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## The Bromberg Balance: Proper Portfolio-Monitoring Agreements in Securities Class Actions

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# THE BROMBERG BALANCE: PROPER PORTFOLIO-MONITORING AGREEMENTS IN SECURITIES CLASS ACTIONS

*Michael J. Kaufman\* and John M. Wunderlich\*\**

## I. INTRODUCTION

PROFESSOR Alan Bromberg was a giant in many fields, including securities-fraud regulation and litigation. Throughout his remarkable work, he struck just the right balance between the goal of preventing and remedying fraud and the goal of facilitating value-maximizing securities transactions unfettered by the cost of frivolous litigation. In particular, he brilliantly led Congress and the Supreme Court in their efforts to “curb frivolous, lawyer driven litigation, while preserving investors’ ability to recover on meritorious claims.”<sup>1</sup>

In this essay, we try our best to honor Professor Bromberg’s legacy by bringing a balanced approach to an issue at the fore of securities litigation: the use by plaintiffs’ law firms of portfolio-monitoring agreements with institutional investors, specifically large pension funds. These agreements can foster investor protection by incentivizing law firms and institutional investors to discover and remedy fraud. Critics, however, contend that law firms’ monitoring arrangements do not actually make any contribution to the fund itself—they instead facilitate lawyer-driven frivolous lawsuits, and they can compromise a fund’s ability to adequately and typically represent a class of investors.

In crafting a “Brombergian” balance, this article shows that the benefits of portfolio-monitoring agreements can be attained without the costs as long as they have two essential components: the arrangement is not exclusive and the institution retains its independence when it decides whether to sue and who to retain if it does.

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1. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313–14 (2007).

## II. PORTFOLIO-MONITORING AGREEMENTS, INSTITUTIONAL INVESTORS, AND SECURITIES CLASS ACTIONS

### A. INSTITUTIONAL INVESTORS' PREFERRED STATUS IN SECURITIES CLASS ACTIONS

Securities-fraud cases usually are prosecuted as representative, class action suits.<sup>2</sup> The defining characteristic of every class action, including securities class actions, is representation, allowing one person (or group) to represent and protect the interests of the whole class.<sup>3</sup> To represent a class, the purported proxy must adequately represent those investors and have a claim that is typical of the group.<sup>4</sup> To adequately represent the class's interests, the representative must not have interests that conflict with those of the class and must possess at least a minimal understanding of the case and the responsibilities that come with the lead spot.<sup>5</sup> The representative must also have a claim that is typical of the class.<sup>6</sup> These two requirements—typicality and adequacy—ensure that the representative will pursue class members' claims with sufficient loyalty, effort, and ability.<sup>7</sup>

Generally, institutional investors are the preferred representatives in securities class actions. Institutional investors, which pool and invest money from the institution's constituents, dominate the trading markets.<sup>8</sup> They are usually long-term, sophisticated shareholders and thus more likely to balance the desire for financial recovery with the need to prevent undue harm to defendant companies.<sup>9</sup> In addition, institutional investors are more likely to know about the legal process and be discerning consumers of legal services, which means they are also more likely to retain the most capable counsel and properly supervise the case.<sup>10</sup> Finally, institutional investors are likely to have substantial financial stakes

2. See *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 625 (1997) (observing that securities cases "readily" satisfy class-action prerequisites).

3. See, e.g., FED. R. CIV. P. 23(a) (allowing one or more members of a class to sue as representatives for all members when certain conditions are met); *Am. Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 550 (1974) ("A federal class action is . . . truly [a] representative suit."); *In re Cendant Corp. Litig.*, 264 F.3d 201, 223 n.3 (3d Cir. 2001) ("In the context of a securities class action, only one entity is entitled to speak for the class, the lead plaintiff").

4. FED. R. CIV. P. 23(a)(3)–(4).

5. See, e.g., William B. Rubenstein, *NEWBERG ON CLASS ACTIONS* § 3:32 (5th ed. 2013).

6. See, e.g., *Hevesi v. Citigroup, Inc.*, 366 F.3d 70, 82 (2d Cir. 2004).

7. See, e.g., William B. Rubenstein, *NEWBERG ON CLASS ACTIONS* § 3:32 (5th ed. 2013).

8. See, e.g., John C. Bogle, former Chief Executive, Vanguard Group, *Restoring Faith in Financial Markets: It is Time Institutional Investors Exerted Control Over Publicly Held Companies*, *WALL STREET JOURNAL* (Jan. 18, 2010) (stating that in the mid-1950s, institutional investors held less than 10% of U.S. stocks, but by 2010, these investors controlled almost 70% of the shares of U.S. companies).

9. See, e.g., Jonathan N. Eisenberg, *LITIGATION SECURITIES CLASS ACTIONS* § 1.02[ii] (2014).

10. See, e.g., Elizabeth Chamblee Burch, *Governing Securities Class Actions*, 80 U. CIN. L. REV. 299, 309 (2011).

in the case's outcome and thus are further encouraged to play an active role in directing the conduct of the litigation.<sup>11</sup>

The preference for institutional investors is by congressional design.<sup>12</sup> In 1995, Congress heard testimony that securities class actions were lawyer-led, frivolous affairs, which entailed attorneys racing to the courthouse to file suit after a company announced bad news that tanked the stock, followed by abusive "fishing expeditions," rather than legitimate discovery.<sup>13</sup> Congress enacted the Private Securities Litigation Reform Act to ensure that the representative who was "most capable of adequately representing the interests of the class" would step forward<sup>14</sup> and, encouraged institutional investors to take the lead.<sup>15</sup> In light of Congress's preference for institutional investors, the federal courts likewise have favored institutional investors to lead these cases.<sup>16</sup> Several studies have found that the presence of institutional investors, such as public and labor pension funds, in the lead spot correlates with positive outcomes for investors, including higher recoveries, lower attorneys' fees, and greater board independence.<sup>17</sup>

11. See, e.g., Jonathan N. Eisenberg, LITIGATION SECURITIES CLASS ACTIONS § 1.02[i] (2014).

12. Elliott J. Weiss and John S. Beckerman argued that institutional investors with significant financial interests would be best suited to monitor counsel in securities class actions. See *Let the Money do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995). Their article is credited with Congress's procedural changes to securities class actions that encourage institutional investors' involvement.

13. See, e.g., S. Rep. No. 104-98, at 4-5, 7-9, 14 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 683-84, 686-88, 693; H.R. Rep. No. 104-369, at 31, 37 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 736.

14. 15 U.S.C. § 78u-4(a)(3)(B)(i)-(iii). The PSLRA does not require the representative to be the "most adequate," but instead makes changes to the selection process to encourage courts to select the most adequate representative. See, e.g., *Berger v. Compaq Computer Corp.* (Berger II), 279 F.3d 313, 313-14 (5th Cir. 2002); *In re Cavanaugh*, 206 F.3d 726, 738-39 (9th Cir. 2002). The PSLRA also made a host of other procedural and substantive changes to the 10b-5 class action to "combat perceived abuses in the securities litigation process and particularly to curb frivolous strike suits, coercive settlements, and excessive legal fees which have become prevalent throughout this process." Lewis D. Lowenfels & Alan R. Bromberg, *A New Standard for Aiders and Abettors Under the Private Securities Litigation Reform Act of 1995*, 52 BUS. LAW. 1 (1996).

15. See, e.g., H.R. Conf. Rep. No. 104-369, at 34 (1995), as reprinted in 1995 U.S.C.C.A.N. 730, 733 ("[I]ncreasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions."); S. Rep. No. 104-98, at 10-11 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 690 ("The Committee intends to increase the likelihood that institutional investors will serve as lead plaintiffs by requiring the court to presume that the member of the purported class with the largest financial stake in the relief sought is the 'most adequate plaintiff.'").

16. See, e.g., *In re Gentiva Sec. Litig.*, 281 F.R.D. 108, 113 (E.D.N.Y. 2012) ("[M]any courts have demonstrated a clear preference for institutional investors to be appointed as lead plaintiffs.").

17. C.S. Agnes Cheng et al., *Institutional Monitoring Through Shareholder Litigation*, 95 J. FIN. & ECON. 356, 362, 374, 377, 380-81 (2010) (finding that securities class actions with an institutional lead plaintiff, especially a public pension fund, are less likely to be dismissed, settle for more money, and achieve greater board independence); Stephen J. Choi et al., *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. U. L.Q. 869, 900-01 (2005) (finding that securi-

## B. THE USE OF PORTFOLIO MONITORING TO COURT INSTITUTIONAL INVESTORS

Because of the preferred status afforded institutional investors, plaintiffs' law firms have aimed to develop relationships with public and labor pension funds and have encouraged them to serve as lead plaintiffs.<sup>18</sup> One way plaintiffs' firms woo these funds is by offering free "portfolio monitoring" or "securities litigation services."<sup>19</sup> The fund provides information on its stock holdings to the law firm, and, in exchange, the firm monitors the fund's investments in order to alert the fund to potential claims premised upon violations of the securities laws or breach of fiduciary duty. The firm offers advice on a variety of litigation tactics and strategies, including whether to file an initial suit, to seek the lead in a pending one, to opt out of an existing or potential class and proceed solo, or to submit a proof of claim in a settlement.<sup>20</sup> Typically, the monitoring agreement does not function as a retainer agreement or an agreement to initiate specific litigation.<sup>21</sup> Once the firm alerts the fund to a potential claim, the monitoring agreement usually does not obligate the fund to pursue the action, and should the fund choose to do so, the agreement usually does not require it to retain any particular firm.

Critics contend that these monitoring arrangements do not actually make any contribution to the pension fund itself.<sup>22</sup> But proponents re-

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ties class actions with public pension funds as lead plaintiffs correlate with higher recoveries); James D. Cox et al., *There are Plaintiffs and . . . There are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 367 (2008) (finding same for labor and public pension funds); Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650, 705-10 (2002) (finding that after the PSLRA, institutional investors, such as pension funds, engaged in a sophisticated evaluation of counsel, sent requests for proposals, and fielded inquiries from law firms); Michael Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions*, 9 J. EMPIRICAL LEGAL STUD. 368, 369 (2012) (finding that public pension funds as lead plaintiff in securities class actions recover more and pay less in attorneys' fees); see also David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions*, 38 DEL. J. CORP. L. 907, 979-80 (2014) (Institutional investors as lead plaintiffs in deal litigation correlates with an increase from the offer to the final price, and lower attorneys' fees).

18. See, e.g., Elizabeth Chamblee Burch, *Optimal Lead Plaintiffs*, 64 VAND. L. REV. 1109, 1121 (2011).

19. See, e.g., Honorable Jed S. Rakoff, *Confidential Informants and Securities Class Actions: Mixed Messages and Motives*, 45 LOY. U. CHICAGO L. REV. 571, 571 (2014); Burch, *supra* note 10, at 301; Burch, *supra* note 18, at 1121.

20. See, e.g., KESSLER TOPAZ MELTZER & CHECK, *Monitoring Your Portfolio*, [http://ktmc.com/investors\\_portfolio.php](http://ktmc.com/investors_portfolio.php); MOTLEY RICE, *Portfolio Monitoring Service*, <http://www.motleyrice.com/securities-and-consumer-fraud/portfolio-monitoring-service>; ROBINS GELLER RUDMAN & DOWD LLP, *What Services Do I Receive?*, <http://www.rgrdlaw.com/services-portfolio-monitoring-services.html>; Wolf Haldenstein, *Institutional Investors Overview*, <http://www.whafh.com/practice-areas/institutional-investors/overview/>.

21. See, e.g., *United Food & Commercial Workers Union v. Chesapeake Energy Corp.*, 281 F.R.D. 641, 649-50 (W.D. Okla. 2012).

22. Edward Siedle, *Class Action Law Firms Invade Public Pensions*, Speech before Massachusetts Association of Contributory Retirement Systems (Hyannis, Mass.) (June 5, 2012), <http://www.forbes.com/sites/edwardsiedle/2012/06/05/class-action-law-firms-invade->

spond that monitoring arrangements do uncover at least some corporate fraud or breaches of fiduciary duty. In fact, although plaintiffs' firms do not discover the majority of fraudulent activity, they do uncover some.<sup>23</sup> Moreover, even if the fund does not choose to file suit or vie for the lead-plaintiff role, these funds "have available to them a rich array of flexible, informal, and relatively inexpensive mechanisms by which they can make their views known to litigants and courts alike."<sup>24</sup> In other words, monitoring services may result in the fund taking action other than litigation.

In addition, proponents of portfolio-monitoring agreements contend that law firms are uniquely positioned to provide valuable services related to the detection of fraud and breaches of fiduciary duties. Pension funds typically own hundreds or thousands of securities, often traded and managed by external money managers. Money managers may be reluctant to identify any losses at all—let alone ones related to fraud or a breach of fiduciary duty—because managers likely do not want to call attention to poor performance or because they view whether a loss is caused by fraud as a legal call that they are unfit to make.<sup>25</sup>

Portfolio-monitoring arrangements may also help pension funds comply with their fiduciary obligations.<sup>26</sup> Pension funds often stand in fiduciary relationships with others, like pension beneficiaries.<sup>27</sup> These institutional investors may be obligated to watch their investments for losses caused by fraud or breach of fiduciary duty and ensure that they do not leave money on the table by missing potential class recoveries.<sup>28</sup>

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public-pensions/5/. Critics also suggest that portfolio monitoring while not per se problematic, breeds other questionable practices, such as pay-to-play arrangements. *Id.* But empirical data to date "suggests that pay-to-play is a less significant driver of public pension fund participation than is widely believed, and is less important than forces related to beneficiary influence over public pension funds." David H. Webber, *Is 'Pay-to-Play' Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031, 2032–33, 2035 (2010). Moreover, if there is, in fact, evidence of a pay-to-play relationship, this alone is likely sufficient to kick the plaintiff from the lead position. *In re Cendant Corp. Litig.*, 264 F.3d 201, 269–70 (3d Cir. 2001) ("[Pay-to-play arrangements constitute] strong (and, quite probably, dispositive) evidence that the presumption [of adequacy] had been rebutted"); see also *In re AT&T Corp.*, 455 F.3d 160, 168 (3d Cir. 2006) (stating that pay-to-play arrangements are "problematic"); *In re Diamond Foods, Inc. Sec. Litig.*, 295 F.R.D. 240, 255–57 (N.D. Cal. 2013) (refusing to disqualify lead plaintiff amid pay-to-play allegations but only because there was no evidence of quid pro quo).

23. I.J. Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213 (2010); Dyck et al., *supra*, at 2225 tbl.2.

24. Joseph A. Grundfest & Michael A. Perino, *The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation*, 38 ARIZ. L. REV. 559, 561 (1996).

25. Sara Hansard, *Attorneys Question Portfolio-Monitoring Services*, INVESTMENTNEWS, <http://www.investmentnews.com/article/20061204/SUB/612040702> (Dec. 4, 2006) (quoting Douglas McKeige, of counsel to Bernstein Litowitz Berger & Grossmann LLP).

26. See, e.g., Berman Devalerio, *Best Practice: Hire More Than One Monitoring Firm*, <http://www.bermandealorio.com/newsfeed/100-best-practice-hire-more-than-one-monitoring-firm>; MOTLEY RICE, *supra* note 20; POMERANTZ LLP, *Portfolio Monitoring*, [http://pomerantzlawfirm.com/?page\\_id=14](http://pomerantzlawfirm.com/?page_id=14); ROBBINS GELLER, *supra* note 20.

27. Hansard, *supra* note 25.

28. Shortly after the PSLRA, the Secretary of Labor (charged with interpreting and enforcing ERISA) filed an amicus brief supporting the Florida State Board of Administration's effort to be appointed as lead plaintiff in several ERISA class actions. In that brief,

As further evidence of their desirability, proponents point out that pension funds themselves often solicit portfolio-monitoring services<sup>29</sup> and other third parties recommend the practice. For instance, in a 2004 study, PriceWaterhouseCoopers observed that public pension funds are playing a greater role in securities litigation and that these funds “benefit from free portfolio monitoring services offered by plaintiffs’ firms to pension funds and other institutional investors.”<sup>30</sup> In 2006, the Government Finance Officers Association, a professional association of state and local government-finance officers, issued a “Best Practice” guide for public pensions participating in securities class actions, which affirmatively recommended that public pensions “develop clear, written procedures for monitoring class action litigation and settlements.”<sup>31</sup>

### III. THE TREATMENT OF PORTFOLIO MONITORING IN THE COURTS

Although the courts initially recognized the value of portfolio-monitoring agreements, they have more recently raised the concern that some of these arrangements might spur lawyer-driven frivolous securities litigation. In *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Systems*,

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the Secretary stated, “Not only is a fiduciary not prohibited from serving as a lead plaintiff, the Secretary believes that a fiduciary has an affirmative duty to determine whether it would be in the interest of the plan participants to do so. The Secretary has previously taken the position that it may not only be prudent to initiate litigation, but also a breach of a fiduciary’s duty to not pursue a valid claim.” Peg O’Hara, *The Role of Pension Plans in Corporate Governance*, SE 40 ALI-ABA 11, 73 (Sept. 30, 1999). As a result of the Secretary’s views, pension funds across the nation began developing and implementing portfolio-monitoring systems as essential components of their efforts to exercise their fiduciary duties. See *Iron Workers Local No. 25 Pension Fund’s Submission in Public Emps.’ Retirement Sys. of Miss. v. Merrill Lynch & Co.*, No. 1:09-cv-01392, 2009 WL 1633177 (S.D.N.Y. Apr. 8, 2009). Other sources have likewise recognized that institutional investors may have a fiduciary obligation to consider whether legal recourse is necessary. See, e.g., James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 440 (2005) (stating that institution’s beneficiaries may be able to state a claim against the institutional investor for failing to file “all cost-justified claims in securities fraud class action settlements”); Jeffrey Haas, *When the Endowment Tanks: Some Lessons for Nonprofits*, BUS. L. TODAY 19 (June 2003) (“[T]he duty of care requires boards to make reasonable inquiries whenever circumstances warrant. . . . At a minimum, those whose endowments have declined must determine whether the declines occurred unnecessarily as a result of others’ misdeeds.”).

29. A quick internet search yields dozens of these RFPs. See, e.g., ILLINOIS STATE UNIVERSITIES RETIREMENT SYSTEM, Securities Litigation Counsel RFP, <http://www.surs.org/news-article/070813/securities-litigation-counsel-rfp>; SAN FRANCISCO EMPLOYEES’ RETIREMENT SYSTEM, Investments, <http://mysfers.org/about-sfers/investments/>; GENERAL TREASURER OF THE STATE OF RHODE ISLAND, Portfolio Monitoring and Securities Fraud Litigation Services, <http://www.pionline.com/apps/pbcs.dll/dcce?date=20130415&module=2&category=rfps&class=3&type=rfp&id=2897595>.

30. Steven Skalak & Daniel Dooley, *Securities Litigation Update – The Pension Fund Factor*, PriceWaterHouseCoopers (2004).

31. Government Finance Officers Association, *Best Practice: Developing a Policy to Participate in Securities Litigation Class Actions*, at 2 (Oct. 6, 2006), <http://www.gfoa.org/downloads/corbaaclassaction.pdf>.

*Inc.*,<sup>32</sup> the court held that a pension fund's monitoring agreement with a plaintiffs' firm did not render the fund an inadequate class representative. There, the defendant argued that the court should disqualify a pension fund from the lead spot because the fund served as a lead plaintiff in three other cases at counsel's request. The court, however, said that "nothing" about the pension fund's relationship with counsel rendered it inadequate. To the contrary, the court favored the fact that the pension fund enjoyed an "ongoing relationship" with counsel to "monitor its investment portfolio for fraud."<sup>33</sup> Similarly, in *In re Cooper Co., Securities Litigation*, the court concluded that portfolio monitoring raised the inference that the institution would be an *adequate* representative because the arrangement shows that the institution is actively involved in and aware of the issues in the case.<sup>34</sup>

In *Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing & Securitization, LLC*,<sup>35</sup> however, the court critically scrutinized portfolio-monitoring arrangements. These arrangements, the court wrote, were "far beyond any traditional contingency arrangement" and instead created a "clear incentive" to discover "fraud" and recommend suit.<sup>36</sup> The court cautioned that these agreements "foster[ ] the very tendencies toward lawyer-driver litigation that the PSLRA was designed to curtail."<sup>37</sup>

Other courts began to recognize the concerns raised in *Iron Workers*.<sup>38</sup>

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32. *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Sys., Inc.*, No. C 01-20418, 2004 WL 5326262 (N.D. Cal. May 27, 2004).

33. *Id.*; see also *In re Am. Italian Pasta Co. Sec. Litig.*, No. 05-0725, 2007 WL 927745, at \*5 (W.D. Mo. Mar. 26, 2007) (stating that a portfolio-monitoring arrangement was "not a problem," raised "nothing alarming," and, in fact, made sense for an institution with "extensive investments" to take steps to be aware of prospective litigation affecting those investments).

34. *In re Cooper Co., Sec. Litig.*, 254 F.R.D. 628 (C.D. Cal. 2009); see also *In re Nepharm, Inc., Sec. Litig.*, 225 F.R.D. 563, 567-68 (N.D. Ill. 2004) (appointing institution as lead plaintiff because ongoing monitoring services by counsel "illustrate[d] involvement in and awareness of the financial affairs at issue").

35. 616 F. Supp. 2d 461 (S.D.N.Y. 2009).

36. *Id.* at 464.

37. *Id.*

38. See, e.g., *In re Morgan Stanley Mortgage Pass-Through Certificates Litig.*, No. 09-CV-012137, 2013 WL 4778157, at \*2 (S.D.N.Y. Sept. 6, 2013) (acknowledging "key concerns" in *Iron Workers*); *In re Diamond Foods, Inc. Sec. Litig.*, 295 F.R.D. 240, 255 (N.D. Cal. 2013) (echoing the concerns raised in *Iron Workers*); *City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp.*, 844 F. Supp. 2d 498, 502-04 (S.D.N.Y. 2012) (same); *Local 703 I.B. of T. Grocery & Food Emps. Welfare Fund v. Regions Fin. Corp.*, 282 F.R.D. 607, 615-16 (N.D. Ala. 2012) (stating that portfolio monitoring is "not without question"); *In re Wash. Mut., Inc. Sec., Derivative, & ERISA Litig.*, No. 2:08-MD-1919, 2010 WL 4272567, at \*8 (W.D. Wash. Oct. 12, 2010) (stating that the firm's "tactics in recruiting . . . strike the Court as unseemly"); *In re Gen. Elec. Sec. Litig.*, No. 09-Civ. 1951, 2009 WL 2259502, at \*6 n.4 (S.D.N.Y. July 29, 2009) (stating that portfolio monitoring gives the judge "some pause"). After *Iron Workers*, however, other courts still recognized the value attendant with monitoring agreements. See, e.g., *Berg v. Guthart*, No. 5:14-cv-00515, 2014 WL 3749780, at \*4 (N.D. Cal. July 30, 2014); *Plumbers & Pipefitters Nat. Pension Fund v. Burns*, 292 F.R.D. 515, 523-24 (N.D. Ohio 2013); *City of Livonia Emps.' Retirement Sys. v. Wyeth*, 284 F.R.D. 173, 179-80 (S.D.N.Y. 2012); *United Food & Commercial Workers Union v. Chesapeake Energy Corp.*, 281 F.R.D. 641, 655 (W.D. Okla. 2012); *In re Ut-*

In *In re Kosmos Energy Ltd. Securities Litigation*, for example, the court, relying on *Iron Workers*, held that a pension fund's monitoring agreement with a plaintiffs' firm that did not allow for competition called the fund's adequacy "into serious question."<sup>39</sup> The court concluded, for several reasons, that the fund was unfit to lead the class.<sup>40</sup> In that case, a pension fund sought to represent the class against a company for allegedly issuing a misleading registration statement in connection with a public offering of stock. The court emphasized that the fund's monitoring arrangement with the plaintiffs' firm was exclusive, meaning that the law firm would be guaranteed to represent the institution if a suit was identified. This "exclusivity," the court said, made the potential for a conflict "even more significant."<sup>41</sup> The court held that the monitoring arrangement, coupled with the fund's chair's "dismaying lack of knowledge and understanding regarding crucial matters," rendered the fund inadequate to lead the class.<sup>42</sup>

As these recent cases suggest, a court may perceive monitoring arrangements as attempts by lawyers to initiate and litigate frivolous cases to recover their own fees rather than benefit the investors they represent.<sup>43</sup>

#### IV. BEST PRACTICES FOR PORTFOLIO MONITORING: NON-EXCLUSIVITY AND INDEPENDENCE

To honor Professor Bromberg's commitment to striking the proper balance between providing effective remedies to victims of securities fraud while deterring frivolous litigation, the courts should support those particular portfolio-monitoring arrangements that will not impair the institution's ability to typically and adequately represent the class. In short, these arrangements should not be exclusive and should retain the institution's independence, features that obviate the risk that firms will advance frivolous lawsuits.

##### A. PORTFOLIO-MONITORING ARRANGEMENTS SHOULD NOT BE EXCLUSIVE

Ensuring that the fund may use several firms to monitor its investments mitigates the risk that a firm will recommend a frivolous suit.<sup>44</sup> If multiple firms monitor an institution's holdings but only a single firm recommends

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starcom, Inc. Sec. Litig., No. C 04-04908, 2010 WL 1945737, at \*8 (N.D. Cal. May 12, 2010); *Silversman v. Motorola, Inc.*, 259 F.R.D. 163, 173 (N.D. Ill. 2009).

39. 2014 WL 1095326, at \*13.

40. *Id.* at \*13.

41. *Id.*

42. *Id.* at \*13-14; see also *Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing & Securitization, LLC*, 616 F. Supp. 2d 461, 463 (S.D.N.Y. 2009).

43. See, e.g., *Iron Workers*, 616 F. Supp. 2d at 463.

44. Even still, the prospect that plaintiffs' lawyers will recommend meritless suits is already addressed by the PSLRA with several safeguards. See, e.g., 15 U.S.C. § 78u-4(a)(3)(B)(vi) (prohibiting a person to be lead plaintiff in more than 5 securities class actions); § 78u-4(a)(2) (requiring the lead plaintiff to certify that the plaintiff has reviewed

suing, then that recommendation is more likely to be suspect by the institution. But if a firm's initial recommendation is corroborated by other firms, then this lends credibility to the recommendation.<sup>45</sup> The institution can play law firms against each other to pressure-test advice or negotiate the best terms for the institutional investor.

Many public pensions already require this competitive process. For instance, the Illinois State Universities Retirement System provides that when a firm identifies a potential claim, the fund, which will retain three to five firms, will "match [its] portfolios against reports of securities litigation cases obtained from Consultants, law firms engaged for securities litigation, and from other sources deemed reliable by Staff . . . ."<sup>46</sup>

In the context of selecting lead plaintiffs, courts view the presence of such competition favorably.<sup>47</sup> For instance, in *Iron Workers*, the court refused to appoint a labor fund over a state fund in part because the labor fund obtained advice on the lawsuit from a single firm whereas the state fund had monitoring arrangements with a dozen firms, none of whom were guaranteed to be hired if litigation followed.<sup>48</sup> Similarly, in *City of Pontiac General Motors Employees' Retirement System v. Lockheed Martin*, the court appointed a pension fund to serve as lead plaintiff and observed with approval that the fund used three separate firms to monitor its investments.<sup>49</sup>

Competition among plaintiffs' firms not only mitigates the risk that plaintiffs' lawyers will "discover" fraud, it also encourages firms to offer an institution the best deal on attorneys' fees. There is empirical evidence that competition and active participation among repeat players at this litigation stage actually reduces the amount of securities class action attor-

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and authorized the complaint, did not buy company shares at counsel's direction, and that the plaintiff is willing to lead the class).

45. Cf. Lead Plaintiffs' Reply Memorandum of Law in Further Support of Motion for Class Certification, No. 1:10-cv-06016 (May 20, 2013), 2013 WL 7165821, at \*9 n.21 (citing testimony of pension fund that it retained another law firm in securities litigation because "it is a \$5 billion pension fund, so . . . it just makes sense to have another set of eyes looking at it").

46. ILLINOIS STATE UNIVERSITIES RETIREMENT SYSTEM, Securities Litigation Counsel RFP, [http://www.surs.org/pdfs/RFP/invest/sec\\_litigation/Securities-Litigation-Counsel-RFP-Ex-A.pdf](http://www.surs.org/pdfs/RFP/invest/sec_litigation/Securities-Litigation-Counsel-RFP-Ex-A.pdf); see also IOWA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, Request for Proposal Number 2006-L-001 for Securities Litigation Consultant Services, at 2 (Aug. 16, 2006), <http://www.ipers.org/publications/rfps/pdf/awarded/2006securitieslitigationcounsel.pdf> ("IPERS may also request advice from any or all members of the pool retained hereunder about any securities litigation matter before making a decision as to whether to retain counsel or which counsel to retain.").

47. See *In re Diamond Foods, Inc. Sec. Litig.*, 295 F.R.D. 240, 255 (N.D. Cal. 2013) (appointing institution as lead plaintiff where institution "retained thirteen law firms to monitor" the institution's investments); *In re Gen. Elec.*, No. 09 Civ. 1951, 2009 WL 2259502, at \*6 (S.D.N.Y. July 29, 2009) (recognizing that if an institution is "monitored by more than one law firm," this would mitigate any potential conflict).

48. *Iron Workers*, 616 F. Supp. 2d at 466.

49. *City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp.*, 844 F. Supp. 2d 498, 502-04 (S.D.N.Y. 2012)

ney's fees.<sup>50</sup> Institutions with multiple monitoring agreements can force law firms to compete on price.<sup>51</sup> In fact, some law firms openly recommend that institutional investors use multiple firms to monitor their investments.<sup>52</sup>

Additionally, competition may increase the quality of the attorneys' prefiling investigation. The prefiling period is a critical period for securities-fraud plaintiffs.<sup>53</sup> If a plaintiffs' firm knows that it will be pitching its case for representation alongside several other firms, that firm should be less motivated to simply free-ride on others' efforts, and more motivated to conduct a thorough prefiling investigation, uncover additional, reliable evidence of the fraud, and piece together facts under a compelling legal theory.

#### B. INSTITUTIONAL INVESTORS SHOULD RETAIN INDEPENDENCE WHEN DECIDING WHETHER TO SUE AND WHICH LAW FIRM TO RETAIN

Ensuring that the institution independently determines whether to sue, and which firm to retain if it does, mitigates any concern that the plaintiffs' firm is driving the litigation or recommending a frivolous case. An independent decision to litigate or not demonstrates that the institution is actively involved in and aware of the issues in the case, and that it is not just the plaintiffs' firm picking the institution's stock and filing suit. Moreover, the institution's use of lawyers or other skilled intermediaries when independently deciding whether to sue provides an additional check on the possibility that plaintiffs' lawyers are recommending frivolous litigation. In fact, many public pension funds already require this level of independence.<sup>54</sup>

Where the institution retains that independence, courts properly take a positive view of portfolio-monitoring arrangements.<sup>55</sup> For example, in

50. Michael A. Perino, *Markets and Monitors: The Impact of Competition and Experience on Attorneys' Fees in Securities Class Actions*, (St. John's Legal Studies, Research Paper No. 06-0034, 2006) (finding support for the hypothesis that competition and active participation of repeat players lower securities class action fees).

51. See David H. Webber, *The Plight of the Individual Investor in Securities Class Actions*, 106 Nw. L. REV. 157, 167 (2012).

52. See, e.g., Berman Devalerio, *supra* note 26; MOTLEY RICE, *supra* note 20.

53. See, e.g., John M. Wunderlich, *The Importance of the Prefiling Phase for Securities-Fraud Litigation*, 45 LOY. U. CHICAGO L.J. 739, 766-68 (2014).

54. See, e.g., STATE OF WISCONSIN INVESTMENT BOARD, *Securities Litigation Class Action Procedures*, <http://www.swib.state.wi.us/Litigation.aspx> (requiring the Board's committee and chief legal counsel to independently review and recommend initiating, joining, appearing in, or submitting a filing in any public-market corporate-fraud litigation); The Iowa Public Employees' Retirement System Securities Monitoring & Litigation Policy, at 2-3 (Sept. 2008), <http://www.ipers.org/publications/misc/pdf/financial/investments/policies/secmonlit.pdf> (requiring the System's legal staff to present a "very strong" basis for suing to the Board, which makes the ultimate determination, before initiating any litigation); California State Teachers' Retirement System Corporate Governance Program Policies, at 3-5 (Apr. 2006), [http://www.calstrs.com/Investments/CorpGovPolicies\\_200604.pdf](http://www.calstrs.com/Investments/CorpGovPolicies_200604.pdf) (requiring the board of directors to determine whether to seek lead plaintiff status based on an internal evaluation and an independent assessment from outside counsel).

55. See, e.g., *In re Kosmos Energy Ltd. Sec. Litig.*, No. 3:12-cv-373, 2014 WL 1095326, at \*13 (N.D. Tex. Mar. 19, 2014) (refusing to appoint an institution as lead plaintiff where,

*Iron Workers*, the court selected a state-pension fund<sup>56</sup> over a labor fund to act as lead plaintiff, in part, because the state fund left the decision whether to bring suit and the oversight of any litigation to the lawyers in the State Attorney General's Office.<sup>57</sup> Further, the institution was free to retain any counsel it wished; in fact, the firm retained by the state fund was different from the firm that recommended suing in the first place.<sup>58</sup>

Additionally, the one ethics watchdog to examine portfolio monitoring found no inherent conflict of interest when the institution retains the ability to decide whether to sue and who to retain. The New York State Bar Association's Committee on Professional Ethics evaluated whether an attorney, without compensation, could monitor a client's investments in order to identify potential claims, even though the client may later consider that attorney to handle, for compensation, any resulting litigation.<sup>59</sup> Assuming that after litigation is identified, the institution is free to take no action or hire another lawyer, the New York State Bar concluded that nothing about the practice was forbidden by the Code of Professional Responsibility. The ethics opinion stated that surely the lawyer would benefit from recommending legal services, but an interest in being hired is inherent in every attorney-client relationship.

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among other problems, the monitoring agreement obligated the institution to retain the monitoring firm); *Plumbers & Pipefitters Nat. Pension Fund v. Burns*, 292 F.R.D. 515, 523 (N.D. Ohio 2013) (appointing institution as lead plaintiff and observing that the institution "was under no obligation to retain" the monitoring firm); *United Food & Commercial Workers Union v. Chesapeake Energy Corp.*, 281 F.R.D. 641, 649-50 (W.D. Okla. 2012) (appointing institution as lead counsel and observing that monitoring services "did not function as a retainer agreement or an agreement to initiate specific litigation, even litigation of those claims identified as a result of . . . monitoring"); *City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp.*, 844 F. Supp. 2d 498, 502-04 (S.D.N.Y. 2012) (appointing institution as lead plaintiff where portfolio-monitoring agreement allowed institution to retain other firms); *In re Wash. Mut., Inc. Sec., Derivative, & ERISA Litig.*, No. 2:08-md-1919, 2010 WL 4272567, at \*8 (W.D. Wash. Oct. 12, 2010) (appointing institution as lead plaintiff and observing that the institution's "board considered counsel's offer, asked questions, and joined in the action freely by taking a vote"); *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Sys., Inc.*, No. C 01-20418, 2004 WL 5326262, at \*4 (N.D. Cal. May 27, 2004) (observing that the institution "elected" to sue after the firm recommended litigation).

56. See, e.g., STATE OF WISCONSIN INVESTMENT BOARD, Securities Litigation Class Action Procedures, <http://www.swib.state.wi.us/Litigation.aspx> (requiring the Board's committee and chief legal counsel to independently review and recommend initiating, joining, appearing in, or submitting a filing in any public-market corporate-fraud litigation); The Iowa Public Employees' Retirement System Securities Monitoring & Litigation Policy, at 2-3 (Sept. 2008), <http://www.ipers.org/publications/misc/pdf/financial/investments/policies/secmonlit.pdf> (requiring the System's legal staff to present a "very strong" basis for suing to the Board, which makes the ultimate determination, before initiating any litigation); California State Teachers' Retirement System Corporate Governance Program Policies, at 3-5 (Apr. 2006), [http://www.calstrs.com/Investments/CorpGovPolicies\\_200604.pdf](http://www.calstrs.com/Investments/CorpGovPolicies_200604.pdf) (requiring the board of directors to determine whether to seek lead plaintiff status based on an internal evaluation and an independent assessment from outside counsel).

57. *Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing & Securitization, LLC*, 616 F. Supp. 2d 461, 466 (S.D.N.Y. 2009).

58. *Id.*

59. New York State Bar Association, Committee on Professional Ethics, Ethics Opinion 824 (July 2, 2008).

## V. CONCLUSION

In this article, we have tried to strike a Brombergian balance by analyzing how portfolio-monitoring agreements can best serve the investor-protection goals of the federal securities laws without burdening businesses and the courts with frivolous litigation. That careful balance requires the courts to endorse those agreements, but only if they are non-exclusive and preserve institutional independence. While some may disagree with how that balance has been struck, none can debate the overriding value of trying to achieve that balance. Nor can anyone who cares about investor protection or the securities markets debate the wonderful legacy of Alan Bromberg, a legacy that challenges us all to search for a delicate balance.