TESTIMONY OF STUART M. GRANT AND JAY W. EISENHOFER TO THE THIRD CIRCUIT TASK FORCE ON SELECTION OF CLASS COUNSEL

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INTRODUCTION

Stuart M. Grant and Jay W. Eisenhofer are directors of Grant & Eisenhofer, a Wilmington, Delaware based law firm with extensive experience in corporate governance and securities litigation. We routinely represent institutional investors, and have on many occasions served as lead counsel to institutional investors who have been appointed lead plaintiffs in securities litigation under the Private Securities Litigation Reform Act ("PSLRA"). Our analysis and suggestions for this Task Force stem from this experience under the PSLRA, which has provided a statutory framework for empowering sophisticated class representatives to take control of what previously had been recognized as lawyer-driven class actions. We believe the answer to some of the Task Force's issues on the selection and compensation of class counsel can be found in the rationale of the PSLRA and in the way that institutional investors have taken up Congress' invitation therein to transform the way that securities class actions are litigated.

THE FIRST STEP - SELECTION OF A LEAD PLAINTIFF

The impetus behind the adoption of the PSLRA was the perception that class actions were developed by lawyers who then went in search of a representative plaintiff for the class. The common complaint was that class actions were "lawyer-driven litigation." A parallel concern was that cases were being settled too cheaply, often without regard to the merits, and with far too much of the recovery going to the lawyers. Judges became frustrated because many felt they were not fulfilling their own obligation to protect class members, who, it was perceived, were paying far too much of their recoveries in attorneys' fees.

In a functioning market economy, this problem would be self-correcting. Buyers – here, the class members – would demand better quality representation and would negotiate lower fees. In class actions as they existed at that time, this market connection was impossible since the buyers – the class representatives – were really chosen by, and subservient to, the lawyers. The PSLRA attempted (and we believe in many cases succeeded in that attempt) to put a buyer with real bargaining power in control of the litigation. The PSLRA establishes a presumption that the plaintiff with the largest financial relief at stake in the litigation – more often than not an institutional investor – is the "most adequate plaintiff" to represent the class. 15 U.S.C. Sec. 77z-1(a)(3)(B)(iii)(I). This presumptive lead plaintiff is charged with the responsibility of finding and retaining appropriate class counsel. 15 U.S.C. Sec. 77z-1(a)(3)(B)(v). Congress concluded that the plaintiff "with the strongest financial interest will pursue the claims with the greatest vigor and will have both the interest and the clout to engage qualified counsel at the best rates for the class."[1] The Congressional intent as shown in the enactment of the PSLRA was premised on the belief that the best way to simulate a market transaction was to put a sophisticated consumer – the lead plaintiff – on one side of the negotiation.

We believe that the key to a court's selection of an appropriate class counsel is to first select the type of lead plaintiff envisioned by the PSLRA. The lead plaintiff should possess clear sophistication in the general subject matter of the litigation and should have a substantial financial interest in the outcome of the litigation, i.e., significant losses or damage. Generally, institutional investors best fit the bill, but lead plaintiff status need not be limited only to such investors. What the court needs to look for in a lead plaintiff is bargaining power equal or superior to that of potential

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[1] In re Cendant Corp. Litig., 182 F.R.D. 144, 145-6 (D.N.J. 1998).

class counsel and a determination to use that power to the advantage of the class. Only with such a plaintiff can the court have confidence that a real market transaction has occurred.

THE OVERARCHING GOAL - TO MAXIMIZE THE CLASS RECOVERY

It is clear from the large body of caselaw relating to the selection of class counsel that the court's primary goal is – and we submit should always be – to maximize the class recovery. In order to do so, a careful balance must be made among a variety of factors, particularly quality and cost. Once the various factors are analyzed by the client, and counsel chosen by the client, a fee agreement must be reached that perfectly aligns counsels' interests with the clients' goals for the litigation.

Some courts have attempted to replicate an effective functioning market for legal services through the auction process. However, despite the good intentions, this effort has failed. Auctions simulate a market but it is a market that operates solely on price. Markets for services – especially sophisticated services – involve more considerations than just price. It is a basic principle of economics that the only market that operates solely on price is a market for a commodity, such as a bushel of corn. In other words, a consumer will look for the lowest price when buying that bushel of corn, because all other things are equal (i.e., quality).

Legal services, like medical or financial services, are far different from commodities. Basic economics teaches that they cannot be distinguished solely on price. Indeed, as the Delaware Chancellor put it so eloquently: "cheap does not mean reasonable" legal representation.[2] A simple example reflects this point. If a judge were to find out that he has a form of cancer that is treatable, what factors would the judge utilize in selecting medical care? Price might be one of the factors but it would hardly be the only one. Similarly, a judge who has a legal problem of some complexity

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[2] In re: Digex, Inc. Shareholders Litig., Cons. C.A. No. 18336, Chandler, C. (Del. Ch., Apr. 6, 2001) (Hearing Trans. at 74).

would be unlikely to choose counsel based solely upon price. Certainly, the defendants in class-action litigation do not select their counsel solely on price. They have a myriad of considerations of which price is but one factor. Judging from the cost of class-action defense counsel, price is not even a particularly important factor and is far outweighed by perceived quality.

Yet courts that conduct an auction cannot possibly simulate the market valuing these additional factors. Factors, such as quality, are far too subjective and any attempt to screen auction participants would create a logistical and political problem for a court. Either the court will be overburdened with applicants or it will be criticized for its designation of firms qualified to join in the auction process. Therefore, even courts that have given consideration to the quality of the services offered by the bidder have still allowed price to be the determinative factor.[3]

We submit that a sophisticated lead plaintiff can blend all of the litigation goals when hiring counsel and establishing a fee structure to compensate that counsel. The process routinely employed by institutional investors – a controlled type of auction commonly referred to as a "beauty contest" – can achieve a balance between price and quality, and provide a fee structure that takes into account both monetary and nonmonetary goals. The institutional investors invite firms they know through experience to be highly qualified to conduct the type of litigation they are pursuing to describe their views of, and strategies for, the case and to propose a fee structure. The institutional investor then chooses the best firm for the engagement based on quality, price and a host of other factors, and

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[3] See, e.g., In re Bank One Shareholders Class Action, 96 F. supp.2d 780 (N.D. Ill. 2000)(suggesting that only lowest bidder could fulfill class representative's obligation to choose best counsel for class); In re Network Assocs., Inc. Scc. Litig, 76 F. Supp.2d 1017 (N.D. Cal. 1999)(representative plaintiff could choose firm other than low bidder but must provide Court with "convincing reason" for having done so).

further negotiates the fee structure to maximize the recovery to the class while providing counsel with the economic incentive to do the same.

The court should review the lead plaintiff's choice of counsel applying the tenets of the business judgment rule. When applied to lead plaintiff's counsel selection, the business judgment rule would create a presumption that the decision will be left undisturbed as long as it was made in good faith and on an informed basis. The selection can be judged to have been made in good faith if the process leading up to it was fair and free of nepotism (i.e., choosing counsel based on familial or political relationships). The lead plaintiff will have met its duty to act in an informed manner if it has followed a process of selection with the earmarks of the beauty contest – testing what the market of lawyers skilled in that practice will bear.

If the court has a sophisticated lead plaintiff before it and is satisfied that the lead plaintiff's process for counsel selection is appropriate, the court can approve the lead plaintiff's selection of counsel, and the concomitant fee agreement, at the outset of the litigation and be confident that it has completely satisfied its Rule 23 and fiduciary duties. The bottom line is that sophisticated clients know better what is in their best interests than do the courts, and their judgment in selecting counsel should be accorded deference when they have followed a procedure designed to keep the risk to the class in proportion to counsel's risk.

RECOVERY MAXIMIZATION OCCURS WHEN THE INTERESTS OF COUNSEL AND THE CLASS ARE PERFECTLY ALIGNED

We believe that the court can best achieve the simulation of a functioning market by making sure that the interests of counsel and the class are perfectly aligned. Alignment of class and counsel interests means that both should share equally in the risk involved in the litigation.

In our view, the fee auctions conducted to date have often misaligned the risk between counsel and the class. For example, many auctions have resulted in descending fee structures – where the lawyers' percentage of additional, incremental recovery decreases over a set schedule. While facially appealing, this structure provides the incentive for counsel to settle as soon as the first dollars are put on the table. Additional work means a diminishing return for the lawyers, conflicting with the class members' interest in pursuing a higher recovery.[4] Indeed, this structure flies in the face of what the American Bar Association has recognized as the reality of litigation – that the toughest dollars of recovery to achieve are the last dollars.[5]

Another potential problem engendered by auctions is a fee structure which gives the lawyer too great an incentive to continue litigating a case beyond what may be in the best interests of the class. Indeed, the Auction Houses case — touted as the prime example of the benefits of fee auctions — is in fact a prime example of misaligned risk. There, the successful bidder in the auction, David Boies, proposed a fee structure that paid him nothing for the first $405 million of recovery but gave him 25% of any recovery above that amount.[6] This type of fee structure again risks pitting the lawyer's interests against those of the class because the lawyer has the incentive to be too risk-tolerant. If the class would be best served by accepting a settlement in the range that provides the

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[4] That is not to suggest that lawyers wholly ignore their duties to their clients, but it must be recognized that lawyers are in fact businesspeople who must make rational economic decisions. Indeed, the ethical rules which govern the general conduct of lawyers recognize and are designed to address situations which could leave clients susceptible to overreaching by even well-intentioned lawyers. These normal human frailties are equally in play in the economics of class actions and could lead to results injurious to the class if not properly checked.

[5] Amer. Bar Ass'n, Formal Op. 94-389 § J ("it is the last dollars...of recovery that require the greatest effort and/or ability on the part of the lawyer").

[6] In re Auction Houses Antitrust Litig., No. 00 Civ. 0648(LAK), 2001 WL 170792 (S.D.N.Y., Feb. 22, 2001).

lawyer with no fee, the lawyer clearly has a conflict because he only has a shot at a fee if he presses on and puts the class' recovery at risk.

Perfect alignment of risk need not be limited to fee structures based upon monetary recovery only. Monetary recovery may not be the only – or even the primary – goal of the litigation. Corporate governance changes, such as a restructuring of the board's composition, new protections for the shareholder franchise, the termination of a transaction, or elimination of option repricing, just to name a few, may be desirable in certain circumstances. Indeed, Congress specifically recognized that one of the benefits of having institutional investors as lead plaintiffs was their ability to look at securities litigation with a broader perspective.[7] Should a court be deciding what the goals of the litigation are, or is that the role of the client? If it is that of the client, doesn't the client need to structure the fee so as to incentivize the lawyers to achieve the goals of the litigation? Auctions simply cannot take all of the litigation goals into account because the fee structures they generate are based solely on monetary class recovery.

In addition to the problem of misaligned risks, fee auctions have also led to forced attorney-client relationships. Requiring a lead plaintiff to use counsel not necessarily of its own choosing runs the risk that the two will not work together efficiently. Lead plaintiff and the auction-winning counsel may have a history of bad blood between them. Indeed, the auction device may well lead to the appointment of counsel who earlier in the litigation fought tooth and nail against the appointment of the ultimately successful lead plaintiff. We have had first hand experience with being forced to work with others who were not our original clients and with law firms not chosen

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[7] Senate Rep. No. 98, 104th Cong., 1st Sess. 1995, 1995 U.S.C.C.A.N. 679, 1995 WL 372783 ("an institutional investor acting as lead plaintiff can, consistent with its fiduciary obligations, balance the interests of the class with the long-term interests of the company and its public investors").

by our client on a co-counsel basis. Invariably, conflicts arose in those situations. Introducing this element of conflict into a relationship which must be as cooperative as possible will put maximization of class recovery at serious risk.

CONCLUSION

We submit that selection of lead counsel is best accomplished by the operation of the free market as long as there is at least equal bargaining power on the part of the lead plaintiff and that the lead plaintiff has exercised that bargaining power in good faith. These standards are generally employed by sophisticated lead plaintiffs and this is where the Court's inquiry should be focused. Courts have a yardstick available to them now in the body of caselaw regarding how PSLRA lead plaintiffs have chosen their lead counsel, and they can measure the process of selection of counsel against it. We must candidly admit that we do not have such a ready solution to offer if the court does not have a sophisticated lead plaintiff before it or if the standards for selection discussed above have not been followed. We do know, however, that it is crucial for counsel to be compensated under a fee structure that aligns the interests of counsel and the class.

Ultimately, the courts must decide if they merely want to reform the current lawyer-driven class action practice to get cheaper representation for the lawyer-driven class, or if they want to transform class litigation overall to empower sophisticated class representatives who will truly drive the litigation. Previous attempts at reform, such as the fee auction, have been a recipe for disaster by leaving the class vulnerable to poorly qualified, albeit inexpensive, counsel and running the risk that a representative plaintiff will be forced to work with counsel who may not share the same views as the plaintiff. We submit that transformation of the entire process is the better and more workable solution.