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CONFLICTS BETWEEN RULE 23 AND SECURITIES REFORM ACT

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DEFENDANTS in securities class actions have often sought to defeat class certification by challenging the adequacy or typicality of the named representative. Many of these challenges have been directed to the sophistication of the lead plaintiff, and the extent to which that party relied on factors other than the integrity of the market or an issuer's public statements, in deciding to purchase the security.

Although some courts have held that sophistication is irrelevant to class representative status, others have left open the possibility that a sophisticated plaintiff may be subject to unique defenses that preclude a finding of typicality, a requirement of Fed. R. Civ. P. 23.

The success of the "sophisticated investor defense," however, has been somewhat limited: While courts generally allow defendants to inquire into a plaintiff's investment history in the course of conducting class discovery, few have denied class certification in the absence of evidence that the class representative relied upon factors unknown to the general public in making his investment decision.

Nevertheless, the viability of the sophisticated investor defense may increase dramatically in the wake of the passage of the Private Securities Litigation Reform Act of 1995. [FN1] The Act creates a presumption that "the most adequate plaintiff" in any putative class action brought under the federal securities laws is the person or group of persons that "in the determination of the court, has the largest financial interest in the relief sought by the class." [FN2]

In adopting this presumption, Congress hoped to attract institutional investors to serve as class representatives, noting that institutions such as pension funds, as the largest shareholders in most companies, are "the ones who have the most to gain from meritorious securities litigation," and therefore "will represent the interests of the plaintiff class more effectively than class members with small amounts at stake." [FN3]

Ironically, it appears that defense counsel in federal securities class actions

may now argue that institutional investors are subject to unique defenses by virtue of the sophistication that convinced Congress to anoint them as the most adequate plaintiffs.

Specifically, certain of these investors are not only likely to receive information not provided to the ordinary shareholder, but also, in some instances, to rely on what could be deemed non-public information, including their own analyses, in making their investment decision, thereby jeopardizing claims of reliance upon the integrity of the market.

Thus, even though the putative class might benefit from the leadership of an informed and knowledgeable institutional plaintiff which is committed to the litigation, such institutional investors might attract challenges to their typicality both from defendants hoping to defeat class certification, and from other members of the class seeking to ensure that the litigation is permitted to proceed as a class action.

Before the Act

Rule 23 of the Federal Rules of Civil Procedure provides that, to be approved as a class representative, the court must find that the representative parties will "fairly and adequately represent the interests of the class." [FN4]

Demonstrating adequacy posed only a limited obstacle to class certification prior to the enactment of the Reform Act, with most courts limiting their inquiry to whether the interests of the class representative are antagonistic to those of the remaining class members, and whether the representative parties, through their attorneys, are prepared to prosecute the action vigorously. [FN5]

Thus, courts generally found the named plaintiff to be adequate in securities class actions where the plaintiff established membership in the class and retained competent counsel, and routinely rejected challenges to adequacy based upon the named representative's credibility, lack of familiarity with the more technical facts underlying the cause of action, reliance on counsel for directing the course of the litigation, or lack of substantial financial resources to prosecute the claims on behalf of the class. [FN6]

During hearings preceding the passage of the Reform Act, Congress heard testimony arguing that the proclivity of courts to approve named plaintiffs as adequate representatives in securities class actions had led to a "race to the courthouse," in which "[p]rofessional plaintiffs who own a nominal number of shares in a wide array of public companies permit lawyers readily to file abusive securities class action lawsuits." [FN7]

Indeed, much of the debate centered on such "professional plaintiffs" who, supposedly, consisted of "many of the 'world's unluckiest investors' [and] repeatedly appeared as lead plaintiffs in securities class action lawsuits." [FN8]

Congress also determined that these professional plaintiffs, many of whom are, according to the proponents of the new law, motivated by questionable agendas and lack a credible interest in the litigation, are not effective representatives or

fiduciaries of other shareholders in securities class actions. [FN9]

Responding to this perceived abuse of federal law, Congress devised a scheme through which the member of the class with the largest financial interest in the outcome of the litigation would be presumed to be the most adequate plaintiff, and would be entrusted with the responsibility of pursuing the action on behalf of the investor class.

The Reform Act provides that, after publication of notice that a securities class action complaint has been filed, the court, upon motion by any purported class member, "shall appoint as lead plaintiff the member or members of the purported plaintiff class that [it] determines to be most capable of adequately representing the interests of class members." [FN10]

In making this determination, the court must presume that the most adequate plaintiff is the person or group of persons that, among other things, "has the largest financial interest in the relief sought by the class ... [and] otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure." [FN11]

The Reform Act appears to provide two opportunities, one explicit and one implicit, to rebut the presumption afforded the plaintiff with the largest financial interest.

First, any member of the putative class may rebut the presumption, but only upon proof that "the presumptively most adequate plaintiff (aa) will not fairly and adequately protect the interests of the class; or (bb) is subject to unique defenses that render such plaintiff incapable of adequately representing the class." [FN12]

Second, (and largely ignored by the Reform Act and relevant legislative history), defendants may challenge the adequacy of the "most adequate plaintiff" during the discovery phase following a motion for class certification, since the provisions of the Reform Act relating to the appointment of a lead plaintiff are "not intended to affect current law with regard to challenges to the adequacy of the class representative or typicality of the claims among the class." [FN13]

The new law appears, therefore, to create a two-tiered structure for selecting the most appropriate class representative, although it is possible that, in the interests of efficiency, courts will combine both tiers in a single proceeding.

#### Typicality

Even though a large institutional investor may be the most adequate plaintiff under the Reform Act, such plaintiffs may not always be typical. Specifically, Rule 23 provides that no class action may be certified unless "the claims or defenses of the representative parties are typical of the claims or defenses of the class." [FN14]

Thus, courts have denied class certification where unique defenses exist, even

where the likelihood that the defense will succeed is questionable, based upon "a concern that representation of the class will suffer if the named plaintiff is preoccupied with a defense which is applicable only to himself." [FN15]

Disputes concerning the typicality of the named representative most commonly arise in fraud on the market cases, in which a proffered representative's reliance upon the specific misstatements at issue will be presumed if the plaintiff relied upon "the integrity of the market" to set a price for the security that incorporates all publicly available information. [FN16]

This presumption may be rebutted, however, by "any showing that severs the link between the alleged misrepresentation and ... [the plaintiff's] decision to trade at a fair market price." [FN17]

Thus, even though it may be "hard to imagine that there ever is a buyer or seller who does not rely on market integrity," [FN18] defendants often raise reliance issues at the class certification stage, contending that even the arguable presence of a defense of non-reliance destroys the typicality of the named representative. [FN19]

Among the more common of these challenges is the "sophisticated investor defense," whereby defendants allege that the named representative, by virtue of his sophistication or access to material information outside of the public domain, was unlikely to have relied upon the alleged misleading information in the marketplace when making his investment decision. [FN20]

Some courts have singled out institutional investors and substantial shareholders as atypical class representatives subject to unique defenses.

Indeed, in one case relying on a fraud on the market theory of liability, the court declined to certify a class where the proposed class representative, a sophisticated investor, had invested \$3 million in the defendant corporation's stock as a result of over 150 trades, engaged in substantial contacts with officers of the company and securities analysts, and had conducted detailed financial studies of the corporation's future prospects.

The court concluded that "[s]uch characteristics are more similar to [an] institutional investor ... than to the average investor held typical in securities cases," rendering certification of the class inappropriate. [FN21]

While most courts have rejected a prophylactic rule proscribing institutional investors from serving as class representatives, many decisions addressing this issue have recognized that a plaintiff's sophistication, along with his access to and communications with corporate insiders, may render him atypical, thereby precluding class certification in certain instances. [FN22]

Similarly, other courts have permitted discovery directed to the named representative's sophistication as relevant to "the issues of plaintiffs' reliance on the alleged fraud, and plaintiffs' burden of showing that they exercised due diligence in investigating the alleged fraud." [FN23]

Indeed, only a small minority of courts have conclusively rejected the sophisticated investor defense, reasoning either that such issues are irrelevant to class certification under the fraud-on-the-market theory or that such issues are more appropriately addressed to the merits of plaintiffs' substantive claims. [FN24]

Ironically, the willingness of many courts to entertain a sophisticated investor defense may undermine the ability of large institutional investors "to take a more active role in securities class action lawsuits," as Congress had hoped. [FN25]

While challenges based upon the sophistication of individual investors often may not have succeeded in recent years, it is clear that some courts not only deem this inquiry to be relevant to class certification, but might uphold a challenge to the named representative if confronted with a large institution that received special access to corporate financial data and had direct dealings with management not generally available to ordinary investors.

Indeed, such relationships between large institutional shareholders and the companies in which they hold sizable investments are likely to be prevalent, especially in view of the increasing willingness of corporate executives to not only meet with, but also accede to the priorities of the large institutional holders. [FN26]

Thus, putative class members seeking representative status may be subject to extensive challenges to their adequacy and typicality under the Reform Act both from class members at the outset of the litigation, and defendants at the class certification stage, which will significantly increase the motion practice involved in prosecuting and defending these actions.

#### Conclusion

While the Reform Act may seek to increase the participation of institutional investors in securities class actions, it is clear that such investors may be subject to challenges to their typicality by both defendants and other plaintiff class members.

Although the receptiveness of courts to these challenges may be unclear, it appears that the mere assertion of these arguments not only creates a variety of problems for plaintiffs, but also provides significant new opportunities for defendants to disrupt class litigation.

Therefore, to avoid these pitfalls, putative class members and experienced counsel should analyze the adequacy and typicality of the proposed class representative at the outset of the litigation to ensure that the party ultimately designated as the most adequate plaintiff, whether a sophisticated institution or an individual investor, will survive defendants' challenges, and will be permitted to pursue the action on behalf of the class.

FN1. H.R. 1058, t Cong., 1st Sess. (1995). The legislation is referred to herein

as the "Reform Act."

FN2. See §27(a)(3)(B)(iii) of the Securities Act of 1933, 15 USC 77a et seq. (the Securities Act); Section 21D(a)(3)(B)(iii) of the Securities Exchange Act of 1934, 15 USC 78a et seq. (the Exchange Act).

FN3. See Statement of Managers - The Private Securities Litigation Reform Act of 1995 (Managers Report) at 4-5.

FN4. Specifically, Rule 23(a) provides that "[o]ne or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class" (emphasis added).

FN5. See, e.g., Gilbert v. First Alert Inc., 904 F.Supp. 714, 719 (N.D. Ill. 1995); Grace v. Perception Technology Corp., 128 FRD 165, 170 (D. Mass. 1989); Longden v. Sunderman, 123 FRD 547, 557 (N.D. Tex. 1988).

FN6. See Gilbert v. First Alert Inc., 904 F.Supp. at 720-21; Randle v. Spectran, 129 F.R.D. 386, 392 (D. Mass. 1988); Longden v. Sunderman, 123 FRD at 557-58.

FN7. Managers Report at 2-3.

FN8. Id. at 2.

FN9. Id. at 2-3.

FN10. See §27(a)(2)(B)(i) of the Securities Act; Section 21D(a)(2)(B)(i) of the Exchange Act.

FN11. See §27(a)(2)(B)(i), (iii)(I) of the Securities Act; Section 21D(a)(2)(B)(i), (iii)(I) of the Exchange Act.

FN12. See §27(a)(2)(B)(iii)(II) of the Securities Act; Section 21D(a)(2)(B)(iii)(II) of the Exchange Act. The ability of other class members to rebut the presumption may be severely curtailed, however, by the prohibition against conducting discovery on this issue unless "the plaintiff first demonstrates a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of adequately representing the class." See § 27(a)(2)(B)(iv) of the Securities Act; Section 21D(a)(2)(B)(iv) of the Exchange Act.

FN13. Managers Report at 5.

FN14. Some courts have combined their adequacy and typicality analyses when deciding class certification motions, based upon the apparent overlap in the language used to describe these prongs of Rule 23. See, e.g., Landry v. Price Waterhouse Chartered Accountants, 123 FRD 474, 477 (SDNY 1989); Priest v. Zayre

Corp., 118 FRD 552, 554 & n. 3 (D. Mass. 1988). As detailed herein, however, most courts have recognized that the applicability of unique defenses to the named representative bears upon typicality, rather than adequacy.

FN15. Warren v. Reserve Fund Inc., 728 F2d 741, 747 (5th Cir. 1984) (holding that the presence of a defense unique to the named plaintiff presents "a sufficient question of typicality to justify a district court's decision to deny class certification"). See also J.H. Cohn & Co. v. American Appraisal Assocs. Inc., 628 F2d 994, 998-99 (7th Cir. 1980) (noting that "the presence of even an arguable defense peculiar to the named plaintiff or a small subset of the plaintiff class may destroy the required typicality of the class"); Zandman v. Joseph, 102 FRD 924, 930 (N.D. Ind. 1984) (same).

FN16. See Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988) (holding that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action").

FN17. Id. at 248. Plaintiffs in Basic alleged that they sold shares of defendant corporation's common stock at artificially depressed prices, based upon defendants' failure to disclose at the time of plaintiffs' sales that the company would be acquired by another entity at a price substantially higher than plaintiffs' selling price. In this context, the Court concluded that "a plaintiff who believed that Basic's statements were false and that Basic was indeed engaged in merger discussions, and who consequently believed that Basic stock was artificially underpriced, but sold his shares nevertheless because of other unrelated concerns, e.g., potential antitrust problems, or political pressures to divest from shares of certain businesses, could not be said to have relied on the integrity of a price he knew had been manipulated." Id. at 249.

FN18. Id. at 246-47, citing Schlanger v. Four-Phase Systems Inc., 555 F.Supp. 535, 538 (SDNY 1982).

FN19. See Note 15, *supra*.

FN20. See Warren v. Reserve Fund Inc., 728 F2d at 747 (denying class certification based upon plaintiff's financial sophistication, since defendants "could argue that [plaintiff] did not exercise due diligence in relying on any reckless omissions or misrepresentations"); J.H. Cohn & Co. v. American Appraisal Assocs., 628 F2d at 998 (upholding denial of class certification on the basis that "a sophisticated investor very familiar with financial statements ... may not be as justified in relying on any material misrepresentations or omissions of material facts as other purchasers of [the defendant company's] stock").

FN21. Zandman v. Joseph, 102 FRD 924, 932 (N.D. Ind. 1984). See also Grace v. Perception Technology Corp., 128 FRD at 169 (finding that typicality was not established where named plaintiff purchased 90 percent of his stock after meeting with two officers of the defendant corporation, and holding that "[p]ersonal contact with corporate officers and special meetings at the company will render a

plaintiff atypical to represent the class"); Landry v. Price Waterhouse Chartered Accountants, 123 FRD 474, 475-77 (SDNY 1989) (denying class certification based upon named plaintiffs' alleged direct contacts with corporate insiders).

FN22. See, e.g., Gilbert v. First Alert Inc., 904 F. at 720 & n. 2 (rejecting sophisticated investor defense, but indicating that result might be different if defense were leveled at "a diversified mutual fund, rather than an individual investor"); Randle v. Spectran, 129 FRD at 392 (rejecting challenge based upon plaintiff's sophistication, but acknowledging distinction where named representative possessed "knowledge available only to an institutional investor or one who had direct contact with corporate officers"); Longden v. Sunderman, 123 FRD at 557 (concluding that individual investor's alleged sophistication did not preclude finding of typicality, as distinguished from named plaintiff in separate case found to be atypical as "a bank vice-president and licensed securities broker").

FN23. In re ML-Lee Acquisition Fund II, L.P. Sec. Litig., 149 F.R.D. 506, 507-08 (D. Del. 1993). Accord In re Harcourt Brace Jovanovich Inc. Sec. Litig., 838 F.Supp. 109, 114 (SDNY 1993); In re PaineWebber Sec. Litig., 151 FRD 248, 249 & n. 2 (SDNY 1993).

FN24. See Burstein v. Applied Extrusion Technologies Inc., 158 FRD 488, 489 (D. Mass. 1994); In re First RepublicBank Sec. Litig., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,554 at 93,546 (N.D. Tex. Aug. 1, 1989); In re SciMed Life Sec. Litig., [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,220 at 94,945 (D. Minn. Nov. 20, 1992); Ragonetti v. Epitope Inc., [1992- 1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,399 at 96,146 (D. Or. Oct. 8, 1992) (same).

FN25. Managers Report at 5.

FN26. See, e.g., Judith H. Dobrzynski, "Small Companies, Big Problems," N.Y. Times, Feb. 6, 1996, at D1, D8 (noting that large pension funds such as the California Public Employees' Retirement System have enjoyed increasing access to the boards of the nation's largest companies in recent years, and that their access to the top management of publicly-held small and medium sized corporations is likely to increase in the future).

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