 23(a)(4) adequacy test that appropriately focuses the adequacy inquiry on the issue of whether the representative plaintiff will stay informed and exercise judgment and control of the litigation. These are qualities that we expect of litigants in other types of litigation. These traits are even more important in the context of representative actions with "absent" parties. As the *Berger* court observed, "Class action lawsuits are intended to serve as a vehicle for capable, committed advocates to pursue the goals of the class members through counsel, not for capable, committed counsel to pursue their own goals through the class members." *Berger*, 257 F.3d 484.

[7] *See Broussard v. Parish of New Orleans*, 2001 U.S. Dist. LEXIS 11941 (E.D. La. Aug. 2, 2001) (Mag. Judge recommended decision) (denying certification, inter alia, for failure to meet *Berger* adequacy test); *Gilmore v. Southwestern Bell Mobile Systems, L.L.C.*, 2001 U.S. Dist. LEXIS 19850 (N.D. Ill. Nov. 29, 2001) (denying certification, in part, because plaintiffs failed to meet their burden of proof on adequacy, citing *Berger*).

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