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AUCTIONS FOR LEAD COUNSEL IN SECURITIES FRAUD SUITS RULED IMPROPER

by

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In response to perceived abuses in securities class action litigation, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA" or "Reform Act"), which is designed to place primary control of private securities litigation in the hands of investors, rather than their lawyers. Specifically, the Reform Act establishes detailed procedures for selecting a lead plaintiff in class action securities lawsuits, and also addresses the proper procedures for selecting lead counsel, and for determining its fee. The United States Court of Appeals for the Third Circuit recently put its stamp on the Reform Act in *In re Cendant Corp. Litigation*, 264 F.3d 201 (3d. Cir. 2001), which is the first circuit court decision to interpret the lead counsel provisions of the PSLRA. The massive opinion, authored by Chief Judge Becker, and joined by Judges Sloviter and Ambro, is noteworthy for its decision that courts should generally respect the lead plaintiff's choice of lead counsel, and not interfere with this choice by holding an "auction" to choose lead counsel by soliciting competitive bids from various law firms. While this decision places the Third Circuit at odds with several courts that have considered the issue, nonetheless its rejection of the "auction" method for selecting lead counsel is consistent with both the text and purpose of the PSLRA.

In 1998, at least sixty-four putative securities fraud class action lawsuits were filed nationwide against Cendant Corporation, one of the world's largest consumer and business service companies, based on alleged accounting irregularities that had artificially inflated Cendant's stock price. *Id.* at 221-22. These cases were transferred to the United States District Court for the District of New Jersey, and consolidated on May 29, 1998. *Id.* at 222. Following the procedures set forth in the Reform Act, the district court appointed the CalPERS Group — a consortium of the three largest publicly-managed pension funds in the United States — as lead plaintiff. *Id.* at 223. The district court refused, however, to approve the Retainer Agreement between the CalPERS Group and its choice of lead counsel, Barrack, Rodos & Bacine ("BRB") and Bernstein Litowitz Berger & Grossman LLP ("BLBG"), choosing instead to conduct an "auction" that solicited bids from interested counsel, with the lowest qualified bid deemed the winner. *Id.* at 224-25. Ultimately, the district

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court appointed BRB and BLBG lead counsel after they matched the lowest bid.[1] *Id.* at 225.

On December 7, 1999, with discovery in the case still at an early stage, Cendant announced a proposed $3.2 billion settlement, with Cendant supplying approximately $2.85 billion of the settlement proceeds and its accountants, Ernst & Young, supplying the balance. *Id.* at 226-27. The district court formally approved the settlement on August 15, 2000, and the next day awarded lead counsel approximately $262 million in attorneys fees pursuant to the fee schedule that had been pre-set via the auction. *Id.* at 229.

The Third Circuit affirmed in part, and reversed in part. As a threshold matter, the court approved the fairness and adequacy of the settlement plan under the multi-factored test that the court had developed in *Girsh v. Jepson*, 521 F.2d 153 (3d Cir. 1975). *Cendant*, 264 F.3d at 231-43. The court then turned to an analysis of the PSLRA, discussing the principles underlying the Reform Act and its treatment of the procedures for selecting a lead plaintiff and lead counsel, as well as determining lead counsel's fee.

The essential thrust behind the Reform Act is to empower investors so that they, and not their lawyers, control private securities litigation. *Id.* at 261-62, 273-74; *see also In re Nice Systems Sec. Litig.*, 188 F.R.D. 206, 214-15 (D.N.J. 1999) (discussing the legislative history behind the PSLRA). In the traditional class action model, judges have been forced to oversee the relationship between the class and its lawyers — in effect, to act as agents for the class — because a large, widely dispersed class cannot effectively supervise its attorneys, and furthermore, the economic interests of the class and its attorneys frequently diverge. *Cendant*, 264 F.3d at 254-55. Unfortunately, however, this model has often failed in practice, as time and institutional constraints have generally prevented courts from actively monitoring lead counsel's performance. *Id* at 255. Moreover, most courts have simply appointed as lead plaintiff the person who filed the first lawsuit, and selected the person's lawyer as lead counsel, thus encouraging a "race to the courthouse" regime under which lead counsel generally selected the lead plaintiff rather than vice versa. *Id.* The Reform Act is designed to address and remedy this situation, relying on the theory that class members will benefit if the plaintiff with the largest financial interest in the litigation is designated the lead plaintiff, because such a lead plaintiff — which normally would be a large, sophisticated institutional investor — is better equipped than a judge to select, retain, and monitor lead counsel. *Id.* at 261-62, 273-74.

With this background in mind, the *Cendant* court easily upheld the district court's decision to appoint the CalPERS Group as lead plaintiff. The court explained that the Group fulfilled the statutory requirements for presumptive lead plaintiff status, because the Group had both "the largest financial interest in the relief sought by the class" and had made a *prima facie* showing that it satisfied the "typicality" and "adequacy" requirements of Rule 23 of the Federal Rules of Civil Procedure. *Id.* at 262-68. Moreover, no class member had presented reliable evidence to rebut the presumption that the Group could adequately protect the class's interests, and therefore the Group had been appropriately designated lead plaintiff. *Id.* at 269-70.

Next, the court analyzed the district court's use of an "auction" to select lead counsel. The text of the Reform Act grants lead plaintiff the power to "select and retain" lead counsel, subject to the "approval" of the district court. *Id.* at 273. Chief Judge Becker interpreted this to mean that the district court's role is limited to "approving" or "disapproving" the lead plaintiff's choice, and therefore an auction is generally an inappropriate vehicle by which to select lead counsel, because an auction permits the court, in effect, to usurp lead plaintiff's statutory right to choose lead counsel itself. *Id.* at 273-74. Moreover, the district court should employ a deferential standard in reviewing lead plaintiff's choice. *Id.* at 274-76. Thus, the court concluded

[1]Both the Retainer Agreement and auction utilized a "percentage of total recovery" approach to establishing counsel's potential fee, which generally has replaced the traditional "lodestar" method (in which the court multiplies hours reasonably worked by a reasonable hourly rate) for determining counsel fees in class actions.

that the district court erred in holding an auction, but this error was harmless because counsel selected via the auction were the same as lead plaintiff's original choice. *Id.* at 279-80.

Although the court clearly frowned upon the use of auctions in securities class actions, it did not entirely rule out their use. For example, if the lead plaintiff demonstrates that it is unwilling or unable to select appropriate counsel, *and* if the district court ultimately concludes that none of the possible lead plaintiffs is capable of fulfilling the role contemplated by the Reform Act (*i.e.*, a sophisticated investor who has suffered sizable losses and who will aggressively serve the interests of the class), then the district court would be justified in assuming direct control over counsel selection. *Id.* at 277. In such a "rare[]" situation, an auction would be one permissible means by which to select counsel. *Id.* at 277-78.

Finally, the court addressed the issue of lead counsel fees. It vacated the auction-driven fee award of $262 million, and ruled that the original Retainer Agreement between CalPERS and BRB and BLBG, which would have generated a fee of up to $187 million, should still be in force. *Id.* at 280-81. The court cautioned, however, that the district court on remand should scrutinize any fee request under the Retainer Agreement, in order to fulfill its "independent obligation to ensure the reasonableness of any fee request." *Id.* at 281-82.

The strength of the *Cendant* decision is its careful attention to both the text and the purpose of the PSLRA. In particular, the court's decision that auctions are generally impermissible in securities class actions swims against a growing tide of judicial authority,[2] and yet it is difficult to quarrel with Chief Judge Becker's analysis. As he explained, the Reform Act states that lead plaintiff shall "select and retain" lead counsel, subject to the "approval" of the court. But the court's power of "approval" should be limited to just that — the power to accept or reject lead plaintiff's choice, and not the power to make that choice for the plaintiff. An auction, in effect, confers upon the court the right to "select and retain" counsel and limits the lead plaintiff to deciding whether to acquiesce in the court's choice — a result that is inconsistent with the statutory text. *Id.* at 275-76.

Surprisingly, most courts to consider this issue have given the statutory text insufficient attention. Many have acknowledged lead plaintiff's right to "select and retain" lead counsel subject merely to court "approval," but have made no attempt to reconcile this statutory language with the existence of a court-ordered auction. *E.g.*, *In re Bank One S'holders Class Actions*, 96 F. Supp. 2d 780, 784-85 (N.D. Ill. 2000); *Wenderhold v. Cylink Corp.*, 188 F.R.D. 577, 587 (N.D. Cal. 1999); *Sherleigh Assoc. LLC v. Windmere-Durable Holdings, Inc.*, 184 F.R.D. 688, 693-94 (S.D. Fla. 1999). Others have failed to cite the relevant statutory language altogether. *E.g.*, *Raftery v. Mercury Finance Co.*, No. 97 C 624, 1997 WL 529553, at *1-*3 (N.D. Ill. Aug. 15, 1997).

In addition, the purpose of the PSLRA is inconsistent with choosing lead counsel via an auction. As noted above, the primary purpose of the Reform Act is to place control of class action securities litigation in the hands of investor plaintiffs, rather than their lawyers. This purpose is principally achieved by appointing a large, sophisticated investor as lead plaintiff who will aggressively protect the interests of the class by, for

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[2]In securities class actions governed by the PSLRA, eight decisions prior to *Cendant* endorsed selecting class counsel by means of an auction: *In re Quintis Sec. Litig.*, 201 F.R.D. 475, 491 (N.D. Cal. 2001); *In re Comdisco Sec. Litig.*, 141 F. Supp. 2d 951, 953 (N.D. Ill. 2001); *In re Bank One S'holders Class Actions*, 96 F. Supp. 2d 780, 784 (N.D. Ill. 2000); *In re Lucent Technologies, Inc., Sec. Litig.*, 194 F.R.D. 137, 156 (D.N.J. 2000); *Wenderhold v. Cylink Corp.*, 188 F.R.D. 577, 587 (N.D. Cal. 1999); *Sherleigh Assoc. LLC v. Windmere-Durable Holdings, Inc.*, 184 F.R.D. 688, 692 (S.D. Fla. 1999); *Raftery v. Mercury Finance Co.*, No. 97 C 624, 1997 WL 529553, at * 3 (N.D. Ill. Aug. 15, 1997); *In re Network Assoc., Inc., Sec. Litig.*, 76 F. Supp. 2d 1017, 1034 (N.D. Cal. 1999) (directing lead plaintiff to conduct an auction). Prior to *Cendant*, only two courts had suggested that such a procedure would be inconsistent with the statute. *In re Razorfish, Inc. Sec. Litig.*, 143 F. Supp. 2d 304, 310 (S.D.N.Y. 2001); *In re Microstrategy Inc. Sec. Litig.*, 110 F. Supp. 2d 427, 437-38 (E.D. Va. 2000).

example, driving a hard bargain with lead counsel and effectively monitoring lead counsel's performance. In class actions outside the PSLRA context, some courts have experimented with auctions because they simulate the market for legal services, and thereby help alleviate the selection and monitoring problems that have plagued the traditional class action model. *E.g.*, *In re Auction Houses Antitrust Litig.*, 197 F.R.D. 71, 78-82 (S.D.N.Y. 2000); *In re Amino Acid Lysine Antitrust Litig.*, 918 F. Supp. 1190, 1192-97 (N.D. Ill. 1996); *In re Oracle Sec. Litig.*, 131 F.R.D. 688, 693-97 (N.D. Calif. 1990). Several courts have imported this reasoning into Reform Act cases, but without considering how the principles behind the Reform Act obviate the need for auctions. *E.g.*, *Bank One*, 96 F. Supp. 2d at 784-85; *Sherleigh*, 184 F.R.D. at 693-96. In doing so, these courts demonstrate a misunderstanding of the PSLRA. As the *Cendant* court trenchantly observed, there is no need to "simulate" the market in cases under the Reform Act, because when a properly-selected lead plaintiff selects counsel in good faith, the fee agreed to by the parties is the market fee. *Cendant*, 264 F.3d at 278. In other words, under the theory of the PSLRA, a sophisticated lead plaintiff will drive an *actual* hard bargain with lead counsel, and thus there is no need to imperfectly *simulate* a hard bargain via an auction.[3]

The *Cendant* opinion may signal the end of court-ordered auctions to select lead counsel in class action securities litigation. As the first circuit court decision to analyze the lead counsel provisions of the PSLRA, *Cendant* sets the stage for other circuits around the country to follow the Third Circuit's lead, especially given the sterling reputation of Chief Judge Becker and the strength of his analysis.[4] In turn, this may encourage large institutional investors to volunteer as lead plaintiffs, as they anticipate that their choice of lead counsel will be respected. *See, e.g.*, John C. Coffee Jr., *Securities: Class Auctions*, NAT'L L.J., Sept. 14, 1998, at B6 (noting that auctions "may chill the willingness of public pension funds and other institutional bidders to serve as lead plaintiffs, if they are to be involuntarily wedded to counsel they did not select," and that *Cendant* was one of the first cases in which CalPERS has been willing to serve as lead plaintiff).

Moreover, as more institutional investors serve as lead plaintiffs, their bargaining power against lead counsel likely will increase. With increased bargaining power, lead plaintiffs may be able to negotiate advantageous fee arrangements that preserve more dollars for aggrieved investors, and less for their lawyers, thus effectuating the policy of the Reform Act. Finally, with repeat clients as lead plaintiffs, plaintiff-side securities lawyers may perform their duties with additional care. *See Cendant*, 264 F.3d at 261 (noting that "if institutional investors frequently served as lead plaintiffs, plaintiff-side securities law firms would grow increasingly concerned about their long-term reputations with such investors and thus might have less incentive to shirk in particular cases" (citing Elliott J. Weiss & John S. Beckerman, *Let The Money Do The Monitoring: How Institutional Investors Can Reduce Agency Costs In Securities Class Actions*, 104 YALE L.J. 2053, 2106-07 (1995))).

In sum, *Cendant* is a careful, well-reasoned opinion that is faithful to both the language and purpose of the PSLRA. The decision is a significant milestone in the interpretation of the Reform Act that may reverse the tide of court-ordered auctions in class action securities litigation, and thus enable the Act to achieve its stated goals.

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[3]Interestingly, this theory appears to have borne out in practice in *Cendant*, as the court-driven auction ultimately generated a $262 million fee for lead counsel, while the fee under the original Retainer Agreement would have been only $187 million at most. *Cendant*, 264 F.3d at 285.

[4]This appears even more likely given the recent publication of an exhaustive Third Circuit Task Force Report on the Selection of Class Counsel, which concludes that "[a]uctions are inconsistent with the goal of the PSLRA." Draft Report of the Third Circuit Task Force, *Selection of Class Counsel*, at 18 (Oct. 3, 2001), *available at* http://www.ca3.uscourts.gov.