Legal Backgrounder

WLF Washington Legal Foundation
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2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 20 No. 11 March 11, 2005

JUDICIAL OVERSIGHT OF CLASS ACTION SECURITIES FRAUD SETTLEMENTS

by

Andrew Edison

There is an old adage that only two things in life are certain: death and taxes. Some might say that another notion can be added to that list: federal judges will not determine that plaintiffs' class counsel has agreed to settle a securities fraud case for less than its fair value. This LEGAL BACKGROUNDER explores why federal judges, who have the ability to exercise significant judicial oversight over class action securities fraud settlements, have been reluctant to carefully police such settlements. This paper will also take a look at the recent high-profile Halliburton securities fraud case and discuss why the court's rejection of the proposed settlement in that case represents the exception, not the rule.

Judicial Oversight of the Settlement Process. Generally, parties to a lawsuit have the unfettered right to decide whether to settle pending litigation. This general rule, however, does not apply to class action litigation and, in particular, class action securities fraud litigation. In class action securities fraud cases, the trial court is charged with the task of determining whether a proposed settlement should be approved. Federal judges are obligated to determine if a proposed settlement is fair, adequate, and reasonable, and not the product of collusion between the parties. Only if these conditions are met are federal judges supposed to approve a proposed class action securities fraud settlement.

The central question is: why are federal judges asked to protect the interests of the absent class members who would be bound by a settlement? Courts have articulated the following rationale: once class counsel reaches a settlement with the defendants to resolve a case, class counsel assumes a position adverse to the class as to how large a fee class counsel should receive. As a result, it is the court's role to act as a "fiduciary" to ensure that the settlement is fair to the absent class members and does not merely serve class counsel's interest. By exercising their "fiduciary obligations" to the absent class members, federal courts ensure the integrity, legitimacy, and fairness of the settlement process.

Although federal judges have the ability to carefully scrutinize potential class action settlements, the reality is that judges rarely exercise this power. For all practical purposes, once

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Andrew Edison is a partner in the trial section at Bracewell & Patterson, L.L.P. where he focuses on securities litigation matters in both state and federal courts. Bracewell & Patterson, L.L.P. is a Houston, Texas based law firm with approximately 400 lawyers in 11 offices worldwide.

class counsel reaches a proposed settlement with the defendants, you can expect the court to rubber stamp the settlement. Indeed, one recent study found that more than ninety percent of proposed settlements in four federal districts were approved without *any* changes made by the presiding judge.

There are several reasons why federal judges are reluctant to actively enforce their role as a protector of absent class members. Some charge that judges are hesitant to undertake a rigorous analysis of a proposed settlement because they are preoccupied with clearing their docket and do not want to do anything to upset that process. That might be true for a limited number of judges. There is, however, a less cynical explanation: federal judges generally do not need to exercise significant judicial oversight at the settlement phase because the current system works effectively to ensure that most class action securities fraud settlements are fair and reasonable. Here's why:

Ten years ago, Congress passed the landmark Private Securities Litigation Reform Act ("PSLRA"), designed to prevent the routine filing of meritless lawsuits against issuers of securities whenever there was a significant change in the issuer's stock price. The PSLRA contained a number of provisions aimed at curbing abusive securities litigation. One of the PSLRA's key provisions installed "lead plaintiff" procedures intended to encourage institutional investors to take control of lawsuits from plaintiffs' lawyers with nominal clients. Under the "lead plaintiff" procedures, the presiding judge is required to appoint as lead plaintiff the person or group of persons whom the court determines to be the most capable of adequately representing the interests of the class members. The PSLRA also provides that the lead plaintiff, subject to court approval, will select and retain counsel to represent the class.

By enacting the PSLRA, "Congress recognized that the judiciary cannot efficiently and effectively police opportunistic behavior of the plaintiffs' bar. The PSLRA assigns this monitoring responsibility to the lead plaintiffs for the class, persons whose interests are more closely aligned with the interests of the absent class members." Lisa L. Casey, *Reforming Securities Class Actions From The Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 BYU L. REV. 1239, 1246 (2003). Since the passage of the PSLRA, institutional investors have seized control of class action securities cases. These institutional investors, many of whom are public pension funds, closely monitor the securities class action cases, carefully negotiating fee agreements with counsel and actively participating in settlement discussions. Generally speaking, the large institutional investors appointed to protect the interests of the absent class members generally do an effective job. As a result, in the vast majority of cases, class counsel no longer acts contrary to the interests of absent class members.

Aside from the PSLRA, federal judges also have the authority — and the obligation — at the class certification stage to assure the adequacy of both the class representatives and class counsel. Case law dictates that a class should be certified only when the class representative understands his unique responsibility to protect the interests of absent class members and is able to fulfill those duties. Likewise, class counsel should be approved only when the court is satisfied that counsel will adequately represent the absent class members.

In light of the PSLRA and the existing class certification procedure, judges are forced to appoint class representatives who will exercise significant oversight in the settlement process. Judges are also required to identify class counsel who will not act contrary to best interests of absent class members. By appointing responsible lead plaintiffs and class counsel at the outset of a case, federal judges rarely have to intercede and exercise significant judicial oversight at the settlement phase. Only when there is a breakdown in the system, and the lead plaintiff and class counsel do not fulfill their obligations, are courts required to intervene in the settlement process. This is best illustrated by the Halliburton case.

The Halliburton Case. In the summer of 2002, numerous class action securities fraud lawsuits were filed against Halliburton Company and several of its former officers and directors. The lawsuits, which were all consolidated before United States District Court Judge Barbara Lynn in Dallas, Texas, claimed that the defendants violated federal securities laws by concealing the extent of Halliburton's asbestos exposure liability and failing to disclose an accounting change that improved the company's earnings report.

As required by the PSLRA, the court appointed several lead plaintiffs to monitor the litigation. One of the lead plaintiffs was the Archdiocese of Milwaukee Supporting Fund ("AMSF"). The court also approved as class counsel the law firm of Schiffrin & Barroway. Two months after the lead plaintiffs and lead counsel were appointed, and before any formal discovery took place, Schiffrin & Barroway commenced settlement negotiations with the defendants. Within months, Schiffrin & Barroway reached a settlement under which Halliburton would pay the class a total of $6 million to resolve all claims. Amazingly, lead counsel did not seek approval from AMSF to initiate settlement negotiations, nor was AMSF even advised that settlement discussions were underway. When AMSF learned of the proposed settlement, it immediately sought to have Schiffrin & Barroway removed from its position as class counsel. AMSF also objected to the proposed settlement on the grounds that it significantly underestimated the value of the lawsuit. After attorneys' fees and costs were to be deducted from the proposed settlement fund, there would be less than $3 million available for the more than 800,000 class members. Once the settlement was announced, Schiffrin & Barroway and the defendants engaged in "confirmatory discovery," exchanging various documents and taking depositions to confirm the fairness of the settlement. For some reason, Schiffrin & Barroway refused to provide the information furnished through this confirmatory discovery process to AMSF, even though AMSF was a lead plaintiff in the case.

After noting that "[t]he Court takes its role as protector of the right of absent class members very seriously," Judge Lynn lambasted Schiffrin & Barroway for the "secret manner in which the [settlement] negotiations commenced and proceeded." Judge Lynn further questioned whether the firm had acted "as carefully as lead counsel should" in protecting the interests of the Halliburton shareholders. Concerned with the firm's failure to inform AMSF of the decision to negotiate with Halliburton, the relatively small size of the proposed settlement and several other terms of the proposed settlement, Judge Lynn rejected the settlement. She ordered that a guardian *ad litem* be appointed to represent absent class members and directed all the parties, including AMSF, to participate in a mediation.

ISBN 1056 3059

Conclusion. Through this prism, Judge Lynn's rejection of the proposed Halliburton settlement is quite unremarkable. After all, what else could Judge Lynn do under the circumstances? Despite the fact that the PSLRA intended for the lead plaintiff — not lawyers — to drive the litigation, Schiffrin & Barroway completely excluded one of the lead plaintiffs from any significant involvement in the case, including the settlement process. Because class counsel failed to fulfill the standards expected of them, Judge Lynn was forced to protect the absent class members. The Halliburton case is an outlier. In most cases, lead counsel will keep the lead plaintiff completely informed, and the lead plaintiff will, therefore, be in a position to actively participate in the litigation and exercise control over the actions of class counsel. Only when the lead plaintiff is not permitted to exercise control over the litigation, as in the Halliburton case, should we expect courts to step in and reject proposed class action securities fraud settlements.

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