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Optimal Lead Plaintiffs

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Optimal Lead Plaintiffs

*Elizabeth Chamblee Burch**

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INTRODUCTION

Good lead counsel is hard to find.¹ We, Congress, the Securities Exchange Commission (“SEC”), and the public trust that class counsel will be a good and faithful agent so long as a lead plaintiff is there to monitor her every move.² Problem is, good lead plaintiffs are hard to find, too. In part, we expect too much: the Private Securities Litigation Reform Act (“PSLRA”) insists that a lead plaintiff monitor the class attorneys and hopes that she will prevent strike suits and deter fraud;³ Rule 23(a)(4), on the other hand, demands that the lead plaintiff adequately represent class members with diverse risk

1. This derivative comes, of course, from FLANNERY O’CONNOR, *A Good Man Is Hard to Find*, in *A GOOD MAN IS HARD TO FIND AND OTHER STORIES* 1, 1 (1955).

2. “‘She would of been a good woman,’ The Misfit said, ‘if [there] had been somebody there to shoot her every minute of her life.’” *Id.* at 23. Of course, counsel’s behavior is also constrained by reputational concerns, ethics rules, and the desire for repeat clients. Still, the lead plaintiff typically raises ethical violations and certainly controls repeat business.

3. See 15 U.S.C. § 78u–4(a)(3)(B)(iii) (2006).

preferences, sophistication levels, and desired remedies.⁴ Contrast, for example, this lead-plaintiff heroine in securities-fraud class actions with a run-of-the-mill class representative from a small stakes, negative-value class action who we hope might have read the complaint and whom we openly dub a “figurehead.”⁵

It doesn’t help that the lead plaintiff’s PSLRA and Rule 23(a) obligations may steer her in opposite directions. She may monitor the class attorney like a hawk and squelch attorney opportunism at every turn, but when her self-interest conflicts with the interests of those she represents, the zealot becomes the oppressor. For example, because institutional lead plaintiffs are more likely to continue to hold stock in a defendant corporation, they may push for corporate-governance reforms, which means that their advocacy will work to the detriment of former shareholders who want to maximize their monetary recovery. This is but one of the predictable divides that often exists between institutional and individual investors. Yet, when judges appoint a lead plaintiff, they look principally for the best monitor with the largest financial loss and consider adequacy only secondarily. Contending that the lead plaintiff’s primary function is to monitor plaintiffs’ attorneys loses sight of her obligations as an adequate class representative—the tether to class members’ constitutional due process rights. Nevertheless, courts push the adequacy question back to the class-certification stage where it might rightly belong if certification was still just another hurdle to trial as opposed to the last judicial checkpoint before settlement.

The solution is simple enough to state succinctly: Appoint lead-plaintiff groups with members who represent the class’s diverse interests. But when courts have appointed *cohesive* groups in the past, the groups have underperformed. The prescription is thus to select lead plaintiffs whose diverse preferences and motivations mirror those of the class. This solution addresses two interrelated process-based problems: (1) that institutional lead plaintiffs tend to inadequately represent individual investors and (2) that lead-plaintiff groups have

4. See FED. R. CIV. P. 23(a)(4) (“[T]he representative parties will fairly and adequately protect the interests of the class.”); *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 623 (1997); *Hansberry v. Lee*, 311 U.S. 32, 42–45 (1940).

5. See Jean Wegman Burns, *Decorative Figureheads: Eliminating Class Representatives in Class Actions*, 42 HASTINGS L.J. 165, 165 (1990) (describing the class representative, at times, as “nothing more than a figurehead with little or no function” and playing “almost no role in the actual prosecution of the class action”); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 94 (1991) (explaining that, “because the named plaintiff is a figurehead,” courts should inquire more into the adequacy of the plaintiffs’ attorney than that of the named plaintiff).

performed poorly historically, which translates into higher agency costs and lower settlement values. Parts I and II explore each problem in turn.

Part I.A contextualizes the problem of inadequate representation by situating the representative relationship within a larger governance theory. While the PSLRA incorporates class members into class governance through the lead-plaintiff appointment process, Rule 23(a)'s typicality and adequacy provisions set forth the constitutional due process qualifications for serving as that representative: the representative must have suffered similar harm and share similar claims as those of the class and her interests must not conflict with class members' interests. These qualifications legitimize the institutional arrangement. Unlike democratic governments where a majority vote legitimizes representatives through consent, the judge is the only actor standing between self-nominated class attorneys and lead plaintiffs, on one hand, and the class itself, on the other. But judges fail to recognize their role in legitimizing the arrangement; from an adequacy standpoint, they increasingly tolerate what they should ordinarily view as debilitating structural conflicts between individual and institutional investors.

Rule 23(a)(4) assumes that the representative's self-interest overlaps with the interests of the represented such that a lead plaintiff pursuing her own interest will benefit others. But, as Part I.B explains, this is not the typical case in securities class actions: institutions' interests diverge from individual investors' interests in predictable ways. For example, institutions are likely to engage in derivatives trading, which means they may experience fewer true losses and be subject to unique defenses; plus, they're more likely to continue to hold shares in the defendant corporation, which means they may prefer different remedies than would former shareholders. Institutions often have "portfolio monitoring agreements" with plaintiffs' law firms (where the firm alerts the institution any time it might have a significant enough loss to serve as lead plaintiff), which gives their attorneys incentives to skew settlement terms and claims-filing practices to favor the institution and encourage repeat business. And institutions, individual investors, and attorneys have risk preferences that vary dramatically depending on how much money is at stake vis-à-vis their overall wealth.⁶

Courts could address these conflicts without the need for congressional action by selecting small lead-plaintiff groups that

6. John C. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 307-08 (2010).

reflect the spectrum of class members' views. But thus far, few judges choose groups with adequacy in mind, and the cohesive groups they do select perform poorly. Part II.A provides a descriptive account of when courts have appointed groups of individuals, institutions, or a mix of the two. It summarizes judicial preferences on group size, members' relationship, cohesiveness, formation, and decisionmaking. Perhaps surprisingly given the PSLRA's preference for institutions, groups serve as lead plaintiff in roughly thirty percent of securities class actions.⁷ Judges seem more willing to appoint a group when its members have a preexisting, cohesive, or cooperative relationship. Homogeneity and cohesion, in other words, are currently desirable characteristics for a lead-plaintiff group.

But empirical evidence shows that cohesive groups perform poorly as monitors—their attorneys receive higher fees and the defendant settles for less. Part II.B explores why. Securities scholars claim that judges should rarely—if ever—appoint groups because doing so is inconsistent with the PSLRA, shifts control from the plaintiffs to their attorneys, and adds to collective-action and free-rider problems. Curiously, neither proceduralists nor securities-law scholars cast these failings as group decisionmaking problems. And yet, by drawing from the group decisionmaking literature, which spans multiple fields within the social sciences, it becomes apparent that the very criteria judges prefer in selecting groups—preexisting relationships, group cohesion, and evidence of coordination—are the same factors that cause paradigmatic group problems—namely, group polarization and confirmation bias.

Accordingly, Part III.A sets forth the normative claim that appointing small, cognitively diverse, richly representative lead-plaintiff groups best addresses both adequate-representation problems and poor group performance. Evidence from the social sciences suggests that cognitively diverse groups—groups with diverse perspectives, interpretations, and heuristics—are more capable problem solvers and thus reach better solutions than homogeneous ones. But we cannot deem lead plaintiffs' decisions qualitatively good or bad in a vacuum; because class members have heterogeneous preferences, we can make that judgment only after considering whether the decision reflects the preferences of the governed. That is, if we measure a lead plaintiff's success only in monitoring terms, we

7. 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, 369 tbl.1 (2008); see also James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1623 tbl.3 (2006).

fail to evaluate how she performs her primary function as an adequate class representative. Monitoring is simply a more specific adequate-representation requirement: the faithful representative, as an agent for the class, should not hire another agent on her principal's behalf without ensuring that the second agent—the attorney—performs as promised. Thus, this Part builds on the two basic assumptions established in Parts I and II: that average class members are diverse and that the representative fulfills her obligations by pursuing her own self-interest, which must be similar to those she represents. Without more than one representative, these assumptions are incompatible.

Part III.B then takes up the mechanics of designing a representative lead-plaintiff group. In particular, it recognizes that adequate representation and cognitive diversity share the same goals of encouraging information sharing and dissent and thereby ties interest diversity to cognitive diversity. It then explains how courts can leverage intraclass conflicts to construct a representative group. Part III.C suggests that encouraging a competitive lead-plaintiff selection process likewise gives the judge more options from which to choose, fosters dissenting norms, and erodes the near monopoly on securities class actions by a handful of plaintiffs' firms. Given the well-known wedge between class counsel's interests and class members' interests, once the judge appoints a representative lead-plaintiff group, lead counsel should allocate lead plaintiffs more decisionmaking autonomy and give their input more weight. Put simply, class counsel should consult and take direction from the lead-plaintiff group on matters that implicate members' values and litigation objectives or affect the case's merits in much the same way that an attorney consults with her client in individual litigation. In short, if lead plaintiffs are to adequately represent their constituents' interests, monitor the lawyers, and minimize agency costs, then, consistent with the PSLRA's goal of increasing client control, they should have more decisionmaking authority.

Finally, Part III.D concludes by contrasting this Article's voice-based reforms with Professor Coffee's well-known arguments advancing exit through opting out⁸ and explains how selecting a diverse lead-plaintiff group is a normatively better solution. It does so by considering pragmatic concerns, including due process, adequate representation, and institutional legitimacy; institutional concerns, such as efficiency and fairness; and regulatory concerns, including deterrence. Ultimately, a representatively diverse lead-plaintiff group

8. Coffee, *supra* note 6, at 326–27.

appropriately reinstates opting out as a last resort rather than a first choice and thereby makes the class-action objection process more meaningful.

I. LEAD PLAINTIFFS, INADEQUATE REPRESENTATIVES

Both the PSLRA's lead-plaintiff provision and Rule 23(a)(4)'s adequate-representation standard aim to diminish two sources of disloyalty: (1) the now familiar principal-agent problems between class counsel and the class itself; and (2) the largely ignored but deeply rooted conflicts between class members, particularly the lead plaintiff and the class. But remedying one does not necessarily cure the other. One can vigorously monitor the attorney, but care only about one's own self-interest. When that self-interest is misaligned with other class members' interests, the vigorous monitor becomes an unwitting tyrant.

The problem is that when judges follow the PSLRA, they seek the best monitor. This leaves adequacy principally as an afterthought, and certainly—reason the courts—something that they can address later, during class certification.⁹ But that rationale worked best when certifying a class began the process and was not the prelude to settlement that it has become today. This Part begins by describing the lead plaintiff's obligations to the class members and the public at large and then highlights the tension that can result when the two point in different directions. It then explores the specific conflicts of interest that tend to arise most frequently between class members and analyzes the resulting due process concerns. Finally, it explains why the ability to opt out of a securities class action fails to satisfactorily resolve these conflicts of interest.

A. *The Lead Plaintiff's Obligations and Legislative Aspirations*

By now, attorney-client agency problems in the class-action context are widely known. Simply put, the attorney's self-interest as the litigation's financier makes her a creditor and the litigation a joint venture with the plaintiffs.¹⁰ Class members, on the other hand, have a small stake in a big problem and thus have little incentive to invest significant time into understanding the litigation or monitoring the

9. See *infra* Part III.B.3, which addresses this problem in more detail.

10. See John C. Coffee, Jr., *Kutak Symposium: Professional Responsibility and the Corporate Lawyer*, 13 GEO. J. LEGAL ETHICS 331, 340–41 (2000) (“[I]n the class action, the plaintiff's attorney is not simply an agent; the attorney is also the financier of the class action. . . . What's more, the attorney is not just a creditor; the attorney is a joint-venturer . . .”).

attorneys. Rule 23's traditional answer to this conundrum is to designate a class representative to "fairly and adequately protect the interests of the class" and ensure that the representative's claims and defenses mirror those of other class members.¹¹ Known as the "adequacy" and "typicality" requirements, these restrictions along with numerosity and commonality govern, in part, when courts may certify class actions.¹²

In securities classes, the call for oversight and attorney monitoring is more explicit. The PSLRA creates a rebuttable presumption that the plaintiff with the largest financial stake who satisfies Rule 23's requirements is the "most adequate," or "lead plaintiff."¹³ Congress hoped that appointing lead plaintiffs would entice institutions with the largest losses to take on this role and, because they had more to gain financially by litigating, they would closely monitor their attorneys.¹⁴ Put differently, the assumptions underlying the PSLRA are somewhat linear: (1) securities class actions supplement the government's regulatory function by incentivizing plaintiffs' attorneys to act as private attorneys general, (2) but private attorneys may act self-interestedly, which necessitates monitoring by the principal (the class members), and (3) appointing plaintiffs with the largest losses to perform that monitoring function helps cabin attorney self-interest and further the government's regulatory function.¹⁵ Making these assumptions explicit exposes a duality for lead plaintiffs—their role includes fulfilling public regulatory aspirations as well as protecting class members' due process rights.

11. FED. R. CIV. P. 23(a)(3) (typicality); *id.* R. 23(a)(4) (adequacy).

12. *Id.* R. 23(a). Of course, a class must meet not only all of Rule 23(a)'s requirements, but also one of Rule 23(b)'s requirements. *Id.* R. 23(b). Most securities class actions proceed under Rule 23(b)(3).

13. 15 U.S.C. § 78u-4(a)(3)(B)(iii) (2006); *In re* Initial Pub. Offering Sec. Litig. (*In re* IPO), 214 F.R.D. 117, 120 (S.D.N.Y. 2002); *see also* Hevesi v. Citigroup, Inc., 366 F.3d 70, 81-82 (2d Cir. 2004). Courts designate lead plaintiffs based primarily on which plaintiff has the largest financial interest. *In re* IPO, 214 F.R.D. at 121; *see also* *In re* Crayfish Co. Sec. Litig., No. 00 Civ. 6766, 2002 U.S. Dist. LEXIS 10134, at *13 (S.D.N.Y. June 6, 2002).

14. Cox & Thomas, *supra* note 7, at 1596.

15. The theory is that, as a shareholder in the defendant corporation, an institution would balk at a lawsuit with frivolous claims. Cox & Thomas, *supra* note 7, at 1597-1602; Cox et al., *supra* note 7, at 365. *See generally* John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983) (critiquing private attorneys general); Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 539 (1997); Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684, 716-17 (1941) (setting forth the classic argument in favor of private attorneys general); William B. Rubenstein, *On What a "Private Attorney General" Is—And Why It Matters*, 57 VAND. L. REV. 2129, 2146 (2004) (discussing the role of plaintiffs' attorneys as private attorneys general).

To be more explicit regarding the first assumption, securities class actions supplement public enforcement efforts through: (1) deterring fraud by making it less profitable and allowing investors to recoup their losses, improve corporate governance, and monitor management,¹⁶ and (2) compensating injured investors. Jill Fisch explains the link between deterrence and compensation as follows: “For shareholders and directors to use the disclosed information to monitor [companies], it must be incorporated into equity prices,” which, in efficient markets, “occurs through informed secondary trading.”¹⁷ Even though many investors diversify their holdings to eliminate firm-specific risk, informed, secondary-market traders heavily research particular corporations, use that information to invest, and thus limit their diversification to profit from their research.¹⁸ It is these investors who make secondary markets more efficient by relying on disclosed information, but who are likewise disproportionately saddled with the cost of securities fraud.¹⁹ Consequently, compensating these investors encourages them to continue to provide a public good (efficient markets), which, in turn, enhances company monitoring and deterrence.²⁰ This explains one link between compensation and deterrence and suggests that focusing purely on achieving deterrence through corporate-governance reforms misses the complementary role that compensation might play by enforcing mandatory-disclosure obligations.

Compensation and deterrence are likewise linked through the class action’s institutional arrangement. Once Congress enables private attorneys to act on behalf of a class and pursue class members’ property interests, it must ensure that class members are treated equitably and that the institutional arrangement is legitimate. Because securities-fraud class actions involve monetary compensation, they trigger the “property” portion of the Due Process Clause’s protection against deprivation of “life, liberty, or property, without due

16. See Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 310–18 (arguing that mandatory disclosures “enhance efficiency by improving corporate governance and increasing liquidity”); Lawrence E. Mitchell, *The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 243, 290–92 (arguing that shareholders have the sophistication and activism to serve as effective monitors).

17. Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 345–47.

18. *Id.* at 346.

19. *Id.* at 346–47.

20. See *id.* at 347–48 (explaining that, because the costs incurred by informed traders “produce a positive governance externality, . . . compensation [for informed traders] is both desirable and noncircular”).

process of law.”²¹ Due process for class actions includes adequate representation, notice, an opportunity to be heard, and an opportunity to opt out.²²

Both due process and the need to legitimize private plaintiffs’ attorneys’ actions on behalf of the class require that the lead plaintiff faithfully represent class members. These obligations include monitoring class attorneys by selecting counsel and lowering the attorneys’ fees,²³ but they also include avoiding structural conflicts between class members and between class members and class counsel, ensuring a fair settlement through voicing objections, and representing plaintiffs’ interests throughout the litigation process. At times, these obligations to the class may conflict with what the public at large might prefer. For instance, maximizing class members’ settlement amount does not always correlate with optimal fraud deterrence, whereas requesting corporate-governance reforms does little to promote former stockholders’ interests.

The more worrisome disconnect, however, occurs when the lead plaintiff lacks the information and incentive to perform the private function of protecting other class members. Even though adequate representation requires the absence of intraclass conflicts,²⁴ but the lead plaintiff is both poorly positioned to acquire this sort of information and poorly incentivized to voice concerns along these lines. Because courts assume that a class representative pursuing her own interests likewise pursues the class’s interests, when this is false, lead plaintiffs who do notice an intraclass rift have little reason to mention it.²⁵ Class counsel is similarly disincentivized. Raising significant intraclass conflicts would require designating additional

21. U.S. CONST. amend. V; *id.* amend. XIV, § 1.

22. *See* *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 623 (1997) (adequate representation); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985) (opt out); *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 317–18 (1950) (notice); *Hansberry v. Lee*, 311 U.S. 32, 42–45 (1940) (adequate representation); *Londoner v. City & Cnty. of Denver*, 210 U.S. 373, 385–86 (1908) (opportunity to be heard). *See generally* Patrick Woolley, *Rethinking the Adequacy of Adequate Representation*, 75 TEX. L. REV. 571 (1997) (discussing the importance of giving class members an opportunity to be heard).

23. 15 U.S.C. § 78u–4(a)(3)(B)(v) (2006). Professors Weiss and Beckerman wrote the seminal article on monitoring by institutional investors, which prompted Congress to enact the PSLRA. 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 (1995).

24. *Amchem Prods., Inc.*, 521 U.S. at 623; *Hansberry*, 311 U.S. at 42–45.

25. Jay Tidmarsh, *Rethinking Adequacy of Representation*, 87 TEX. L. REV. 1137, 1142 (2009).

lawyers, which would reduce current counsel's fee.²⁶ Enter then the defendant, an unlikely champion of plaintiffs' due process rights, but one who exploits potential intraclass rifts as reasons not to certify the class or to narrow its definition.²⁷ These incentives, however, last only until the defendant decides to settle. Settling shifts the game into a peacemaking mode where achieving finality means keeping as many class members as possible in the settlement.

B. Diverse Interests and Conflicts of Interest

The lead plaintiff's wide-ranging obligations to the public as well as to class members make her vulnerable to the generalist's problem: she must be all things to all people and thus pleases few and performs few functions well. This is particularly problematic given that appointing a lead plaintiff often eclipses further inquiry into questions about adequacy and typicality. And the lead-plaintiff selection process places the judge in an uneasy quasi-inquisitorial role: though the adversarial process helps, adversaries often form alliances, withdraw competing motions, and combine forces before the judge has a chance to rule.²⁸ This quasi-inquisitorial model necessitates a vigilant gatekeeper who will enforce Rule 23's adequacy and typicality standards, yet judges treat the process gingerly, unsure of their judicial or fiduciary obligations.²⁹ Because lead plaintiffs tend to be sophisticated and have more at stake than a named plaintiff would in a small-claims class action, once chosen, judges tend to trust

26. Granted, an attorney's interest in developing a solid reputation may provide some incentive for her to maximize class members' interests. Still, because the lead plaintiff selects lead counsel, this undercuts the attorney's reputational incentive to some degree.

27. Yet, courts have held that defendants may not engage in discovery to challenge the lead plaintiff's adequacy until class certification. *Fields v. Biomatrix, Inc.*, 198 F.R.D. 451, 455 (D.N.J. 2000). Before Congress enacted the PSLRA, a study by the Federal Judicial Center found "[i]n all or nearly all securities [class action] cases in the four districts, defendants disputed the ability of named plaintiffs to represent the class, often basing their arguments on alleged conflicts or purportedly unique facts applicable to the representatives." Thomas E. Willging et al., *An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges*, 71 N.Y.U. L. REV. 74, 81–82, 90 (1996).

28. See *In re The Baan Co. Sec. Litig.*, 186 F.R.D. 214, 215 & n.1 (D.D.C. 1999) ("It sometimes occurs that groups which start out in adverse positions form alliances, leaving it to the Court to divine the arguments adverse to the alliance and to weigh the relative merit of those arguments.").

29. At least one court has expressed open disdain for having to play a role in the appointment process, even though, after Rule 23's 2003 amendments, courts play an increasingly active role in all class actions. *In re Molson Coors Brewing Co. Sec. Litig.*, 233 F.R.D. 147, 149 n.4 (D. Del. 2005) (observing that having to appoint a lead plaintiff "consume[s] judicial resources," leading the court to question "whether the right incentives are yet in place").

them to play a far greater role than a named plaintiff ever would in a negative-value consumer class action.³⁰

Congress hoped that institutions would take on this role. But empirical data on institutional lead plaintiffs' performance is mixed. While institutions do tend to increase overall settlement size, they also take cases with the largest defendants.³¹ Estimates as to how often institutions serve as lead plaintiff ranged from eight to twelve percent before 2005, to sixty-five percent in 2009.³² By contrast, groups of institutional and noninstitutional investors as well as groups comprised solely of individuals represent the class around thirty percent of the time.³³

1. Institutional Interests Versus Individuals' Interests

When institutions serve as lead plaintiff, they may not adequately represent other class members. Adequate representation assumes that the named plaintiff (the lead plaintiff in securities class actions) will act self-interestedly,³⁴ which works well so long as her interests align with the class's interests. Because the lead plaintiff hires class counsel, when this initial assumption is false, inadequate representation taints not only the relationship between the lead plaintiff and the class, but also between class members and class counsel.

30. See *infra* Part III.B.3. Compare *Berger v. Compaq Computer Corp.*, 257 F.3d 475, 483 (5th Cir. 2001) ("Any lingering uncertainty, with respect to the adequacy standard in securities fraud class actions, has been conclusively resolved by the PSLRA's requirement that securities class actions be managed by active, able class representatives who are informed and can demonstrate they are directing the litigation. In this way, the PSLRA raises the standard adequacy threshold."), with *In re Cavanaugh*, 306 F.3d 726, 738–39 (9th Cir. 2002) ("Although Congress made several important changes in the [PSLRA], it pointedly did not change the requirements of Rule 23. Indeed, it incorporated Rule 23 explicitly in one portion of the statute . . . and enacted language that is identical to Rule 23's typicality and adequacy requirements . . ."). For the Seventh Circuit's opinion on the judge's role as a fiduciary for a certified class, see *Reynolds v. Beneficial National Bank*, 288 F.3d 277, 279–80 (7th Cir. 2002).

31. Cox & Thomas, *supra* note 7, at 1624 tbl.4, 1625.

32. ELLEN M. RYAN & LAURA E. SIMMONS, SECURITIES CLASS ACTION SETTLEMENTS: 2009 REVIEW AND ANALYSIS 10 (2009) ("Cases involving institutional investors as lead plaintiffs are also associated with significantly higher settlements"); Cox & Thomas, *supra* note 7, at 1623 tbl.3 (noting that single institutions served as lead plaintiff in around eight percent of the cases studied); Cox et al., *supra* note 7, at 369, 378–79, 385 (presenting data from 773 settled securities class actions between 1993 and 2005).

33. Cox et al., *supra* note 7, at 369 tbl.1; see also Cox & Thomas, *supra* note 7, at 1623 tbl.3.

34. See PRINCIPLES OF THE LAW OF AGGREGATE LITIGATION § 1.05 cmt. h (2010) [hereinafter PRINCIPLES] ("By acting in ways that help themselves, these parties should help others automatically.").

After the PSLRA, plaintiffs' law firms sought to maintain their competitive advantage by courting large institutions, developing repeat relationships with them, and encouraging them to serve as lead plaintiff.³⁵ This courting process may involve "pay-to-play" practices where plaintiffs' law firms contribute to the political campaigns of those selecting counsel for public or labor pension funds as well as hiring lobbyists to meet with the officials who control those funds.³⁶ Lobbyists encourage pension funds to serve as lead plaintiff and to then select the lobbyist's law-firm employer as lead counsel.³⁷ These practices forge repeat relationships and inhibit competition in ways that lack merit and transparency. And because other eligible institutions like banks, mutual funds, and insurance companies maintain commercial relationships with the defendants or defendants' customers, public and union pension funds are the institutions that typically take on the lead-plaintiff role.³⁸

35. John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better than "Voice"*, 30 CARDOZO L. REV. 407, 420, 425 (2008); Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 63–64 (2001).

36. Drew T. Johnson-Skinner, *Paying-to-Play in Securities Class Actions: A Look at Lawyers' Campaign Contributions*, 84 N.Y.U. L. REV. 1725, 1726–27 (2009); Stephen J. Choi et al., *The Price of Pay to Play in Securities Class Actions 2–3* (U. Mich. Law & Econ., Empirical Legal Stud. Ctr. Paper No. 09–025, 2011), available at <http://ssrn.com/abstract=1527047>. *But see* 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, 2031 (2010) (casting doubt on the pay-to-play theory and finding "no support for the theory that unions drive beneficiary board members to obtain lead plaintiff appointments"). The *Cendant* litigation is one of the best-known examples. *See In re Cendant Corp. Litig.*, 243 F. Supp. 2d 166, 174 (D.N.J. 2003), *aff'd*, 404 F.3d 173 (3d Cir. 2005) (approving the lead counsel's fee of \$55 million, plus interest); John C. Coffee, Jr., *'Pay-to-Play' Reform: What, How and Why?*, N.Y. L.J., May 21, 2009; Cox & Thomas, *supra* note 7, at 1611–13 (describing the pay-to-play practice in *Cendant*).

37. A search by Jim Cox and Randall Thomas for the sixteen law firms regularly engaged in shareholder litigation found that in six states three of the best-known law firms disclosed hiring lobbyists, including the law firms of Milberg Weiss, Abbey Gardy & Squitieri and Bernstein, Liebhard & Lifshiz. Cox & Thomas, *supra* note 7, at 1613–14; *see also* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 186–87 tbl.12 (2004) (listing the law firms bringing the largest number of Delaware complaints).

38. Cox & Thomas, *supra* note 7, at 1609; *see also* 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, 877–80 (2006) (noting the failure of mutual funds to participate as lead plaintiff in securities class actions). At the end of 2006, pension funds accounted for the largest block of institutional investor assets, public pension funds held an aggregate share of 10 percent of all U.S. stocks, and private pension funds held approximately 13.6 percent of the equity market. Barry B. Burr, *Institutional Investors Increase Ownership of U.S. Companies to an All-Time High*, PENSIONS & INVESTMENTS, Sept. 5, 2008, <http://www.pionline.com/article/20080905/REG/809049969>.

Law firms' courting process also involves "portfolio monitoring," where the law firm keeps abreast of the institution's holdings and notifies it whenever it suffers a significant enough loss that it could serve as the lead plaintiff in a related class action. Portfolio monitoring is a preexisting contractual relationship between the lead plaintiff and class counsel. Preexisting relationships typically give courts pause, particularly when counsel has no relationship with other class members and no subclassing exists.³⁹ But most courts find free portfolio monitoring in exchange for retaining the law firm unproblematic; they refuse to disqualify the lead plaintiff unless they find a stronger connection, like long-term friendships or familial relationships.⁴⁰

Although courts have been slow to recognize it, portfolio monitoring is both widespread and troubling.⁴¹ The few courts who agree reason that the practice "creates a clear incentive for [the law firm] to discover 'fraud' in the investments it monitors" and thereby "fosters the very tendencies toward lawyer-driven litigation that the PSLRA was designed to curtail."⁴² Plus, regularly depending on the same law firm makes it unlikely that institutions will bargain for

39. Samuel Issacharoff, *Class Action Conflicts*, 30 U.C. DAVIS L. REV. 805, 832–33 (1997) ("[T]here should be a strong presumption against class certification in any type of case in which there are preexisting contractual relationships between plaintiffs' counsel and one segment or section of the proposed class and no preexisting contractual relationship between the plaintiffs' counsel and another section of the class . . ."); see also *Amchem Prods. Inc. v. Windsor*, 521 U.S. 591, 626–27 (1997) (explaining the need for subclasses).

40. See *London v. Wal-Mart Stores, Inc.*, 340 F.3d 1246, 1253–55 (11th Cir. 2003) (finding the class representative inadequate based on an ongoing friendship and former business relationship with class counsel); *Susman v. Lincoln Am. Corp.*, 561 F.2d 86, 93–95 (7th Cir. 1977) (observing that class representatives may be inadequate when he may be "more interested in maximizing the 'return' to his counsel than in aggressively presenting the proposed class action"); *In re UTStarcom, Inc. Sec. Litig.*, No. C 04–04908 JW, 2010 WL 1945737, at *8 (N.D. Cal. May 12, 2010) (finding the class representative adequate despite its portfolio-monitoring agreement with class counsel); *In re Am. Italian Pasta Co. Sec. Litig.*, No. 05–0725–CV–W–ODS, 2007 WL 927745, at *4 (W.D. Mo. Mar. 26, 2007) (finding class representatives and class counsel were both adequate despite a "prior, long-standing relationship in which Class Counsel monitors Lead Plaintiff's investments and advises it of any litigation that may affect them"); *Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Sys., Inc.*, No. C 01–20418 JW, 2004 WL 5326262, at *4 (N.D. Cal. May 27, 2004) (finding the class representative adequate despite having a portfolio-monitoring agreement with Milberg Weiss and serving as lead plaintiff in three other cases at Milberg Weiss's request); *In re Discovery Zone Sec. Litig.*, 169 F.R.D. 104, 109 (N.D. Ill. 1996) (disqualifying two named plaintiffs as inadequate because the plaintiffs served as class counsels' personal stockbrokers).

41. As one plaintiffs' lawyer at Coughlin Stoia acknowledged, "this portfolio monitoring is not something that's unique to our firm." *Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing & Securitization, LLC*, 616 F. Supp. 2d 461, 465 (S.D.N.Y. 2009); see also *Institutional Investors: Portfolio Monitoring Program*, MILBERG LLP <http://www.milberg.com/practice/practicedetail.aspx?pgid=796> (last visited Apr. 3, 2011).

42. *Iron Workers Local No. 25 Pension Fund*, 616 F. Supp. 2d at 464.

lower attorneys' fees or monitor trusted counsel.⁴³ To be fair, some pension funds, such as MissPERS, use plaintiffs' firms for free investment monitoring, but rely on multiple law firms and guarantee none that it will be selected as lead counsel.⁴⁴ In some ways, portfolio monitoring is commendable—it encourages institutional investors to get involved, enforces substantive rights, and may uncover and deter fraud. But ongoing business relationships between the lead plaintiff and counsel appear improper, may cause counsel to maximize the institutional lead plaintiff's return to the class's detriment, and may encourage counsel to litigate in ways that establish favorable precedent for the institution.

When viewed from an adequacy-of-representation perspective, these law-firm-courting practices are less troubling if the institutional lead plaintiff's long and short-term interests align with the class. But that isn't the case. Ongoing relationships between institutions and class counsel—whether they result from portfolio monitoring, pay-to-play practices, or lobbying tactics—tempt class counsel to inadequately represent the class by favoring the lead-plaintiff institution over other class members, including other institutions and individual investors. And while other institutional investors receive individually tailored legal advice from rival plaintiff firms and opt out, most individual investors lack that luxury.

An institution's interest diverges from individual investors' interests in at least four predictable ways. These differences create intraclass conflicts and jeopardize class counsel's relationship with the class when counsel faithfully pursues the institutional lead plaintiff's preferences. First, institutions are more likely to trade in derivatives, which courts often overlook when calculating which putative lead plaintiff experienced the largest financial loss.⁴⁵ An institution may thus have a large voting stake in a defendant company without the risks of economic exposure, which means that it did not actually experience the largest financial loss.⁴⁶ Accordingly, it may not pursue the class action with the same vigor as a lead plaintiff that truly

43. See Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1529 (2006) (questioning “whether the lead plaintiff provision really encourages greater monitoring of plaintiff law firms” and asserting that institutions that rely on the same plaintiff law firms “are unlikely to negotiate vigorously with plaintiff law firms for lower fees”).

44. *Iron Workers Local No. 25 Pension Fund*, 616 F. Supp. 2d at 467 & n.3.

45. David H. Webber, *The Plight of the Individual Investor in Securities Class Actions* 20–23 (NYU Law & Econ. Research Paper Series No. 10–19, 2011), available at <http://ssrn.com/abstract=1601982>.

46. *Id.* at 23–24.

experienced the largest financial loss and may be subject to unique defenses in pressing the class's claims.⁴⁷

Second, institutions may still own stock in the defendant corporation, which means their interests align with the defendant's long-term financial well-being, whereas former shareholders want to recover as much as possible.⁴⁸ This preference affects whom institutions sue and the way they settle claims. For example, an institution that cares about the defendant's financial solvency may be more willing to target the individual officers and directors, whereas former shareholders care less about the source of compensation and more about the amount. Moreover, institutional lead plaintiffs only marginally increase settlement size and thus seem to view settlements as trade-offs, not as a means to maximize recovery.⁴⁹ On the upside, targeting the individual wrongdoers and exchanging large recoveries for corporate-governance reforms helps deter fraud through measures

47. *Id.* at 24, 27–29 (“[A]ppointment of an institutional class members [sic] as lead plaintiff carries the risk that they will not have the desired motivation to monitor class counsel because of hidden derivatives trading . . . as well as the risk that the institutions will be disqualified at the class certification stage because of unique defenses raised by this trading. It is a near certainty that the issue of whether the derivatives trader is typical and adequate will have to be litigated, which incurs costs for the class”); see also *Gluck v. Cellstar Corp.*, 976 F. Supp. 542 (N.D. Tex. 1997). When calculating the “largest financial interest,” some courts use a first-in, first-out accounting method, while others have used a last-in, first-out method. But under either method, courts focus on purchasing and selling common and preferred stock, not derivatives. *Webber*, *supra* note 45, at 22–26.

48. See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1503 (1996) (describing how, when it comes to damages, class members who are continuing shareholders have different economic interests than members who are former shareholders); Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 546 (1997) (“The litigation objectives of institutional investors may also differ from those of the individual investors in the class. Obviously an institution that continues to own stock is poorly suited to represent investors who are no longer invested in the company.”); R. Chris Heck, *Conflict and Aggregation: Appointing Institutional Investors as Sole Lead Plaintiffs Under the PSLRA*, 66 U. CHI. L. REV. 1199, 1211 (1999) (“Former stockholders have an incentive to claim as much recovery as possible, while present stockholders want to maximize the joint values of their recovery plus the value of the stock they still hold.”); cf. *In re Cendant Corp. Litig.*, 264 F.3d 201, 244 (3d Cir. 2001) (“[A]n institutional investor with enormous stakes in a company is highly unlikely to divest all of its holdings in that company, even after a securities class action is filed in which it is a class member.”); *In re Baan Co. Sec. Litig.*, 186 F.R.D. 214, 217–18 (D.D.C. 1999) (“[C]ounsel may assume that the interest of the class is to receive the maximum payment possible, even if such payment would threaten the Company’s ability to remain an ongoing concern. But the majority of the [class]—who have indicated that they are typical of the class—continue to hold their securities; their losses remain unrealized.”) (citation omitted); *Gluck*, 976 F. Supp. at 548 (appointing an institutional investor and reasoning that “[t]hough considering the long term interests of defendant companies might in some circumstances reduce the immediate damage payments to the plaintiff class[,] . . . it will also improve the chances that the company will experience future growth”).

49. *Cox & Thomas*, *supra* note 7, at 1636; see also *In re Cendant Corp.*, 264 F.3d at 227, 246 (3d Cir. 2001) (agreeing to the lead plaintiff’s request for corporate-governance changes).

like electoral accountability for directors, audit procedures, say-on-pay initiatives, and increased transparency.⁵⁰ Targeting the individual wrongdoers also avoids the circularity problem—that essentially investors are paying investors minus expensive transaction costs from the attorneys. The downside, however, is that if the institutional lead plaintiff focuses principally on corporate reforms as opposed to individual liability, then those reforms may have less punitive and deterrent effect. Plus, when institutions and former shareholders want fundamentally different remedies, it means that the lead plaintiff's interest conflicts squarely with those who want to maximize their recovery. Accordingly, a single lead plaintiff cannot adequately represent the entire class.⁵¹ Moreover, instituting corporate-governance reform through securities class actions circumvents democratic voting procedures and other established channels for shareholder reforms.⁵²

50. *Governance Reform Latest Settlement Bargaining Chip?*, COMPLIANCE WEEK, (Sept. 2, 2003), <http://www.complianceweek.com/pages/login.aspx?returl=/governance-reform-latest-settlement-bargaining-chip/article/182561/&pagetypeid=28&articleid=182561&accesslevel=2&expireddays=0&accessAndPrice=0> (“In most [shareholder litigation] cases, the agreements to undertake reform are in addition to financial payments, but in some—including Siebel Systems’ recent announcement that it would limit the stock options given to its directors and institute other checks and balances to settle a shareholder lawsuit filed by the Teachers’ Retirement System of Louisiana—the governance changes comprise the bulk of key settlement issues.”); Press Release, Milberg LLP, Milberg and Governance for Owners Unite to Promote Corporate Governance, available at http://www.milberg.com/files/tbl_s47Details/FileUpload265/469/GO-Milberg.pdf (“Milberg has often sought corporate governance enhancements as part of its litigation efforts.”); see also Taub Stephen, *First Backdating Lawsuit Ends in Whimper*, COMPLIANCE WEEK (Jan. 9, 2007), <http://www.complianceweek.com/pages/login.aspx?returl=/first-backdating-lawsuit-ends-in-whimper/article/184630/&pagetypeid=28&articleid=184630&accesslevel=2&expireddays=0&accessAndPrice=0> (noting that Lerach Coughlin, who represented CalPERS, was appointed the lead plaintiff in the options-backdating securities class-action suit against UnitedHealth and requested “non-monetary relief, including corporate-governance reform and forcing the corporate insiders to bear their own legal fees); Louis M. Thompson, Jr., *The Individual Investor: A Potential ‘Swing’ Voter*, COMPLIANCE WEEK (May 22, 2007), <http://www.complianceweek.com/pages/login.aspx?returl=/the-individual-investor-a-potential-swing-voter/article/184919/&pagetypeid=28&articleid=184919&accesslevel=2&expireddays=0&accessAndPrice=0> (describing “the growing role of activist institutional investors”).

51. Alexander, *supra* note 48, at 1505; Fisch, *supra* note 48, at 546; Heck, *supra* note 48, at 1211; see also Anthony Marchetta et al., *Corporate Reform Through Securities Class Action Settlements*, N.Y. L.J. (Sept. 21, 2007), <http://www.law.com/jsp/nylj/PubArticleNY.jsp?id=900005491591&slreturn=1&hblogin=1>; cf. *In re Cell Pathways, Inc. Sec. Litig.* II, 203 F.R.D. 189, 192 n.2 (E.D. Pa. 2001) (disqualifying two plaintiffs who “expressed a concern about the impact of the case on the company defendant”).

52. Marchetta et al., *supra* note 51 (arguing that seeking corporate-governance reform through litigation “circumvent[s] the channels through which shareholders properly may seek corporate governance changes”).

To date, court challenges along these lines have met with mixed success.⁵³ Despite the PSLRA's language that the lead plaintiff must satisfy Rule 23's requirements,⁵⁴ some courts claim that its preference for institutional investors trumps typicality and adequacy and that balancing damages with corporate-governance reforms during settlement is economically sound and beneficial for most investors.⁵⁵ Other courts recognize that conflict exists, but encourage former shareholders to file a separate action.⁵⁶

Third, the behavioral economics literature suggests that decisionmakers are more willing risk takers when less money is at stake.⁵⁷ This so-called "peanuts effect," where people take risks when playing for "peanuts," suggests that investors with less at stake in a securities class action will be less risk averse when litigating.⁵⁸ In other words, a small stakeholder is apt to litigate toward trial rather than to settle.

But who counts as a "small stakeholder" in any given securities class action and what counts as "peanuts" to any claimant depends on how much money is at stake vis-à-vis a claimant's overall wealth. What amounts to peanuts to a corporation where the recovery is a fractional percentage of its overall portfolio could be an individual investor's life savings. For instance, in one recent study, pension funds reported recovering an average of \$6.75 million a year from shareholder litigation, but that constituted on average only 0.035% of

53. *Compare In re Gemstar-TV Guide Int'l Sec. Litig.*, 209 F.R.D. 447, 453 (C.D. Cal. 2002) (declining to find a conflict between selling and holding plaintiffs), *with In re Cendant Corp.*, 264 F.3d at 244 (noting the conflict between holding and selling plaintiffs, but finding that "Congress must have thought that the situation present here does not inherently create an unacceptable conflict of interest.").

54. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(cc) (2006); *see also* *Hevesi v. Citigroup, Inc.*, 366 F.3d 70, 83 (2d Cir. 2004) ("[T]here is no reason to believe that the PSLRA altered the preexisting standard by which class representatives are evaluated under Rule 23."); H.R. REP. NO. 104-369, at 34 (1995) (Conf. Rep.) ("The provisions of the bill 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.").

55. *See, e.g.*, *Gluck v. CellStar Corp.*, 976 F. Supp. 542, 548 (N.D. Tex. 1997).

56. *See, e.g.*, *In re Party City Sec. Litig.*, 189 F.R.D. 91, 111-12 (D.N.J. 1999).

57. Harry Markowitz, *The Utility of Wealth*, 60 J. POL. ECON. 151, 151 (1952); Drazen Prelec & George Loewenstein, *Decision Making over Time and Under Uncertainty: A Common Approach*, 37 MGMT. SCI. 770, 770 (1991); Bethany J. Weber & Gretchen B. Chapman, *Playing for Peanuts: Why Is Risk Seeking More Common for Low-Stakes Gambles?*, 97 ORG. BEHAV. & HUM. DECISION PROCESSES 31, 31-33 (2005).

58. *See* Michael Gousgounis, *Association-Driven Aggregate Litigation: Peanuts Effect and Democratization of Litigation Governance 5* (May 1, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1469046>.

each fund's total assets.⁵⁹ Because most individual investors hold underdiversified portfolios, they are likely to be more risk averse since they have more at stake overall.⁶⁰ Accordingly, in any given securities class action, if the plaintiff with the largest claim faces less loss vis-à-vis its overall wealth, then it is more likely to take risks even though a smaller shareholder with her lifesavings at stake would prefer to settle.

Fourth, because institutional investors hold heavily diversified portfolios, they may rationally think that, over time, fraud is just as likely to benefit as it is to harm them.⁶¹ On any given day, the institution may be in the plaintiff class suing the defendant corporation or in the shareholder group bearing the brunt of settlement costs.⁶² Thus, there is less incentive to incur transactional costs from protracted litigation or from monitoring the attorneys.

2. Due Process Concerns

It is not a huge leap to suggest that systemic incentives encourage institutional lead plaintiffs to inadequately represent the class. Still, whether these conflicts amount to inadequate representation depends on how we define “interests” and “conflicts,” two concepts that remain doctrinally muddled despite prolific academic commentary.⁶³ The way in which we approach these terms

59. Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 333 (2008) (“There is considerable variation in fund recoveries, ranging from 0.209% of fund assets down to 0.003% of assets. . . . [F]or many funds, it remains an open question as to whether litigation recoveries are economically significant.”).

60. Brad M. Barber & Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 J. FIN. 773, 778 (2000) (noting that typical individual investors have portfolios with only four stocks); William N. Goetzmann & Alok Kumar, *Equity Portfolio Diversification*, 12 REV. FIN. 433, 433–34, 444, 460 (2008) (finding that “on average, individual investors hold underdiversified portfolios” with an average number of between four and seven stocks, and that under-diversification is greater in retirement accounts). The Goetzmann and Kumar study accounted for mutual funds and found that mutual fund holders had a better-diversified portfolio. *Id.* at 435. An earlier 1995 article, which used data from 1983, reported that that “[t]he median US stockholder holds a single publicly traded stock.” Morgan Kelly, *All Their Eggs in One Basket: Portfolio Diversification of US Households*, 27 J. ECON. BEHAV. & ORG. 87, 88 (1995). The recent economic downturn is making small investors even more cautious. Graham Bowley, *In Striking Shift, Small Investors Flee Stock Market*, N.Y. TIMES, Aug. 22, 2010, at A1.

61. Fisch, *supra* note 48, at 546.

62. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1538, 1556 (2006).

63. For various academic proposals on addressing adequate representation in the face of conflicting interests, see, for example, Samuel Issacharoff & Richard A. Nagareda, *Class Settlements Under Attack*, 156 U. PA. L. REV. 1649, 1677–97 (2008); Geoffrey P. Miller, *Conflicts*

likewise depends on which model we employ to frame the relationship between class members and their representative. This Section explores three models—the Kalven-Rosenfield model, the corporate-law model, and the governance model—and the ways in which they incorporate “interests” and “conflicts.” By unleashing these terms from the models to which they are tied and importing the courts’ current use of “interests” into the governance model, judges can continue to certify classes by broadly defining interests, but can safeguard procedural due process by appointing adequate lead plaintiffs.

In their seminal article, *The Contemporary Function of the Class Suit*, Harry Kalven and Maurice Rosenfield provided one of the first modern models for understanding the class’s relationship to its representative.⁶⁴ They view privately enforcing securities laws as an outcropping of or complement to the SEC’s administrative body.⁶⁵ As such, they implicitly adopted a broad definition of interests.⁶⁶ As Steve Yeazell explains it, the Kalven-Rosenfield view essentially wedded two ideas: “First, it embraces the interest definition of the class, requiring no more than an (assumedly) shared interest in recouping losses. Second, it links that concept of the interest class not to any particular social group but to the general task of law enforcement.”⁶⁷ The difficulty here, however, is in finding any meaningful line that separates the interests of the class representative and the class, on one hand, from the public at large, on the other. Still, in 1941, plaintiffs opted into rather than out of class actions and thus consented to the representation. This counterbalanced an expansive view of when someone could represent another’s interest.⁶⁸ According to the Kalven-Rosenfield view, the divide between institutions and individual investors is less troubling—both have a basic interest in recovering their losses and enforcing substantive rights.⁶⁹

of Interest in Class Action Litigation: An Inquiry into the Appropriate Standard, 2003 U. CHI. LEGAL F. 581, 582 (suggesting that “a conflict of interest should be deemed impermissible if a reasonable plaintiff, operating under a veil of ignorance as to his or her role in the class, would refuse to consent to the arrangement”); Richard A. Nagareda, *Administering Adequacy in Class Representation*, 82 TEX. L. REV. 287, 318–24 (2003); Tidmarsh, *supra* note 25, at 1137.

64. Kalven & Rosenfield, *supra* note 15, at 686–88, 699.

65. *Id.* at 687.

66. *Id.* at 691–93, 699.

67. STEPHEN C. YEAZELL, FROM MEDIEVAL GROUP LITIGATION TO THE MODERN CLASS ACTION 232 (1987).

68. Kalven & Rosenfield, *supra* note 15, at 692–94, 694 n.33, 711.

69. *Id.* at 710, 717–19. One commentator has argued that adequate representation should not be a concern so long as class members are not made worse off than they would have been by individually controlling their cases. Tidmarsh, *supra* note 25, at 1151–58 (2009). In response, I have argued that this may create problems of its own, including questions about procedural legitimacy. Elizabeth Chamblee Burch, *Procedural Adequacy*, 88 TEX. L. REV. 55, 58 (2010).

The absence of actual consent and today's iteration of Rule 23(b)(3) as an opt-out class has necessitated a more robust identity of interests between the representative and the represented. These changes have likewise reframed the ways in which we view the representative's relationship with the represented in both economic and governance terms.

The private, corporate-law model, as developed principally by John Coffee, casts the relationship between the class members and their representatives as one between the principals (the class members) and the agents (the attorney and class representative).⁷⁰ In particular, it views the class members' relationship to their agents as a fundamental problem inherent in the separation of ownership and control.⁷¹ When owners employ managers to control their assets, as in the shareholder-director relationship, the managers may lack the incentive to maximize the owners' assets. Actors within securities class actions are subject to the same economic pressures: the attorneys act as financiers, but the class members truly own the claim.

The public, governance model, as articulated by Sam Issacharoff and Richard Nagareda, views the class member-class representative relationship as one between the representatives, or governors, and the members, the governed.⁷² Although this model encompasses the problem of aligning principals' and agents' incentives, the focus is on the institutional arrangement's legitimacy. Just as a government's legitimacy rests on "the ability to curb oppressive, abusive, or self-serving behavior that may emerge from within the newly created governing class," the class action serves in part to tax the individual class members and appoint an agent on their behalf.⁷³ Recognizing the need for an agent, however, tells us little about whether that agent acts properly or whether we should presume that the agent's actions are legitimate.⁷⁴ Thus, as in the principal-agent relationship in the corporate-law model, the interests between the representative and represented must align. But, depending on the governance arrangement, what legitimizes the

70. See, e.g., John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370 (2000); John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987). Samuel Issacharoff has also applied the labels "exit", "voice", and "loyalty" to the class context. Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions*, 1999 SUP. CT. REV. 337, 366.

71. PRINCIPLES, *supra* note 34, § 1.04 cmt. b.

72. See, e.g., Issacharoff, *supra* note 70, at 338–40; Richard A. Nagareda, *Class Actions in the Administrative State: Kalven and Rosenfield Revisited*, 75 U. CHI. L. REV. 603, 635–39 (2008).

73. Issacharoff, *supra* note 70, at 339.

74. *Id.* at 340.

representative's actions on behalf of the governed shifts between loyalty through adequate representation, exit through opt-out opportunities, and voice through opportunities to be heard.⁷⁵

Using the governance model as its template, the American Law Institute's *Principles of the Law of Aggregate Litigation* suggests that structural conflicts endanger adequate representation.⁷⁶ Although eliminating every conflict is impossible, adequate representation protects against conflicts "that would present a significant risk that the lawyers for claimants might skew systematically the conduct of the litigation so as to favor some claimants over others on grounds aside from reasoned evaluation of their respective claims or to disfavor claimants generally vis-à-vis the lawyers themselves."⁷⁷ In this vein, courts should pay "particular attention to conflicts with a significant potential to skew the conduct of settlement negotiations" and to "the alignment between the economic interests of claimants and their lawyers"⁷⁸

From a structural conflicts-of-interest perspective, an institutional lead plaintiff acting self-interestedly, as Rule 23(a) assumes it will, may inadequately represent the class. As Sam Issacharoff explains, "When agents have external loyalties, such that they will profit off satellite dealings with the defendant, there is no basis for trusting their stewardship."⁷⁹ Public and union pension funds, the most likely institutional lead plaintiffs, may select class counsel based on less transparent influences—portfolio-monitoring agreements, lobbyists, or pay-to-play practices.⁸⁰ Because the lead plaintiff typically selects class counsel,⁸¹ once selected, counsel has nearly every incentive to placate the institution in exchange for repeat business. But counsel has few incentives to loyally represent the rest

75. See Nagareda, *supra* note 72, at 638.

76. PRINCIPLES, *supra* note 34, §§ 1.05, 2.07(a). Samuel Issacharoff was the reporter on the project, and Robert Klonoff, Richard Nagareda, and Charles Silver served as associate reporters.

77. *Id.* § 2.07(a)(1)(B).

78. *Id.* § 2.07 cmt. d.

79. See Issacharoff, *supra* note 70, at 381.

80. Pension funds may also have fiduciary duties under the Employee Retirement Income Security Act ("ERISA") that could affect or differ from their lead-plaintiff responsibilities. See Craig C. Martin & Matthew H. Metcalf, *The Fiduciary Duties of Institutional Investors in Securities Litigation*, 56 BUS. LAW. 1381, 1404–09 (2001).

81. 15 U.S.C. § 77z-1(a)(3)(B)(v) (2006); see also § 78u-4(a)(3)(B)(v) ("The most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class."); *In re Cendant Corp. Litig.*, 264 F.3d 201, 274 (3d Cir. 2001) ("[T]he court should generally employ a deferential standard in reviewing the lead plaintiff's choices [of counsel]."); *In re Flight Safety Tech., Inc. Sec. Litig.*, 231 F.R.D. 124, 132 (D. Conn. 2005) ("Lead plaintiffs have the discretion to retain counsel of their choice to represent the class, subject to court approval.")

of the class and even fewer incentives to point out rifts between class members that would require subclassing and separate representation.

Yet, when modern-day courts consider the typicality and adequacy requirements in securities class actions, they tend to adopt a view more akin to Kalven and Rosenfield's than the ALI's. For example, in discussing securities cases, a leading treatise on the subject summarizes judges' inquiries in Kalven-Rosenfield terms: "[T]ypicality may be met when the named plaintiff and class members have sustained monetary injury from the defendant's conduct and seek to recover damages for losses . . . which affect all class members, despite individual differences."⁸²

Although broadly defining interests allows courts to certify securities classes, it disregards the PSLRA's directive to take the governance model one step further. The lead-plaintiff appointment process directs judges to incorporate class members with significant financial interests into class governance, thereby giving voice to the governed. Thus, in securities class actions, the institutional arrangement's legitimacy—at least for individual investors—hinges on voice and loyalty. (As explained momentarily, opting out is unrealistic for noninstitutional investors without individualized legal advice.⁸³)

Absent typical claims and similar interests, the voice and loyalty rights that authorize the securities class action's institutional arrangement collapse. The judge, of course, is the one who determines typicality and adequacy. As such, judges are the only gatekeepers standing between the self-nominated, self-interested would-be class representative and the governed. But when judges broadly define interests in both certifying the class and in appointing the lead plaintiff, they miss the importance of their role in incorporating qualified putative class members into class governance.

82. NEWBERG ON CLASS ACTIONS § 22:24 (4th ed. 2002 & Supp. 2010); *see also* Endo v. Albertine, 147 F.R.D. 164, 167–68 (N.D. Ill. 1993). Likewise, in their seminal work that led to Congress passing the PSLRA, Elliott Weiss and John Beckerman devoted little attention to potential conflicts of interest between institutions and the remaining class members. 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, 2109 (1995) (“In class actions in which institutional investors serve as lead plaintiffs, questions relating to typicality rarely should arise.”); *see also* S. REP. NO. 104–98, at 11 n.32 (observing that Weiss and Beckerman’s article “provided the basis for the ‘most adequate plaintiff’ provision”); Choi et al., *supra* note 38, at 879 (“Weiss and Beckerman devoted relatively little attention to exploring the ways in which institutional investors’ interests might diverge from those of the rest of the class.”).

83. *See infra* Part I.C.

C. The Opt-Out Trend

Given the potential intraclass conflicts, it's no surprise that plaintiffs opt out of securities class actions. But the opt outs generally do not include those most prejudiced by an inadequate representative—the individual investors. Instead, institutions opt out.⁸⁴ One 2008 survey of pension funds reported that sixty percent of its respondents pursued individual lawsuits instead of remaining in the class.⁸⁵ Those who opted out cited various reasons for doing so, such as maximizing their recovery, pursuing additional claims, controlling litigation strategy and settlement, suing in a preferred (often state-court) forum, leveraging their position to demand corporate-governance changes, and receiving settlement funds quickly.⁸⁶ Put simply, institutions prefer to procedurally control their claims and attorneys—they want autonomy. Further distilled, though they may not fear “inadequate” representation, they want the best representation possible where their attorney faithfully and diligently works to achieve their desired outcome.⁸⁷

Opting out as a large institution makes perfect sense given the class action's historical purpose. Rule 23(b)(3) class actions are designed to serve clients with small-stakes claims or—where cases are economically viable but difficult to litigate effectively on an individual basis—to amass claims and thereby create a credible threat. For instance, as a 1937 SEC report explained, “The wide diffusion of securities has created a situation where the single and isolated security holder usually is helpless in protecting his own interests or

84. See Coffee, *supra* note 35, at 416–17.

85. Choi & Fisch, *supra* note 59, at 331–32.

86. BLAIR A. NICHOLAS & IAN D. BERG, WHY INSTITUTIONAL INVESTORS OPT-OUT OF SECURITIES FRAUD CLASS ACTIONS AND PURSUE DIRECT INDIVIDUAL ACTIONS 4–6, available at http://www.blbgilaw.com/news/publications/data/00113/_res/id=sa_File1/PLIreprint7_22_09#2.pdf; Choi & Fisch, *supra* note 59, at 331–32; Josh Gerstein, *Investors Opt Out of Time Warner Class Action Suit*, N.Y. SUN, Feb. 8, 2006, at 5. Opt-outs have fared better in several high-profile lawsuits. See, e.g., Josh Gerstein, *Time Warner Case Finds a Surprise*, N.Y. SUN, Dec. 7, 2006, at 1 (describing the AOL Time Warner opt-outs); Kevin LaCroix, *Opt-Outs: A Worrisome Trend in Securities Class Action Litigation*, OAKBRIDGE INSIGHTS, Apr. 2007, at 1, 1, 3 (describing opt-outs in the WorldCom litigation). When plaintiffs opt out and sue either on their own or in consolidated proceedings with fewer than fifty plaintiffs, they can avoid the Securities Litigation Uniform Standards Act (SLUSA), which applies only to proceedings with class allegations or fifty or more plaintiffs. If they opt out after a class-action settlement, then SLUSA's stay no longer applies. 15 U.S.C. § 78u-4(b)(3)(D); see also Coffee, *supra* note 35, at 430–31 (explaining how opt-outs can avoid federal restraints and move to a more favorable state-court forum).

87. See Burch, *supra* note 69, at 60.

pleading his own cause.”⁸⁸ Absent the class vehicle to overcome collective-action problems, the wrongdoer may go scot-free and be undeterred from committing future fraud.

But here’s the thing: as times have changed, so has institutional ownership in the equities market. In 1966, when the Advisory Committee drafted Rule 23 in its modern form, household investors owned 83 percent of U.S. equities and institutions owned only 17 percent; in 1995, when Congress enacted the PSLRA, household investors owned 49.2 percent and institutions owned 50.8 percent.⁸⁹ Household investors’ equity ownership continues to decline. In 2008, they accounted for only 36.2 percent of U.S. equity holdings, whereas institutions held 63.8 percent.⁹⁰

From these statistics, one might wonder why institutions use an outdated class vehicle at all; why not initiate their own lawsuit instead of remaining in the class and then opting out? In part, the answer is tied to competitive plaintiffs’ attorneys. Plaintiffs’ attorneys work for contingent fees and the larger their client base, the greater their fee. Or, if the judge does not select their pension fund as the lead plaintiff, then waiting to opt that fund out of the class after the defendant proposes a settlement means class counsel will have already done much of work for them. Even if the opt-out’s attorney lacks access to the behind-the-scenes information, litigating is a safer gamble once the class attorneys shepherd it successfully through the pretrial process. The other part of the answer is that institutions persist with class actions only until discovering that the proposed settlement is undesirable—the payout is too low or it fails to include their preferred remedy. Only then does it make sense for the institution to leave the pack’s relative safety and opt out.

The problem is, opting out is a true option only for institutions and the special few receiving individual legal advice. Opting out systematically disadvantages smaller, individual investors. They’re faced with a Hobson’s Choice: theoretically, they could opt out, but doing so is not a realistic option; or, they could remain in the class where the lead-plaintiff institution chases its own interests, lead counsel conspires with the lead plaintiff, the judge prefers to settle, and the defendant disproportionately reduces the class’s share to pay

88. SEC. & EXCH. COMM’N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART II, at 1 (1937).

89. SEC. INDUS. ASS’N, SECURITIES INDUSTRY FACT BOOK 66 (2001). Household investors include individuals and households of individuals. *Id.*

90. J. WILLIAM HICKS, INTERNATIONAL DIMENSIONS OF U.S. SECURITIES LAW § 2:29 (2009) (citing SEC. INDUS. ASS’N, *supra* note 89, at 65).

off or prevent the opt outs. What's more, when institutions opt out they eliminate a would-be objector's dissenting voice and add to the probability that the small investor—the one the class vehicle was meant to protect—will be inadequately represented. Plus, because larger institutions create a credible threat against the defendant and are more likely to opt out, as the savvy defendant pursues finality, it is likely to skew its settlement offer in the institutions' favor and further prejudice the rest of the class.

II. LEAD-PLAINTIFF GROUPS

What then is a court to do? Courts could define “interests” in ALI terms across the board, but that would make it more difficult to certify a securities class, which would, in turn, undermine private enforcement's deterrent effect.⁹¹ Or courts could subclass based on different interests. But, while subclassing would alleviate the adequate-representation problem, it may undermine the subclass's settlement leverage. Divorcing noninstitutional investors from the institutions that typically hold large stakes could drastically weaken individual investors' credible threat against the defendant. And suggesting that individual investors opt out of the class vehicle that was designed for their very situation is equally implausible. The most pragmatic solution, as Part III explores, is to keep with current doctrine and define “interests” in Kalven-Rosenfield terms when certifying the class, but to understand the judge's role in appointing lead plaintiffs as one that incorporates qualified representatives into class governance.

Appointing a lead-plaintiff group with members who represent the class's diverse interests could alleviate systemic conflicts of interest and the due process problems they create. But lead-plaintiff groups have long been criticized as poor attorney monitors. Since Congress passed the PSLRA, courts and commentators have taken assorted and conflicting positions on the merits of designating multiple institutions or individuals as the lead plaintiff.

This tension comes, in part, from Milberg Weiss's early strategy to maintain its market dominance post-PSLRA. While many

91. As I've elaborated elsewhere, private enforcement through securities class actions furthers regulatory goals. Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 69 (2008) (explaining how securities class actions generate positive spillovers). *But see* Amanda M. Rose, *The Multi-enforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2176 (2010) (suggesting that multiple enforcers, including private enforcement actions, do not make sense from a deterrence perspective).

plaintiffs' law firms developed close relationships with pension funds (a strategy that caused its own conflicts), Milberg Weiss relied on the PSLRA's presumption that the "most adequate plaintiff" is "the person or *group* of persons that . . . has the largest financial interest"⁹² It cobbled together as many plaintiffs as it took to achieve the largest financial interest.⁹³ These large and unwieldy aggregations, however, did little to further Congress's goal of reinstating client control, instilling a viable check on plaintiffs' attorneys, or dislodging Milberg Weiss's near monopoly. When Congress passed the PSLRA, one of its most notable targets was Bill Lerach (then a named partner in Milberg, Weiss, Bershad, Hynes & Lerach), who famously said, "I have the greatest practice of law in the world . . . I have no clients."⁹⁴ Not surprisingly then, academics and the SEC opposed Milberg Weiss's large aggregations and denounced them as inconsistent with congressional intent.⁹⁵

Despite early efforts to thwart lead-plaintiff groups, courts have gradually embraced smaller groups, at least where they demonstrate cohesiveness and an ability to control class counsel. Academics, however, remain skeptical. Empirical evidence measuring settlement size and attorneys' fees demonstrates that lead-plaintiff groups tend not to perform well on either front.⁹⁶ Thus, to better understand why and under what circumstances courts select groups and to develop a working hypothesis about why groups have performed poorly, this Part begins by teasing out the criteria courts use to appoint groups including group size, members' relationship, and group cohesion. Next, it examines whether groups form from a competitive lead-plaintiff process and how they make decisions. It then reevaluates conventional academic criticisms and uses the social science literature on group decisionmaking to offer an alternative and more likely rationale for underperformance—group polarization and confirmation bias. As it turns out, group cohesion and homogeneity—

92. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2006) (emphasis added); *see also* 15 U.S.C. § 78u-4(a)(3)(B)(i) (the court "shall appoint as lead plaintiff the member or members of the purported plaintiff class . . .").

93. Coffee, *supra* note 35, at 415.

94. S. REP. NO. 104-98, at 6 & n.8 (1995) (citing William P. Barrett, *I Have No Clients*, FORBES, Oct. 11, 1993, at 52 (quoting William Lerach)).

95. *See, e.g.*, Brief for Securities & Exchange Comm'n. as Amici Curiae, *Switzenbaum v. Orbital Sci. Corp.*, 187 F.R.D. 246 (E.D. Va. May 18, 1998) (No. 99-197-A), *available at* <http://www.sec.gov/litigation/briefs/orbital.htm>; Fisch, *supra* note 35, at 69 ("Aggregation is inconsistent with the client empowerment objective of the PSLRA and is unsupported by the legislative history.").

96. *See infra* notes 169-81 and accompanying text.

traits courts wholeheartedly embrace in selecting groups—exacerbate these conditions.

A. Court-Appointed Groups: The Lure of Homogeneity and Cohesion

Although courts and commentators refer to “lead-plaintiff groups” generically, group performance varies based on (1) whether the group forms from a competitive lead-plaintiff selection process and (2) the type of group members (individual investors,⁹⁷ institutions,⁹⁸ or a combination⁹⁹). Not all groups are created equal. In a comprehensive study of lead plaintiffs and agency costs, Stephen Choi examined lead plaintiffs’ pretrial motions from 2003 to 2005 and found that “groups that form where competition continues to exist for lead-plaintiff status correlate with a significant increase in attorney hours (and thus lower agency costs) compared with non-aggregating lead plaintiffs.”¹⁰⁰ Lead-plaintiff groups comprised solely of individual investors did not significantly affect the number of attorney hours and thus did not decrease agency costs, but groups that included institutional investors “correlate[d] with significantly lower attorney agency costs.”¹⁰¹ Interestingly, appointing labor union pension funds did not correlate

97. See, e.g., *In re Ribozyme Pharms., Inc. Sec. Litig.*, 192 F.R.D. 656, 660–62 (D. Colo. 2000) (appointing five private investors); *In re Nice Sys. Sec. Litig.*, 188 F.R.D. 206, 220–21 (D.N.J. 1999) (appointing five individual investors); *In re Advanced Tissue Scis. Sec. Litig.*, 184 F.R.D. 346, 351–53 (S.D. Cal. 1998) (appointing six individual investors).

98. See, e.g., *Reimer v. Ambac Fin. Group, Inc.*, No. 08 Civ. 411(NRB), 2008 WL 2073931, at *3 (S.D.N.Y. May 9, 2008) (appointing a group of three public pension funds); *City of Brockton Ret. Sys. v. Shaw Group, Inc.*, 2007 U.S. Dist. LEXIS 72745, at *10–14 (S.D.N.Y. Sept. 25, 2007) (appointing two institutional investors); *In re Bank One S’holders Class Actions*, 96 F. Supp. 2d 780, 783 (N.D. Ill. 2000) (appointing a group of six institutional investors); *Local 144 Nursing Home Pension Fund v. Honeywell Int’l, Inc.*, No. 00–3605 (DRD), 2000 WL 33173017, at *4–5 (D.N.J. Nov. 16, 2000) (appointing a group comprised of five institutional investors); *Switzenbaum*, 187 F.R.D. at 250–51 (appointing five pension funds); *In re Cendant Corp. Litig.*, 182 F.R.D. 144, 147, 149–50 (D.N.J. 1998) (appointing three state retirement funds, except for the claim where they had a conflict of interest).

99. See, e.g., *In re Host Am. Corp. Sec. Litig.*, 236 F.R.D. 102, 105–06 (D. Conn. 2006) (appointing a group that consisted of a broker-dealer/hedge fund and two individual investors and noting that the group composition would “provid[e] a diversity of representation reflective of the makeup of the class as a whole”); *In re Flight Safety Tech., Inc. Sec. Litig.*, 231 F.R.D. 124, 131–33 (D. Conn. 2005) (appointing one individual and one institutional investor, represented by two law firms); *In re MicroStrategy, Inc. Sec. Litig.*, 110 F. Supp. 2d 427, 438–39 (E.D. Va. 2000) (appointing one institutional and one individual investor); *In re Oxford Health Plans, Inc. Sec. Litig.*, 182 F.R.D. 42, 45 (S.D.N.Y. 1998) (appointing a pension fund, three individual investors, and an institutional investor).

100. Stephen J. Choi, *Motions for Lead Plaintiff in Securities Class Actions* 27 (N.Y.U. Law & Econ. Research Paper No. 08–53, June 2009), available at <http://ssrn.com/abstract=1293926>.

101. *Id.* at 27–28, 36.

with lower agency costs,¹⁰² which suggests that some of the same practices causing conflicts of interest—such as portfolio-monitoring agreements and pay-to-play practices—may affect pension funds' monitoring abilities.

1. Courts' Criteria

Courts' willingness to designate groups as lead plaintiffs ranges from skeptical to accepting. Earlier commentators situated courts' opinions into three categories: (1) those that liberally appoint groups of unrelated investors;¹⁰³ (2) those that allow aggregation but limit the size;¹⁰⁴ and (3) those that select only closely knit groups or refuse to appoint groups at all.¹⁰⁵ But in the past ten years, most courts have moved away from the extremes and allow some aggregation.

Given this shift, what was formerly the second category is now best viewed as two rough categories. In the first category, courts appoint groups of unrelated investors so long as there is no bad faith in forming the group.¹⁰⁶ These courts employ a "rule of reason" test, where they assess the group's ability to represent the class's interests and determine whether the group furthers or inhibits lawyer-driven litigation.¹⁰⁷ Using this rationale, a court might reject a group that tries to bootstrap members to the group at the last minute, but accept groups formed in good faith before the filing deadline even absent a relationship that predates the litigation.¹⁰⁸ The second "middle"

102. *Id.* at 36.

103. *See, e.g., In re Advanced Tissue Scis. Sec. Litig.*, 184 F.R.D. 346, 352–53 (S.D. Cal. 1998) (appointing six out of 250 unrelated individual investors in the McKitty Group).

104. *See, e.g., In re Baan Co. Sec. Litig.*, 186 F.R.D. 214, 217–18 (D.D.C. 1999) (narrowing the proposed group from twenty to three); *In re Reliance Acceptance Grp.*, 1998 WL 388260, at *1 n.3, *3 n.11 (W.D. Tex. 1998) (approving a motion that six members of a larger class of sixty-one be appointed to serve as lead plaintiffs).

105. *See, e.g., Goldberger v. Pxre Grp., Ltd.*, No. 06–CV–3410 (KMK), 2007 WL 980417, at *4 (S.D.N.Y. Mar. 30, 2007); *In re Veeco Instruments, Inc. Sec. Litig.*, 233 F.R.D. 330, 334 (S.D.N.Y. 2005) ("Courts (including this one) view such aggregations of individual shareholders with disapproval."); *Aronson v. McKesson HBOC, Inc.*, 79 F. Supp. 2d 1146, 1153 (N.D. Cal. 1999) (refusing to aggregate unrelated plaintiffs); *In re Donnkenny Inc. Sec. Litig.*, 171 F.R.D. 156, 157–58 (S.D.N.Y. 1997) (holding that unrelated investors cannot be considered a "group of persons"). For views from earlier commentators, see Fisch, *supra* note 35, at 65–69; Heck, *supra* note 48, at 1214–16.

106. *See, e.g., Barnet v. Elan Corp.*, 236 F.R.D. 158, 162 (S.D.N.Y. 2005) (noting that there was no evidence of a group forming in bad faith).

107. *See, e.g., id.*

108. *See, e.g., Switzenbaum v. Orbital Sci. Corp.*, 187 F.R.D. 246, 250 (E.D. Va. 1999) (refusing to appoint a group that was not forthcoming about conflicts and attempted to bootstrap members in and out of its leadership).

category includes courts that are willing to select lead-plaintiff groups that demonstrate cohesiveness—some require a preexisting relationship, but most are willing to appoint unrelated members.¹⁰⁹ These courts use a “case-by-case” analysis and prefer groups who outline plans for coordination and decisionmaking and demonstrate control over their attorneys.¹¹⁰ Thus, courts tend to fall along the following spectrum:

| <i>Broad interpretation of “groups”</i> | | <i>Narrow interpretation of “groups”</i> | | |
|---|---|--|--|--|
| ← | | → | | |
| Permit joinder and appointment of unrelated group members ¹¹¹ | Appoint groups with the largest financial interest so long as no bad faith exists ¹¹² | Appoint groups demonstrating cohesiveness even when group formation does not predate the litigation ¹¹³ | Appoint only close-knit groups with preexisting relationships ¹¹⁴ | Refusal to appoint groups ¹¹⁵ |

109. See *In re Versata, Inc. Sec. Litig.*, No. C 01-1439 SI, 2001 WL 34012374, at *5 (N.D. Cal. Aug. 20, 2001) (finding that a prelitigation relationship requirement is too rigid because “[t]he beneficial characteristics sought in a group with a preexisting relationship-cohesiveness, an ability to direct litigation, and collective confluence with the interests of the class can be found in unrelated groups on a case-by-case basis”).

110. See, e.g., *Crawford v. Onyx Software Corp.*, No. C01-1346L, 2002 WL 356760, at *2 (W.D. Wash. Jan. 10, 2002) (refusing to appoint a group of three individual investors who could not coordinate their actions to control their lawyer); *In re MicroStrategy Sec. Litig.*, 110 F. Supp. 2d 427, 435 (E.D. Va. 2000) (using a case-by-case approach because it allowed maximum flexibility to best represent the interests of the class).

111. See, e.g., *In re Advanced Tissue Scis. Sec. Litig.*, 184 F.R.D. 346, 347 (S.D. Cal. 1998) (appointing six out of 250 unrelated individual investors in the McKitty Group).

112. See, e.g., *Barnet v. Elan Corp., PLC*, 236 F.R.D. 158, 162-63 (S.D.N.Y. 2005) (appointing a group of five institutions and one individual with no preexisting relationship).

113. See, e.g., *Eichenholtz v. Verifone Holdings, Inc.*, No. C 07-06140 MHP, 2008 WL 3925289, at *8 (N.D. Cal. Aug. 22, 2008) (“[T]he court also finds that a pre-existing relationship between entities that comprise a group is not required if the resulting group is small and cohesive enough such that it can adequately control and oversee the litigation.”); *Yousefi v. Lockheed Martin*, 70 F. Supp. 2d 1061, 1068 (C.D. Cal. 1999) (appointing a small group of unrelated plaintiffs).

114. See, e.g., *In re Waste Mgmt., Inc.*, 128 F. Supp. 2d 401, 413 (S.D. Tex. 2000) (“[A] small group with the largest financial interest in the outcome of the litigation and a pre-litigation relationship based on more than their losing investment, satisfies the terms of the PSLRA and serves the purpose behind its enactment.”); *In re E.Spire Comm’n, Inc., Sec. Litig.*, 231 F.R.D. 207, 213 (D. Md. 2000) (“Had the Matassa Group been able to show that its members had a relationship with each other based upon factors independent of this class action, there would then be more support for their argument that they should be presumed to be the most adequate

The courts willing to appoint groups consider the following factors and rationales, but weigh them differently.

Size.—On the whole, courts prefer smaller groups and principally reject larger ones as inconsistent with the PSLRA's intent.¹¹⁶ The larger the group, the less members are able to exert control.¹¹⁷ Conversely, smaller groups more effectively manage the litigation and lawyers.¹¹⁸ The SEC, for example, has opined that groups between three and five members are acceptable because the “group is small enough to be capable of effectively managing the litigation and the lawyers,” to “facilitate joint decisionmaking,” and to “assure that each group member has a sufficiently large stake in the litigation.”¹¹⁹ Not all courts strictly adhere to this recommendation; some simply want to ensure that the group is not too unwieldy to manage the litigation.¹²⁰

Members' Relationship.—Some courts care whether the proposed group members are related or unrelated, with some

lead plaintiff. However, they have failed to show that they are a ‘cohesive group,’ foreclosing their appointment as the most adequate lead plaintiffs.”); *Sakhrani v. Brightpoint, Inc.*, 78 F. Supp. 2d 845, 846 (S.D. Ind. 1999) (“Where the members of the group do not share business or other relationships independent of the lawsuit, however, this court concludes that appointment of such an artificial group of persons as lead plaintiffs should be rare under the PSLRA.”).

115. See, e.g., *In re Donkenny, Inc. Sec. Litig.*, 171 F.R.D. 156, 158 (S.D.N.Y. 1997) (expressing concern that appointing a group would allow the attorney to control the litigation).

116. See, e.g., *Smith v. Suprema Specialties, Inc.*, 206 F. Supp. 2d 627, 636–37 (D.N.J. 2002) (considering whether a group of five individuals was too large to represent the class); *In re Baan Sec. Litig.*, 186 F.R.D. 214, 217 (D.D.C. 1999) (rejecting a group of 466 shareholders represented by a subgroup of twenty shareholders designated by the group and finding that a small committee would be more effective and efficient).

117. *But see D'Hondt v. Digi Int'l Inc.*, No. CIV 97–5 JRT RLE, 1997 WL 405668, at *3 (D. Minn. Apr. 3, 1997) (“[A]n equally cogent assertion can be broached that, when more greatly numbered, the Lead Plaintiffs can more effectively withstand any supposed effort by the class counsel to seize control of the class claims.”).

118. See, e.g., *Barnet v. Elan Corp.*, 236 F.R.D. 158, 162 (S.D.N.Y. 2005) (considering size in light of ability to effectively manage litigation); *Brown v. Computerized Thermal Imaging, Inc.*, No. 02–611–KI, 2002 WL 31109563 (D. Or. Sept. 24, 2002) (appointing a group of four individuals, two of whom were related, but the others were unrelated); *In re Baan*, 186 F.R.D. at 217 (“[A] small committee will generally be far more forceful, effective and efficient than a larger aggregation.”).

119. Memorandum of the Sec. and Exch. Comm'n, Amicus Curiae at 1, *In re Baan*, 186 F.R.D. 214.

120. See *Funke v. Life Fin. Corp.*, No. 99 Civ. 11877(CBM), 2003 WL 194204, at *5 (S.D.N.Y. Jan. 28, 2003) (appointing nine individual plaintiffs); *Weltz v. Lee*, 199 F.R.D. 129, 133 (S.D.N.Y. 2001) (appointing seven investors); cf. *In re Advanced Tissue Scis. Sec. Litig.*, 184 F.R.D. 346, 352 (S.D. Cal. 1998) (refusing to appoint over 250 unrelated investors); *Chill v. Green Tree Fin. Corp.*, 181 F.R.D. 398, 408 (D. Minn. 1998) (declining to appoint a group with over 300 members because it “would threaten the interests of the class, would subvert the intent of Congress, and would be too unwieldy to allow for the just, speedy and inexpensive determination of this action”).

preferring members with a prelitigation relationship,¹²¹ others protecting against groups aggregated for the sole purpose of becoming the lead plaintiff,¹²² and still others ignoring members' relationship entirely.¹²³ Courts that disallow groups with unrelated members do so for several reasons: some claim that appointing unrelated investors improperly interprets the term "groups" in the PSLRA because they have "nothing in common with one another beyond their investment;"¹²⁴ others worry that unrelated members cannot "collectively ride herd on counsel anywhere as well as could a single sophisticated entity,"¹²⁵ and others reason that absent "something to bind them together as a unit, there is no reason for the individual members of the group to speak and act with a uniform purpose" and adequately monitor their attorneys.¹²⁶ In short, courts are concerned that the plaintiffs' attorneys simply manufactured a coalition to form the largest financial interest and have their firm designated lead counsel. The "group" is thus not a true group, but a hodgepodge of investors who happened to enter into retainer agreements with the same law firm.¹²⁷

Group Cohesion.—When courts do appoint groups of unrelated investors, they look for a cohesive group that coordinates its litigation efforts.¹²⁸ These courts reason that a cohesive group "is more likely to

121. See, e.g., *In re Gemstar-TV Guide Int'l, Inc. Sec. Litig.*, 209 F.R.D. 447, 451 (C.D. Cal. 2002) (declining to appoint a group aggregated solely for litigation purposes); *In re Waste Mgmt., Inc.*, 128 F. Supp. 2d 401, 413 (S.D. Tex. 2000) ("[A] small group with the largest financial interest in the outcome of the litigation and a pre-litigation relationship based on more than their losing investment, satisfies the terms of the PSLRA and serves the purpose behind its enactment.").

122. See, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 201, 267 (3d Cir. 2001) ("If, for example, a court were to determine that the movant 'group' with the largest losses had been created by the efforts of lawyers hoping to ensure their eventual appointment as lead counsel, it could well conclude, based on [the PSLRA's] history, that the members of that 'group' could not be counted on to monitor counsel in a sufficient manner.").

123. See, e.g., *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, No. 8:06-CV-1716-T-23EAJ, 2007 WL 170556 (M.D. Fla. Jan. 18, 2007) (appointing a lead plaintiff group based solely on which group had the largest financial interest).

124. *In re Conesco, Inc. Sec. Litig.* 120 F. Supp. 2d 729, 733 (S.D. Ind. 2000) (quoting *Sakhrani v. Brightpoint, Inc.*, 78 F. Supp. 2d 845, 853 (S.D. Ind. 1999)).

125. *In re Razorfish, Inc. Sec. Litig.*, 143 F. Supp. 2d 304, 309 (S.D.N.Y. 2001).

126. *In re Telxon Corp. Sec. Litig.*, 67 F. Supp. 2d 803, 815-16 (N.D. Ohio 1999).

127. *Goldberger v. Pxre Grp., Ltd.*, No. 06-CV-3410 (KMK), 2007 WL 980417, at *4 (S.D.N.Y. Mar. 30, 2007) ("An amalgam of unrelated individuals undoubtedly is different than a joint venture of closely related parties."); *Telxon Corp.*, 67 F. Supp. 2d at 813-16 (demanding more than the "twin fortuities" of suffering a loss and sharing the same attorney); *In re Network Assocs. Sec. Litig.*, 76 F. Supp. 2d 1017, 1022 (N.D. Cal. 1999) ("The only thing the investors have in common, however, is the lawyer. They have no link to each other.").

128. See, e.g., *Eichenholtz v. Verifone Holdings, Inc.*, No. C 07-06140 MHP, 2008 WL 3925289, at *8 (N.D. Cal. Aug. 22, 2008) ("[T]he court also finds that a pre-existing relationship

function smoothly,”¹²⁹ though adequate representation has never required smooth sailing and eliminating dissent actually proves detrimental to better decisionmaking.¹³⁰ Nevertheless, courts look for evidence of cohesion such as organizational meetings, a cohesive identity (such as a prelitigation relationship), decisionmaking procedures, information sharing, litigation-management agreements, plans for cooperation, and members who have something in common besides their investment.¹³¹ Courts typically use plaintiffs’ prelitigation relationship as a proxy for cohesiveness.¹³²

While most courts accept a general allegation that the group will coordinate its efforts, others expect specific evidence of how members will conduct discovery, coordinate litigation strategy, resolve their differences, and make decisions.¹³³ Consequently, plaintiffs’ attorneys stress the group’s cohesive nature and the absence of

between entities that comprise a group is not required if the resulting group is small and cohesive enough such that it can adequately control and oversee the litigation.”); *In re Nature’s Sunshine Prods., Inc.*, No. 2:06–CV–267 TS, 2006 WL 2380965, at *1–2 (D. Utah Aug. 16, 2006) (emphasizing the court’s concern with plaintiffs’ ability to adequately conduct litigation as a cohesive group); *Schrivver v. IMAPC Mortg. Holdings, Inc.*, 2006 U.S. Dist. Lexis 40607, at *25 (C.D. Cal. May 1, 2006) ([W]hile not per se impermissible[,] lead plaintiffs under the PSLRA[] are not adequate class representatives absent a showing that they are able to coordinate their efforts in the litigation.”); *In re Flight Safety Techs., Inc. Sec. Litig.*, 231 F.R.D. 124, 129 (D. Conn. 2005) (rejecting a proposed group because the motion “contains no indication of how the newly expanded group would function, such as whether certain lead plaintiffs would handle certain aspects of the litigation or whether decisions would be made by group consensus”).

129. *Freudenberg v. E*Trade Fin. Corp.*, No. 07 Civ. 8538, 2008 WL 2876373, at *4 (S.D.N.Y. July 16, 2008); *Xianglin Shi v. Sina Corp.*, No. 05 Civ. 2154(NRB), 2005 WL 1561438, at *5 (S.D.N.Y. July 1, 2005); *cf. Switzenbaum v. Orbital Sci. Corp.*, 187 F.R.D. 246, 250–51 (E.D. Va. 1999) (tying the group’s inability to communicate who its members are to inadequate representation).

130. *See infra* notes 190–202 and accompanying text.

131. *See, e.g., Varghese v. China Shenghuo Pharm. Holdings, Inc.*, 589 F. Supp. 2d 388, 392 (S.D.N.Y. 2008) (citing evidence of a prelitigation relationship as an important factor in determining cohesiveness); *Freudenberg*, 2008 WL 2876373, at *5 (same); *In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427, 457–58 (S.D. Tex. 2002) (accepting an *in camera* “comprehensive litigation management agreement” that “addresses all collective decisions that will be required[,] . . . establishes a media policy for counsel that restricts statements to the press, and creates procedures for monitoring and managing the litigation,” but rejecting the group because it was not cohesive and was “artificially created”); *In re Conseco, Inc. Sec. Litig.*, 120 F. Supp. 2d 729, 733 (S.D. Ind. 2000); *Local 144 Nursing Home Pension Fund v. Honeywell Int’l, Inc.*, 2000 U.S. Dist. LEXIS 16712, at *13–14 (D.N.J. Nov. 16, 2000); *In re Network Assocs., Sec. Litig.*, 76 F. Supp. 2d 1017, 1022 (N.D. Cal. 1999).

132. *See, e.g., Smith v. Suprema Specialties, Inc.*, 206 F. Supp. 2d 627, 636–37 (D.N.J. 2002) (finding that, despite affidavits explaining how the group would work together, its preexisting relationship was minimal and there was no “sufficient connection to bind them together as a unit”).

133. *See, e.g., Varghese*, 589 F. Supp. 2d at 392 (requiring proposed groups to demonstrate an ability and desire to work cooperatively); *Eichenholtz*, 2008 WL 3925289, at *9 (conducting a rigorous inquiry into group cohesion and coordination).

antagonistic interests.¹³⁴ But a few go further and include declarations from putative lead plaintiffs who jointly commit to pursue the litigation and explain how they will consult through “face-to-face and electronic communications,” “share information,” and manage the day-to-day litigation aspects.¹³⁵ Likewise, courts reject groups with members who compete with one another, reasoning that “investors are likely to have different investment strategies and may be subject to unique defenses” and that coordination problems inherent between competitive entities “will outweigh whatever gains are to be had through the grouping.”¹³⁶

2. Group Decisionmaking

Group cohesion and members’ relationship go hand in hand, but do not automatically translate into better decisionmaking or monitoring. Yet, judges only occasionally require plaintiffs to explain their decisionmaking processes.¹³⁷ Though most groups neglect to explain how they will decide, those that do show quite a range.¹³⁸ Nearly all groups agree to have periodic conference calls, but some make decisions through group consensus, while others employ a simple one-vote-per-entity voting arrangement, and still others might use a proportional voting arrangement based on either the financial loss amount or the number of the entity’s shares.¹³⁹ One group even

134. Memorandum of Points and Authorities in Support of the Pension Fund Group’s Motion for the Appointment of Lead Plaintiff and Approval of Its Selection of Lead Counsel at 9, *In re Cardinal Health, Inc. Sec. Litig.*, 226 F.R.D. 298, 308 (S.D. Ohio 2005) (No. 04–00575); Motion of the Israeli Inst. Investor Grp. for Consolidation, Appointment as Lead Plaintiff and Approval of Lead Plaintiff’s Selection of Lead Counsel, Memorandum of Points and Authorities in Support Thereof at 12, *Eichenholtz*, 2008 WL 3925289 (conclusively alleging that “[t]he Israeli Institutional Investor Group consists of five institutional investors, which are a cohesive, ‘small group of manageable size that is capable of joint decision-making regarding the litigation’”) (internal citation omitted).

135. Memorandum of Law in Support of the Motion of the Kristen-Straxton Group for Consolidation of All Related Cases, Appointment of Lead Plaintiff and Approval of the Selection of Lead Counsel at 10–11, *Freudenberg*, 2008 WL 2876373.

136. *Eichenholtz*, 2008 WL 3925289, at *9.

137. See, e.g., *In re Versata*, 2001 U.S. Dist. LEXIS 24270, at *17 (N.D. Cal. Aug. 17, 2001).

138. See, e.g., *In re Cell Pathways, Inc. Sec. Litig.*, 203 F.R.D. 189, 194 (E.D. Pa. 2001) (ordering the lead-plaintiff group to coordinate their activities on a number of fronts, but providing no indicia of how decisions would be made).

139. See *Eichenholtz*, 2008 WL 3925289, at *9 (“The joint decision-making, however, is simply one vote per constituent entity, independent of the number of shares held by the entity.”); *In re Host Am. Corp. Sec. Litig.*, 236 F.R.D. 102, 109 (D. Conn. 2006) (including a plan with a “dispute resolution protocol if consensus cannot be reached”); *In re Cardinal Health, Inc. Sec. Litig.*, 226 F.R.D. 298, 308 (S.D. Ohio 2005) (quoting class counsel as saying, “[t]he clients themselves have agreed that they will have periodic conference calls . . . [and] I believe that their

went so far as to agree to a dispute-resolution procedure involving a retired federal judge or mediator if it could not reach consensus on an issue.¹⁴⁰ But these groups are the exception, not the rule.

3. Level of Competition and Timing of Group Formation

Competition, whether in the marketplace or the courtroom, can reduce agency costs.¹⁴¹ When more plaintiffs compete to become lead plaintiff, their attorneys might offer to lower their fees, the court has more options from which to choose, and competing plaintiffs have incentives to uncover potentially disabling conflicts of interest in other movants.¹⁴² But competition levels vary depending on when groups form. Some groups come to the lead-plaintiff selection process already intact and then compete,¹⁴³ others arrive intact and are large enough to immediately derail any would-be competitors,¹⁴⁴ others voluntarily aggregate because of the competitive process,¹⁴⁵ and still others are court appointed after the competitive process.¹⁴⁶

current intention is to make decisions through consensus and agreement as opposed to voting, but ultimately they will be the masters of how decisions are to be made”).

140. Declaration of Carolantic Partners, LLC in Support of the Carolantic Group’s Motion for Appointment as Lead Plaintiff Pursuant to § 21D(A)(3)(B) of the Securities Exchange Act of 1934 at 2, *In re Host Am. Corp.*, 236 F.R.D. at 109 (No. 05–1250, Exhibit E to Docket No. 37–3) (“The Carolantic Group agrees that all decisions will be by consensus. In the unlikely event that the Carolantic Group is unable to reach a consensus on a given issue, the Carolantic Group and lead counsel will present in person (or telephonically to facilitate speedy and efficient resolution) their respective positions to a retired federal judge and/or experienced mediator, who will render a binding decision.”).

141. Choi, *supra* note 100, at 34 (observing evidence “that greater competition for lead plaintiff correlates with lower attorney fees”).

142. *Id.* at 27. In conducting his study, Choi focused principally on whether the lead plaintiffs aggregated into groups after other competing plaintiffs voluntarily withdrew their motions (thus potentially reflecting a side deal) or whether the groups formed in the face of continuing competition. His study did not include groups that came to the selection process already intact. *Id.* at 27–28 & n.24.

143. *See, e.g., In re Doral Fin. Corp. Sec. Litig.*, 414 F. Supp. 2d 398, 400–02 (S.D.N.Y. 2006) (considering five groups of unrelated investors that each filed motions for lead plaintiff); *Cardinal Health*, 226 F.R.D. at 305–11 (appointing a preexisting group of six pension funds all represented by Lerach Coughlin—but removing two that were subject to conflicts—over one state department of treasury, two individual institutional investors, and one family trust).

144. *See, e.g., Reimer v. Ambac Fin. Group, Inc.*, No. 08 Civ. 411(NRB), 2008 WL 2073931, at *3 (S.D.N.Y. May 9, 2008) (appointing a group of three pension funds that cooperated before the litigation through joint conference calls).

145. *See, e.g., In re XM Satellite Radio Holdings Sec. Litig.*, 237 F.R.D. 13, 16 (D.D.C. 2006) (“Some seventeen days after the parties filed their motions, two of the individual movants . . . withdrew their motions and joined forces with the Zarif Group, and the newly reconstituted group re-named itself”); *In re Flight Safety Tech., Inc. Sec. Litig.*, 231 F.R.D. 124, 128 (D. Conn. 2005) (including two groups—one made up of six individuals, the other with three individuals and one institution—that “joined forces and filed a joint motion” before the court could rule on the competing motions); *In re Cell Pathways, Inc. Sec. Litig.*, 203 F.R.D. 189, 191

When groups form before filing a lead-plaintiff motion, a single law firm tends to represent them,¹⁴⁷ whereas groups forming from competition include more than one law firm.¹⁴⁸ As Stephen Choi reasons, plaintiffs' attorneys are unlikely to form coalitions with each other until they "know the full range of competing motions and thus the value of entering into a coalition with another plaintiffs' attorney firm."¹⁴⁹ As one court recognized, this practice "gives new meaning to Lord Palmerston's quotation: 'We have no eternal allies and we have no perpetual enemies.'"¹⁵⁰

On occasion, courts manipulate the group by trimming or expanding it to further congressional intent or to eliminate conflicting interests. For example, in *In re Cardinal Health, Inc. Securities Litigation*, the court removed two pension funds with a net gain that were subject to unique defenses.¹⁵¹ It reasoned that group members need "not necessarily rise and fall as a group," and that it could "break apart a proposed group in search of the most adequate lead plaintiff."¹⁵² Likewise, the court in *In re Oxford Health Plans* designed its own group from three competing plaintiffs' groups: one pension

(E.D. Pa. 2001) (appointing a group comprised of two competing groups that initially filed and each former group's counsel as co-lead counsel); *In re Donnkenny, Inc. Sec. Litig.*, 171 F.R.D. 156, 157–58 (S.D.N.Y. 1997) (refusing to appoint a group as lead plaintiff where competing plaintiffs consolidated and proposed that their counsel be appointed as co-counsel).

146. *See, e.g.*, *Freudenberg v. E*Trade Fin. Corp.*, No. 07 Civ. 8538, 2008 WL 2876373, at *8 (S.D.N.Y. July 16, 2008) (appointing a group and an individual with the largest financial loss as well as the law firms of each as co-lead counsel); *In re Star Gas Sec. Litig.*, No. 3:04cv1766 (JBA) 2005 U.S. Dist. LEXIS 5827, at *13 (D. Conn. Apr. 8, 2005) (appointing an individual with the largest losses, an institutional investor, and an individual with the largest losses stemming from stock purchases early in the class period); *In re Oxford Health Plans, Inc. Sec. Litig.*, 182 F.R.D. 42, 45 (S.D.N.Y. 1998) (appointing competing groups as co-lead plaintiffs).

147. *See, e.g.*, *Cardinal Health*, 226 F.R.D. at 305–11 (appointing a preexisting group of six pension funds all represented by Lerach Coughlin). For a contrary example, see *In re Flight Safety Tech., Inc. Sec. Litig.*, 231 F.R.D. 124, 128 (D. Conn. 2005) (including a group comprised of "three individuals and one institution represented by an additional two law firms").

148. *See, e.g.*, *Cell Pathways*, 203 F.R.D. at 191 (appointing a group comprised of two competing groups that initially filed and each former group's counsel as co-lead counsel).

149. Choi, *supra* note 100, at 27–28 & n.24.

150. *Flight Safety Tech.*, 231 F.R.D. at 130 (quoting JOHN BARTLETT, BARTLETT'S FAMILIAR QUOTATIONS 417:20 (Justin Kaplan ed., 17th ed. 2002)).

151. 226 F.R.D. at 305–08 (S.D. Ohio 2005).

152. *Id.* at 308 (quoting *In re Surebeam Corp. Sec. Litig.*, No. 03 CV 1721 JM (POR), 2003 U.S. Dist. LEXIS 25022, at *23 (S.D. Cal. Jan. 5, 2004)); *see also Flight Safety Tech.*, 231 F.R.D. at 131 (rejecting what appeared to be a last-minute coalition between groups, but appointing two group members to serve as co-lead plaintiff); *Newman v. Eagle Bldg. Tech.*, 209 F.R.D. 499, 505 (S.D. Fla. 2002) (removing one member based on inadequacy, but appointing the remainder of the group as the lead plaintiff).

fund, one group of thirty-five individuals, and one corporation.¹⁵³ It built a group with the pension fund, the corporation, and three individuals, and gave each “entity” a single equal vote.¹⁵⁴ The court explained that this “provide[d] the proposed class with the substantial benefits of joint decision-making and joint funding” and, in the event of a settlement, would give the court confidence that it was not “affected by any possible differences in aims or viewpoints.”¹⁵⁵

In sum, a few themes emerge from this descriptive overview. The PSLRA designed lead plaintiffs to act as *gatekeepers*—attorneys cannot file strike suits without a “client”—and as *monitors*—to rein in and watch over attorneys for the class’s benefit. Thus, initially courts were wary of lead-plaintiff groups, particularly large groups contrived by the very plaintiffs’ attorneys that Congress intended to sideline. Over time, however, courts began to graft congressional purposes onto the word “group” in ways that might further Congress’s attorney-monitoring goal. Consequently, courts value cooperation, coordination, and group cohesion and use evidence of these traits as proxies for client control. Likewise, judges embrace groups with relationships that predate the litigation because they form organically, without attorney encouragement. Yet, few plaintiffs provide—and few courts require—a detailed decisionmaking plan. And only the rarest court devotes significant attention to whether the group members adequately represent the whole class. Unfortunately, although cohesion and cooperation sound intuitively good and harmonious, as we will see, they are the same traits that can lead to disastrously poor decisionmaking. Nevertheless, the move toward gradually accepting groups as lead plaintiffs has enormous potential to adequately represent investors with heterogeneous interests.

153. *In re Oxford Health Plans, Inc. Sec. Litig.*, 182 F.R.D. 42, 44–45 (S.D.N.Y. 1998); see also *Laborers Local 1298 Pension Fund v. Campbell Soup Co.*, No. CIV.A. 00–152 (J.E.I.), 2000 U.S. Dist. LEXIS 5481, at *11 (D.N.J. Apr. 24, 2000) (“The Court also considers it desirable to have both an institutional investor, like Connecticut, and individual investors, like DeValle and Green, included as lead plaintiffs since each may bring a unique perspective to the litigation.”); *Yousefi v. Lockheed Martin Corp.*, 70 F. Supp. 2d 1061, 1071 (C.D. Cal. 1999) (“The Court also finds that with the appointment of one lead plaintiff who is an individual private investor and one lead plaintiff that is an institutional investor, the lead plaintiffs will represent a broader range of shareholder interests than if the Court appointed an individual or an institutional investor alone.”). For criticism of the *Oxford Health Plans* decision, see Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA After a Decade, or “Look What’s Happened to My Baby”*, 61 VAND. L. REV. 543, 565–67 (2008). Likewise, there is some anecdotal evidence that the plaintiffs’ lawyers in *Oxford Health Plans* could have settled the case much earlier for the same amount.

154. *Oxford Health Plans*, 182 F.R.D. at 45–46.

155. *Id.*

B. Collective Failure

Before we can claim that a group performs poorly, we need to rethink our metrics for success or failure. Remember that lead plaintiffs fail in part because we expect too much of them. In nearly every other kind of class action (excepting antitrust, perhaps), we think of class representatives as figureheads.¹⁵⁶ But we expect more from securities-class-action lead plaintiffs because many investors—particularly institutions—are sophisticated and, if enough money is at stake, the lead plaintiff will be interested enough to monitor the attorneys. Because these plaintiffs must also be adequate representatives, we harness the rest of the class to their self-interest and heave a sigh of relief.

Consider the lead plaintiff's obligations as primary responsibilities and secondary spillovers. In order of authority, the lead plaintiff must first and foremost serve as an adequate representative—a constitutional due process requirement embodied in Rule 23(a)(4). As a close second, the lead plaintiff must also monitor the class attorney, as Congress dictated through the PSLRA. Although Congress zeroed in on the monitoring function, monitoring is actually a more specific adequate-representation requirement: the faithful representative, as an agent for the class, should not hire another agent on her principals' behalf without ensuring that the second agent—the attorney—performs as promised. Consequently, if the lead plaintiff performs as hoped, she will adequately represent the class members by monitoring the class attorney. This, we predict, will generate important spillovers, too—monitoring means fewer strike suits, which means corporate behavior will be sanctioned only when fraudulent, which means corporate actors can avoid lawsuits by following the law, which means that securities class actions may deter fraud.¹⁵⁷

So, what does this say about measuring success or failure? Measuring success only in terms of monitoring through metrics like settlement size or reducing attorneys' fees only partially answers the bigger question of how the lead plaintiff performs her primary function as an adequate class representative. As illustrated by the potential conflicts between individual and institutional investors, class

156. See generally Burns, *supra* note 5, at 165 (“The role of the class representative in class actions has become something of an enigma.”).

157. See generally Burch, *supra* note 91 (explaining how securities class actions generate positive spillovers). But see generally Rose, *supra* note 91 (suggesting that multiple enforcers, including private enforcement actions, do not make sense from a deterrence perspective).

members are diverse. Accordingly, we want a lead plaintiff to make better decisions on behalf of her principals. “Better” has no objective quality as good or bad, but rather a subjective quality in that it reflects her principals’ desires. As such, it is nearly impossible to measure “better” in quantifiable terms. One could determine the number of collateral attacks on any given settlement, but that surely captures only the most dissatisfied members. Polling the class is likewise impractical. Thus, while no absolute metric exists, the best proxy is to judge adequacy *ex ante* by considering what a reasonable investor with particular interests would want in a representative.

So far then, it is the representative quality that we are after in appointing a lead plaintiff, and we must take two fundamental assumptions into account to achieve this: (1) that average class members are diverse and (2) that the representative fulfills her obligations not by polling constituents but by pursuing her own self-interest, which we presume is the same as those she represents. The problem is then obvious: these two assumptions point in different directions unless we have more than one representative.

Enter the group. Ideally, group members represent the class’s diverse interests such that when each member pursues her own self-interest, the group resembles a microcosm of the whole class. But as we’ve seen, courts pick groups based not on diversity, but on cohesiveness. Consequently, this Section considers critiques of current lead-plaintiff groups beginning with those by securities-class-action scholars. It then draws from the social science literature on group decisionmaking to offer an alternative explanation for lead-plaintiff groups’ poor performance.

1. Legal Academics’ Criticisms

Most academics disfavor aggregating lead plaintiffs. But their criticisms focus on the lead plaintiff’s monitoring function, not her primary role as an adequate representative. Though these criticisms vary, they fall into three interrelated categories. First, some contend that aggregating is inconsistent with the PSLRA’s text and legislative history and that the word “group” is an anomaly.¹⁵⁸ The PSLRA

158. Fisch, *supra* note 35, at 69–71 (2001). Part of Jill Fisch’s argument centers on the inappropriateness of aggregating the alleged losses to determine whether the group has the largest financial interest and a significant incentive to litigate. After her article was published in 2001, however, the Supreme Court decided *Exxon Mobil Corp. v. Allapattah Services, Inc.*, which overruled *Zahn v. International Paper Co.* (a case on which she relied), and Congress enacted the Class Action Fairness Act, which allows class members to calculate the amount in controversy by determining the aggregate loss. 28 U.S.C. § 1332(d)(6) (2006) (“In any class action, the claims of

typically uses “plaintiff” in its singular form. While not addressed in the legislative history, critics contend that Congress meant the word “group” to “encompass associated institutions such as different funds from the same mutual fund group.”¹⁵⁹ Most courts, on the other hand, give the term its plain meaning and select groups when they are small enough to monitor their attorneys.¹⁶⁰ Although legislative history on the word’s meaning is sparse, Congress’s goal of instilling a client monitor is unmistakable. Thus, as explained shortly, some then argue that aggregating lead plaintiffs fails to fulfill this goal and thereby undermines the statute’s objectives.¹⁶¹

Second, academics worry that aggregating shifts control from lead plaintiffs to their attorneys and fails to decrease agency costs. Several rationales motivate this claim including: group decisionmaking is less efficient, members’ smaller individual stakes reduce their incentives to participate actively, and if the attorney engineers the group she is likely to direct and manage it too.¹⁶² The claim that group decisionmaking is less efficient because it “divides decisionmaking” and thus “slow[s] litigation” when decisionmakers disagree¹⁶³ may or may not be true as judged by pure decisionmaking time—one person can easily make a fast judgment call, but it may result in less informed and thus less representative decisions.¹⁶⁴ As

the individual class members shall be aggregated to determine whether the matter in controversy exceeds the sum or value of \$5,000,000, exclusive of interests and costs.”); *Exxon Mobil Corp. v. Allapattah Servs., Inc.*, 545 U.S. 546 (2005) (holding that the supplemental-jurisdiction statute permits additional class members to join the action even when they do not meet the minimal amount-in-controversy requirement). These changes undermine the argument that it is inappropriate to aggregate claims for jurisdictional purposes. It does not, however, change the incentives for pursuing the litigation. Accordingly, this Article argues that group members should still have the largest losses to maintain lead plaintiffs’ litigation incentives.

159. Fisch, *supra* note 35, at 70 & n.118 (citing Elliott Weiss, Remarks at Conference on Complex Litigation, Inst. for Law and Econ. Pol’y (Apr. 14, 2000)); *see also* Cox & Thomas, *supra* note 7, at 1616–17 (“This may well cause us to wonder if ‘persons,’ as used in the act, poorly expresses Congress’s vision because the plural usage was never intended to include natural persons but institutions.”).

160. *But see In re Donnkenny, Inc. Sec. Litig.*, 171 F.R.D. 156, 157–58 (S.D.N.Y. 1997) (noting that the statutory language did not forbid appointing a group, but refusing to appoint aggregated investors because it contravened legislative history).

161. *See, e.g.*, Fisch, *supra* note 35, at 69–71 (arguing that aggregation is contrary to the legislative history).

162. *See, e.g.*, Cox & Thomas, *supra* note 7, at 1596 (listing reasons to oppose aggregation); Fisch, *supra* note 35, at 71–73 (same).

163. Heck, *supra* note 48, at 1221.

164. Some studies even show that groups take no longer to make decisions than individuals, but that they do consistently outperform them. *See, e.g.*, Alan S. Blinder & John Morgan, *Are Two Heads Better than One?: An Experimental Analysis of Group vs. Individual Decisionmaking* (Nat’l Bureau of Econ. Research, Working Paper No. W7909, 2000), available at <http://www.nber.org/papers/w7909> (finding that, contrary to popular belief, groups do not make

recent research has revealed, diverse groups often make more informed decisions than a single expert alone.¹⁶⁵ So, while efficiency is important, it should not automatically outweigh adequate-representation concerns. Plus, courts have addressed these academic concerns, in part, by continuing to appoint the plaintiffs with the largest financial stake as group members, limiting group size, and occasionally selecting groups with a mix of individuals and institutions.

Third, and related, commentators suggest that groups generate additional free-rider and collective-action problems: if each lead plaintiff believes that the other is monitoring then each will shirk her responsibilities, leading to collective failure.¹⁶⁶ This concern echoes the worry that group members lack ample incentive to monitor, or have “no greater incentive” than an individual with the largest loss.¹⁶⁷ But empirical data cast some doubt on whether collective-action problems truly inhibit all groups; some groups are more successful than others, particularly when they include an institution.¹⁶⁸ Although this collective-action problem is the most worrisome, it is not only indigenous to groups; in theory, it pervades all securities class actions. An institution receiving only its pro rata settlement share has little reason to take on monitoring costs or open itself up to discovery.

Empirical data and descriptive statistics from smaller case samples underscore these concerns. In 2006, Jim Cox and Randall Thomas published a study using several datasets on published cases in Westlaw and LexisNexis, such as one dataset on thirty-five securities-class-action settlements from 1996–98 and one dataset including 388 pre- and post-PSLRA cases from multiple sources.¹⁶⁹ From their data, they suggested a few observations. First, institutional lead plaintiffs tend to cherry pick cases where there are larger estimated losses, substantially capitalized defendants, and the SEC has filed a parallel action.¹⁷⁰ Thus, while institutions add value, that value is “perhaps not as much as was expected by the architects

decisions more slowly than individuals and that there is no significant difference in decisionmaking time between majority rule and unanimity rule).

165. See *infra* Part III.A.

166. Cox & Thomas, *supra* note 7, at 1617; Heck, *supra* note 48, at 1220–21.

167. Cox & Thomas, *supra* note 7, at 1617.

168. See *supra* note 101 and accompanying text.

169. Cox & Thomas, *supra* note 7, at 1619–20, 1622–23.

170. *Id.* at 1629–30; see also Choi et al., *supra* note 38, at 870 (finding that private institutional lead plaintiffs are not associated with larger class recoveries, that public pension funds are, but that public pension funds may also “cherry-pick” the cases “with the largest potential damages and the strongest evidence of fraud”).

of PSLRA's lead plaintiff provision."¹⁷¹ Second, among noninstitutional lead plaintiffs, individuals best increase the settlement size in smaller cases, whereas individual-investor groups and noninstitutional entities perform better in larger ones.¹⁷² And third, individual-investor groups "perform better than individuals as lead plaintiffs in larger cases, while groups that include an entity yield larger settlements and greater provable loss ratios than those that occur" in individual-investor groups.¹⁷³ Accordingly, as among noninstitutional plaintiffs,¹⁷⁴ Cox and Thomas conclude that courts should consider the case size and select individual plaintiffs in cases against firms with less capital and groups in bigger cases with larger recoverable losses.¹⁷⁵

More recently, Stephen Choi studied all securities class actions filed between 2003 and 2004 (482 actions) to determine which kind of lead plaintiff (institutions, individuals, or various mixes of the two) reduced attorney agency costs as measured by the requested attorneys' fee and the number of hours worked.¹⁷⁶ First, he found that mixed groups with institutional and individual investors "are more effective in generating economically significant, lower attorney fees compared with groups of non-institutional investors."¹⁷⁷ Second, noninstitutional-investor groups do not perform better than a single individual.¹⁷⁸ Finally, institutional-investor groups "correlate with significantly lower attorney agency costs," but "labor union pension funds do not follow this general trend and may, in fact, correlate with increased agency costs."¹⁷⁹ In short, groups can improve class welfare only when the members converge through a competitive process and include institutions.¹⁸⁰ When the group includes a mix of diverse

171. Cox & Thomas, *supra* note 7, at 1636.

172. *Id.* at 1632–33.

173. *Id.* at 1638–39.

174. It is not clear where mixed groups, containing institutions and individuals fall in these broader conclusions, but tables early in the article suggest that these groups might be combined into the institutional category. *See id.* at 1624–27 & tbls.4, 5, 6, 7, & 8 (combining categories 1 ("institution") and 3 ("institution-individuals") into one total "Institutional Lead Plaintiffs" line and "All Other Lead Plaintiffs Post-PSLRA" into a separate line).

175. *Id.* at 1639.

176. Choi, *supra* note 100, at 1–2.

177. *Id.* at 35.

178. *Id.*

179. *Id.* at 36.

180. *Id.* at 27, 35.

perspectives—both institutions and individuals—it outperforms more homogeneous groups with just individuals.¹⁸¹

2. Due Process and Group Decisionmaking Critiques

Social science evidence suggests that cognitively diverse groups—groups with diverse perspectives, interpretations, and heuristics—can be more capable problem solvers and reach more representative solutions than homogeneous ones.¹⁸² Consequently, traditional academic criticisms only partially explain why lead-plaintiff groups underperform. The group decisionmaking literature, which ranges in discipline from political science, organizational theory, social choice, and psychology to economics and mathematical modeling, provides an alternative explanation. Admittedly, no empirical study directly examines whether diverse groups in securities class actions make better decisions; on the other hand, empirical data is not likely to tell us much about whether someone is an adequate representative or whether settlements reflect most class members' viewpoints.¹⁸³ Thus, both this critique and Part III's prescription include conceptual integrations and empirical generalizations from robust principles in the available literature on group decisionmaking and cognitive, as opposed to visible, diversity.

Remember that if we measure a lead plaintiff's success only in monitoring terms, we fail to capture how the lead plaintiff performs her primary duties as an adequate class representative. Our two basic assumptions so far have been: (1) that class members' interests are diverse in some significant respects and (2) that the representative fulfills its obligations by pursuing its own self-interest, which must be similar to those it represents. As noted, without more than one representative, these two assumptions are incompatible. We thus have two related reasons to pursue a diverse group: ensuring adequate representation and avoiding group polarization through cognitive diversity.

Presently, courts look for group cohesiveness and members who, ideally, have a prelitigation relationship. They want homogeneous groups with like-minded members who collectively push

181. Although the fact that mixed groups perform better based on traditional metrics lends support to the argument that groups with diverse perspectives outperform homogenous groups according to those indicators, the indicators themselves may not reflect whether group members are adequately representing class members' preferences.

182. See *infra* Part III.A.

183. Studies on the number of opt-outs may give researchers a rough idea, however.

a single agenda.¹⁸⁴ Only occasionally do courts appoint groups based on adequate representation. As a notable exception, the court in *In re Host America Corp. Securities Litigation* observed that the two putative lead-plaintiff groups each contained “institutional and individual investors,” which provided “a diversity of representation reflective of the makeup of the class as a whole.”¹⁸⁵ And some courts mix institutional and individual investors because they each bring “a unique perspective to the litigation”¹⁸⁶ and maintain “balance among the demographics of the lead plaintiff group members, [which] improves diversity of experience.”¹⁸⁷ But these courts are outliers; most overlook the issue and actively pursue cohesiveness, cooperation, and homogeneity.

Sameness and homogeneity provoke group decisionmaking’s most detrimental effects: confirmation bias,¹⁸⁸ group polarization, and possibly groupthink. Confirmation bias enters into group decisionmaking when, for example, group members’ conviction makes them discount contrary evidence and retain their presently favored approach.¹⁸⁹ Emphasizing group consensus over dissent and contrary evidence, at its extreme, permits groupthink, a mode of decisionmaking where group members identify so coextensively with the group that dissenting thoughts never emerge.¹⁹⁰ Cohesiveness—the principal trait courts use in appointing lead-plaintiff groups—is

184. In general, increased homogeneity among group members correlates with greater group cohesion, fewer conflicts, and more cooperation. See Eden B. King et al., *Conflict and Cooperation in Diverse Workgroups*, 65 J. SOC. ISSUES 261, 278 (2009); Daan van Knippenberg et al., *Work Group Diversity and Group Performance: An Integrative Model and Research Agenda*, 89 J. APPLIED PSYCHOL. 1008, 1009 (2004).

185. 236 F.R.D. 102, 106 (D. Conn. 2006).

186. *Laborers Local 11298 Pension Fund v. Campbell Soup Co.*, No. CIV.A. 00-152 (JEL), 2000 WL 486956, at *3 (D.N.J. Apr. 24, 2000).

187. *Holley v. Kitty Hawk, Inc.*, 200 F.R.D. 275, 280 (N.D. Tex. 2001); see also *In re Universal Access, Inc.*, 209 F.R.D. 379, 384 (N.D. Tex. 2002) (“[T]he appointment of a group of persons to acts [sic] as lead plaintiff is appropriate under the PSLRA and, indeed, is sometimes favored in light of the diversity of experience and interests of the group members.”).

188. Unlike group polarization and groupthink, confirmation bias is an individual bias that can be exacerbated or mollified by group decisionmaking. See Stefan Schulz-Hardt et al., *Biased Information Search in Group Decision Making*, 78 J. PERSONALITY & SOC. PSYCHOL. 655, 656-58 (2000).

189. See Joshua Klayman, *Varieties of Confirmation Bias*, in *DECISION MAKING FROM A COGNITIVE PERSPECTIVE* 385, 385-87, 398 (Jerome Busemeyer & Reid Hastie eds., 1995); Raymond S. Nickerson, *Confirmation Bias: A Ubiquitous Phenomenon in Many Guises*, 2 REV. GEN. PSYCHOL. 175, 178, 210 (1998); Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 504-05 (2002).

190. See generally IRVING JANIS, *GROUPTHINK* (2d ed. 1982) (explaining how “groupthink” inhibits the expression of dissenting or alternative viewpoints).

also a principal precursor to groupthink.¹⁹¹ Other conditions contributing to groupthink include group isolation and insulation, which prevent members from introducing outside information; partial leadership; poor decisionmaking procedures; and group members with homogeneous ideologies and backgrounds.¹⁹²

Despite its popularity, groupthink has received little support in laboratory testing.¹⁹³ Many researchers today would categorize it as an extreme version of group polarization.¹⁹⁴ That is, if the group deliberates but is comprised of people who are principally like-minded—let's say risk averse (such as, attorneys with a significant stake in the litigation's financing or a lead plaintiff with the most at stake vis-à-vis her overall wealth)—then deliberating makes a cautious group even more cautious and vice versa.¹⁹⁵ Simply put, group members may take more extreme positions after discussing them with like-minded others.¹⁹⁶ Confident people—those likely to be general counsel of institutions, on corporate boards, or law firm

191. *Id.* at 176.

192. *Id.* at 176–77; see also Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 32 (2002) (explaining that “[b]oardroom culture encourages groupthink”).

193. David D. Henningsen et al., *Examining the Symptoms of Groupthink and Retrospective Sensemaking*, 37 SMALL GROUP RES. 36, 38–41 (2006). Although Janis's views still predominate popular notions about groups, research in the years since his publication has been quite skeptical. See Robert S. Baron, *So Right It's Wrong: Groupthink and the Ubiquitous Nature of Polarized Group Decision Making*, in ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 219, 219 (Mark P. Zanna ed., 2005) (“A review of the research and debate regarding Janis's groupthink model leads to the conclusion that after some 30 years of investigation, the evidence has largely failed to support the formulation's more ambitious and controversial predictions, specifically those linking certain antecedent conditions with groupthink phenomena.”); Norbert L. Kerr & R. Scott Tindale, *Group Performance and Decision Making*, 55 ANN. REV. PSYCHOL. 623, 640 (2004).

194. See, e.g., CASS R. SUNSTEIN, WHY SOCIETIES NEED DISSENT 142 (2003) (“Janis's examples are best seen as case studies in group polarization.”); Glen Whyte, *Groupthink Reconsidered*, 14 ACAD. MGMT. REV. 40, 40–41 (1989); Glen Whyte, *Recasting Janis's Groupthink Model: The Key Role of Collective Efficacy in Decision Fiascoes*, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 185, 185–86 (1998). Others might characterize groupthink as having more of an element of social conformity. See, e.g., Clark McCauley, *The Nature of Social Influence in Groupthink: Compliance and Internalization*, 57 J. PERSONALITY & SOC. PSYCHOL. 250 (1989).

195. CASS R. SUNSTEIN, GOING TO EXTREMES: HOW LIKE MINDS UNITE AND DIVIDE 3–4 (2009); JAMES SUROWIECKI, THE WISDOM OF CROWDS 184–85 (2005); Michael A. Hogg & Scott A. Reid, *Social Identity, Self-Categorization, and the Communication of Group Norms*, 16 COMM. THEORY 7, 18–19 (2006).

196. See Michael A. Hogg, *Social Identity, Self-Categorization, and the Small Group*, in UNDERSTANDING GROUP BEHAVIOR: SMALL GROUP PROCESSES AND INTERPERSONAL RELATIONS 227, 234 (Erich Witte & James H. Davis eds., 1996) (“[T]raditional explanations of group polarization fall into two broad categories: (a) those that emphasize compliance, for self-presentational motives, with the culturally valued position as it is represented by the distribution of ingroup positions, and (b) those that emphasize the intrinsic persuasiveness of novel arguments brought up in discussion that support one's original position.”).

partners in charge of multimillion dollar securities-fraud lawsuits—are even more likely to polarize groups.¹⁹⁷ Similarly, group polarization and bad decisions occur with greater frequency and intensity when group members are connected through friendship, mutual affection, or solidarity,¹⁹⁸ which is far more likely in groups with prelitigation relationships.

Dissenters thwart group polarization and confirmation bias by challenging the status quo and introducing new information into the discussion.¹⁹⁹ But the appointment of cooperative, homogeneous groups combined with the trend toward opting out removes dissent, leaves only like-minded members in the group, and thus exacerbates group polarization.²⁰⁰ As Albert Hirschman rationalized, if exit is an easy and economically viable option, people will leave rather than dissent.²⁰¹ This is particularly true when dissent has no outlet or where, even if an outlet theoretically exists, dissent will fall on deaf ears. In a diverse, representative group, members can dissent in two settings: (1) in initial strategy sessions and meetings geared toward settlement design, and (2) if those efforts fail, by objecting to the settlement's fairness during the court's Rule 23(e) fairness hearing.

Currently, like-minded groups and opting out constrict and weaken these opportunities. Once defendants and lead plaintiffs strike a bargain, they have little incentive to change the terms at the fairness hearing unless the judge sends them back to the bargaining

197. SUNSTEIN, *supra* note 194, at 129; Maryla Zaleska, *The Stability of Extreme and Moderate Responses in Different Situations*, in *GROUP DECISION MAKING* 163, 164 (H. Brandstatter et al. eds., 1982). Individuals working alone do, however, tend to brainstorm more ideas than groups. Gayle W. Hill, *Group Versus Individual Performance: Are N + 1 Heads Better than One?*, 91 *PSYCHOL. BULL.* 517, 527 (1982). Although individuals working alone may generate more ideas, they also tend to overlook the flaws. Bainbridge, *supra* note 192, at 29.

198. SUNSTEIN, *supra* note 194, at 129–30; Michael A. Hogg & Sarah C. Hains, *Friendship and Group Identification: A New Look at the Role of Cohesiveness in Groupthink*, 28 *EUR. J. SOC. PSYCHOL.* 323, 323–35 (1998).

199. SUNSTEIN, *supra* note 194, at 129–30; Ulrich Klocke, *How to Improve Decision Making in Small Groups: Effects of Dissent and Training Interventions*, 38 *SMALL GROUP RES.* 437, 437–38, 460–62 (2007).

200. See SUNSTEIN, *supra* note 194, at 131–32; Felix C. Brodbeck et al., *The Dissemination of Critical, Unshared Information in Decision-Making Groups: The Effects of Pre-Discussion Dissent*, 32 *EUR. J. SOC. PSYCHOL.*, 35, 35–39 (2002).

201. ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* 46 (1972). John Coffee and Samuel Issacharoff have introduced and incorporated Hirschman's work into the class-action context. Coffee, *supra* note 35, at 407; John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 *COLUM. L. REV.* 370 (2000); Coffee, *supra* note 6, at 288; Issacharoff, *supra* note 70, at 366–67.

table.²⁰² Judicial self-interest factors in, too. It's much easier to approve the deal, know that any appeal is subject to the abuse-of-discretion standard, and thereby clear the docket for other matters.

In sum, current lead-plaintiff groups tend to make poor decisions—as data on attorneys' fees and settlement size shows—in part because they are cohesive, cooperative, and like-minded. They may thus fall prey to quintessential group problems like confirmation bias and group polarization. Moreover, because they are cohesive, group members fail to represent the class's diverse interests.

III. DIVERSIFYING AND OPTIMIZING LEAD-PLAINTIFF GROUPS

A richly representative group could alleviate adequate-representation problems without jeopardizing class certification, hence the counterintuitive remedy: Appoint a diverse lead-plaintiff group and link diversity to members' heterogeneous preferences. In general, group decisionmaking is optimal when: (1) each member has unique but unshared information, as diverse class representatives would and (2) the group can make the best decision only by sharing and incorporating this information, which is likewise necessary for reaching a settlement that reflects the class's diverse interests.²⁰³ Accordingly, this Part relies on social science studies to paint a clearer picture of why court-appointed groups might have performed poorly in the past based on settlement size and attorneys' fees and to postulate ways in which courts could designate more effective groups.

After using this literature to construct the case for diversity, the remaining sections make six conceptual moves to support and execute the normative claim that judges should appoint representative lead-plaintiff groups. First, I link cognitive diversity to adequate representation through their mutual indicators: dissent and information sharing. Diversity is beneficial because it adds a dissenting voice and prompts people with unique information to share and discuss it.²⁰⁴ Likewise, we expect an adequate representative to dissent when the group's direction conflicts with her own interests and to support her position by sharing information. Second, appointing a small, representative group means considering who the putative class members are: what is their training and experience; do they have different sophistication levels, financial interests, risk preferences,

202. Plus, changing the agreed upon outcome creates cognitive dissonance for participants. See LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE 189–90 (1957).

203. Klocke, *supra* note 199, at 437–38.

204. Hogg & Reid, *supra* note 195, at 18–19.

external fiduciary obligations, and desired remedies; and what is their relationship with lead counsel? Third, encouraging a competitive lead-plaintiff appointment process fosters dissenting norms and opens up the legal-services market, which may reduce attorneys' fees and encourage agents to faithfully represent their principals' interests. Fourth, because certifying the class typically marks the litigation process's near-end, whenever possible, judges should evaluate adequacy when initially selecting lead plaintiffs and, when necessary, subclass those with fundamentally diverse preferences. Fifth, consistent with the PSLRA's aim of client control, once a richly diverse lead-plaintiff group adequately represents the class's interests, the group should wield more decisionmaking authority through a supermajority voting procedure. Finally, I conclude by contrasting this proposal with opting out and explain how this voice-based reform outperforms exit in pragmatic, institutional, and regulatory terms.

*A. The Case for Cognitive Diversity: Definitions, Explanations,
and Limitations*

Making the case for a cognitively diverse lead-plaintiff group necessitates a basic knowledge of the rifts in the diversity literature, which is as varied as its subject matter. Accordingly, I do not attempt to provide a full, positive account. Instead, I introduce the theories in a foundational way to define diversity for this Article's purposes, to be transparent about which approach best fits lead plaintiffs, and to note some problems and limitations with that approach.

The diversity literature divides into two rough perspectives.²⁰⁵ First, the optimistic view posits that cognitive diversity—diverse knowledge and expertise that fosters contrasting perspectives, interpretations, and heuristics—leads to creative solutions, novel insights, and enhanced problem solving in complex decisions when group members interact constructively and exchange information.²⁰⁶

205. There is, however, an emerging "hybrid" view that integrates the social categorization and information/decisionmaking theories by suggesting that the "visibility of demographic diversity variables would influence affective conflict (which in turn should influence affective outcomes), whereas job relatedness of demographic diversity variables would influence substantive conflict (which in turn should influence cognitive task performance)." King et al., *supra* note 184, at 274 (citing Lisa Pelled, *Demographic Diversity, Conflict, and Work Group Outcomes: An Intervening Process Theory*, 7 *ORG. SCI.* 615 (1996)).

206. Elizabeth Mannix & Margaret A. Neale, *What Differences Make a Difference?: The Promise and Reality of Diverse Teams in Organizations*, 6 *PSYCHOL. SCI. PUB. INT.* 31, 33–34, 42–43 (2005) ("[T]he information-processing view tends to be at odds with the trait approach to diversity and tends to avoid measuring what are sometimes known as 'demographic proxies' such

That is, cognitively diverse groups will likely have more dissenters, engage in more debate, base that debate on additional information, avoid premature consensus, and thereby reach creative solutions that reflect the class's interests.²⁰⁷ This theory is known as the information-processing or decisionmaking approach. Achieving its benefits requires group members to exchange information, which, in turn, means they must be willing to endure some task conflict (as opposed to relational or emotional conflict), such as debate and discussion.²⁰⁸

Second, the pessimistic view, which includes both the similarity-attraction paradigm²⁰⁹ and the social-identity and self-categorization theories,²¹⁰ tends to focus on either visible differences such as race, ethnicity, age, gender, physical disabilities, and other demographic dissimilarities, or employment tenure.²¹¹ This view

as gender, race, or age."); *see also, e.g.*, SCOTT E. PAGE, *THE DIFFERENCE: HOW THE POWER OF DIVERSITY CREATES BETTER GROUPS, FIRMS, SCHOOLS, AND SOCIETIES* 7–8 (2007); L. Hoffman & N. Maier, *Quality and Acceptance of Problem Solutions by Members of Homogeneous and Heterogeneous Groups*, 62 J. ABNORMAL & SOC. PSYCHOL. 401 (1961); C. Nemeth, *Differential Contributions of Majority and Minority Influence*, 93 PSYCHOL. REV. 23 (1986).

207. King et al., *supra* note 184, at 272; Stefan Schulz-Hardt et al., *Dissent as a Facilitator: Individual- and Group-Level Effects on Creativity and Performance*, in *THE PSYCHOLOGY OF CONFLICT AND CONFLICT MANAGEMENT IN ORGANIZATIONS* 149, 150–55 (Carsten K.W. De Dreu & Michele J. Gelfand eds., 2008).

208. *See* D.H. Gruenfeld et al., *Group Composition and Decision Making: How Member Familiarity and Information Distribution Affect Process and Performance*, 67 ORG. BEHAV. & HUM. DECISION PROCESSES 1 (1996); King et al., *supra* note 184, at 267, 272–75; E. Mannix & K. Jehn, *Let's Norm and Storm, but Not Right Now: Integrating Models of Group Development and Performance*, in *RESEARCH ON MANAGING GROUPS AND TEAMS: TIME IN GROUPS* 11, 21 (E. Mannix et al. eds., 2004); Pelled, *supra* note 205, at 615; T. Simons et al., *Making Use of Difference: Diversity, Debate, and Decision Comprehensiveness in Top Management Teams*, 42 ACAD. MGMT. J. 662 (1999).

209. The similarity-attraction paradigm predicts that those with surface-level similarity are attracted to and communicate well with one another, whereas heterogeneous groups (in terms of racial diversity, for example) run into process-related problems that cause communication difficulties. *See generally* M.E. Rosenbaum, *The Repulsion Hypothesis: On the Nondevelopment of Relationships*, 51 J. PERSONALITY & SOC. PSYCHOL. 1156 (1986); A. Townsend & K. Scott, *Team Racial Composition, Member Attitudes, and Performance: A Field Study*, 40 INDUS. REL. 317 (2001); H. Triandis, *Cognitive Similarity and Communication in a Dyad*, 13 HUM. REL. 175 (1960).

210. As two commentators explain, “[s]elf-categorization is the process by which people define their self-concepts in terms of membership in social groups,” and “[s]ocial-identity theory provides both a cognitive and motivational perspective on the origins and consequences of group identification.” Mannix & Neale, *supra* note 206, at 40; *see also, e.g.*, MICHAEL A. HOGG & DOMINIC ABRAMS, *SOCIAL IDENTIFICATIONS: A SOCIAL PSYCHOLOGY OF INTERGROUP RELATIONS AND GROUP PROCESSES* (1988) (social identity theory); John C. Turner, *Social Categorization and the Self Concept: A Social Cognitive Theory of Group Behavior*, in *ADVANCES IN GROUP PROCESSES* 77 (Edward J. Lawler ed., 1985) (social-categorization theory).

211. King et al., *supra* note 184, at 267–68, 276; Mannix & Neale, *supra* note 206, at 41–42; *see also, e.g.*, K.A. Jehn et al., *Why Differences Make a Difference: A Field Study of Diversity*,

posits that identity diversity causes social rifts, poor group cohesion, difficult intragroup relations, and thus negative group outcomes.²¹² Put differently, diversity increases relational conflict and decreases cooperation. To oversimplify then, a group incorporating and relying on members with diverse but relevant perspectives and skills may outperform one that simply cobbles together members with visible demographic or identity diversity.²¹³

Given the two varied outcomes, the natural question becomes to what extent identity diversity produces cognitive diversity. Unfortunately, the answer largely depends on the context. We form our identities based on a variety of factors—race, gender, sexual orientation, disabilities, culture, and socioeconomic status, to name a few. As Scott Page, a professor of complex systems, political science, and economics, explains, if every group member “grew up in an upper middle-class household, went to the same prep school, and then went to Yale, where they studied the same texts under the same professors, they may not be that cognitively diverse, regardless of how diverse their identity classifications may be.”²¹⁴ So, identity diversity is not always a predictable proxy for cognitive diversity, although, as explored shortly, cognitive diversity does correlate with *interest* diversity.²¹⁵

In the context of securities class actions, intraclass conflicts between investors and institutions are based not on differences such as race or gender (as an employment-discrimination class action might be), but on factors such as derivatives trading, equity holdings, desired remedies, risk preferences, sophistication levels, and information access. These factors affect which remedies the lead plaintiff requests and pursues as well as how she makes litigation decisions. Consequently, the optimistic, information-processing/decisionmaking approach that focuses on cognitive as opposed to demographic or identity diversity is a better fit for securities class actions.

Notice, however, that courts implicitly take the opposite view: that they should appoint cohesive, cooperative groups. It makes sense intuitively—that conflict undermines rather than improves performance—yet, these groups likely lack divergent perspectives,

Conflict, and Performance in Workgroups, 44 ADMIN. SCI. Q. 741 (1999); T. Kochan et al., *The Effects of Diversity on Business Performance: Report of the Diversity Research Network*, 42 HUM. RES. MGMT. 3 (2003) (studying racial and gender diversity).

212. See King et al., *supra* note 184, at 268; Mannix & Neale, *supra* note 206, at 41–42;

213. See David A. Thomas & Robin J. Ely, *Making Differences Matter: A New Paradigm for Managing Diversity*, HARV. BUS. REV., Sept.–Oct. 1996, at 79.

214. PAGE, *supra* note 206, at 359.

215. See *infra* Part III.B.1.

motivations, and interests. This means that they do not represent the whole class, may reach consensus prematurely, and are prone toward group decisionmaking's negative effects—confirmation bias, group polarization, and perhaps groupthink.

Wide-ranging group decisionmaking research supports the claim that diverse groups outperform homogeneous ones in problem-solving tasks that demand analysis and evaluation.²¹⁶ The rationale is simple: if everyone is the same, then collectively they are limited in the same ways and by the same perspectives and heuristics that limit them individually.²¹⁷ We thus have two reasons to pursue diversity in appointing lead-plaintiff groups. First, cognitively diverse group members who represent disparate interests, dissent when those interests differ from others' interests, and share information with each other are apt to make more representative decisions and are less susceptible to typical group problems like confirmation bias and group polarization. Second, because institutional interests diverge from individual investors' interests, institutions pursuing their own self-interest are unlikely to adequately represent the whole class.

With regard to the first rationale, one might object that because many individuals comprise an institution, an institution already makes cognitively diverse decisions. But most institutions have an oligarchic decisionmaking structure, which means that a few can direct and siphon off the ideas of the many. The institution's general counsel may be the final decisionmaker,²¹⁸ or a handful of people may be involved in the decisionmaking process.²¹⁹ In Adrian Vermeule's words, if the decisionmaking process "requires or allows few minds to accept or reject the many-minded judgment, or even just to interpret it, then the resulting decision may be little better than if

216. Hill, *supra* note 197, at 533; Schulz-Hardt et al., *supra* note 207, at 162–63.

217. PAGE, *supra* note 206, at 157.

218. See, e.g., R. Randall Roche, *My Experience as a Lead Plaintiff*, INSTITUTIONAL INVESTOR ADVOC., 4th Quarter 2000, at 1, 3, available at http://www.blbglaw.com/news/publications/advocate/2000/04/_res/id=sa_File1/adv2000Q4.pdf ("[In my capacity as general counsel], I had primary responsibility on behalf of the Louisiana Retirement Systems for supervising the prosecution of the action. In that capacity, I reviewed all of the important pleadings in the case, and attended the hearing on defendants' motion to dismiss the complaint. I was consulted on all major strategic decisions. I also participated in several face-to-face meetings with defense counsel regarding the scope of discovery and defendants' objections.").

219. Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650, 704–10 & n.311 (2002) (principally citing and relying on interviews with institutions' general counsel as evidence of how institutions select lead counsel and supervise the litigation process in securities class actions); cf. MODEL RULES OF PROF'L CONDUCT R. 1.4 cmt. 6 (2007) ("When the client is an organization or group, it is often impossible or inappropriate to inform every one of its members about its legal affairs; ordinarily, the lawyer should address communications to the appropriate officials of the organization.").

the one mind had simply decided for itself, right from the start.”²²⁰ If only a few sophisticated people in an institution make decisions,²²¹ they will probably lack the contrasting perspectives (the ability to see and construe possibilities in different ways), heuristics (the method that people use to solve problems), and interests that foster multiple solutions.²²² Either way, the many ideas of institutional decisionmakers all concern what’s best for the institution, not what’s best for the class as a whole.

B. Design Fundamentals

1. Appointing and Incentivizing a Small, Representative Group

Thus far, two literatures—one vast interdisciplinary literature on group decisionmaking and one constitutionally based literature on adequate representation—both point toward diversifying the lead-plaintiff group. But the two are not necessarily synonymous: one could easily assemble a cognitively diverse group of an astronaut, lawyer, scientist, teacher, and engineer who have no incentive or qualifications to adequately represent investors in a securities class action. Though less likely, it is also possible to have a representative group that lacks cognitive diversity. In most cases, however, selecting qualified representatives based on their diverse interests will create a cognitively diverse group filled with dissimilar preferences and heuristics.

To explain, short of looking inside someone’s head, assembling a cognitively diverse group requires some assumptions, some of which I’ve engaged already while critiquing lead-plaintiff groups. Thus, it’s easier to achieve cognitive diversity by considering what we want diverse group members to do—share new information and dissent.²²³ Picking group members with new information who will dissent means

220. Adrian Vermeule, *Many-Minds Arguments in Legal Theory*, 1 J. LEGAL ANALYSIS 1, 33 (2009).

221. Institutions are often lauded for possessing superior knowledge and financial sophistication, which makes them better suited to act as litigation monitors. *See, e.g.*, Weiss & Beckerman, *supra* note 23, at 2126–27 (“[Institutions] have the knowledge and financial sophistication necessary to serve as effective litigation monitors.”).

222. *See* PAGE, *supra* note 206, at 7–8, 144–52.

223. What one insider observed in the corporate context—“The highest-performing companies have extremely contentious boards that regard dissent as an obligation and that treat no subject as undiscussable”—is equally true in the lead-plaintiff context. Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, HARV. BUS. REV., Sept. 2002, at 106, 111.

searching for plaintiffs who represent various points along the spectrum of class members' interests.²²⁴

This avoids cognitive diversity's main pitfall—it's too hard to judge someone's training and experience (the two direct causes of cognitive diversity) from the information plaintiffs provide. Speculating about who will dissent and possess different information based on class members' interests is simple but effective. Because class members' aims and preferences vary, a representative group will likely include dissenters who challenge the status quo and inject new information into the discussion (as opposed to just being contrarian).²²⁵

When group members dissent and share information, their actions dovetail with adequate representation's aims. Having someone represent you means that they will dissent on your behalf when your interests are in danger, vocalize your interests to the group, and, if that fails, to the judge. Adequate representation protects against the risk that one's attorney "might skew [the litigation] systematically" to favor some class members over others "on grounds aside from reasoned evaluation of their respective claims."²²⁶ In practice, this means two things: (1) appointing someone to speak on behalf of a class member's unique interests when deciding critical matters, such as settlement negotiations and terms; and (2) actually voicing those interests, particularly when they could be subverted, by using and disclosing relevant information. In short, adequate representation means more than mere loyalty; it means participating in the process, speaking up, dissenting, objecting, and if need be, leading the charge to opt out.

Coming full circle then, judges and attorneys can leverage structural conflicts to ensure relevant diversity in appointing lead-plaintiff groups. In this way, dissent and information sharing allow representative groups to reap cognitive diversity's principal benefits—making decisions that reflect the group's preferences and avoiding dangerous group tendencies. Although each lead-plaintiff group will differ depending on the class definition, to appoint a representatively diverse lead-plaintiff group, courts should consider each dimension of the following six variables:

224. See generally Stefan Schulz-Hardt et al., *Productive Conflict in Group Decision Making: Genuine and Contrived Dissent as Strategies to Counteract Biased Information Seeking*, 88 *ORG. BEHAV. & HUM. DECISION PROCESSES* 563, 582–83 (2002) (explaining that genuine dissent counteracts group polarization and proposing that appointing heterogeneous group members with different functional and educational background will produce dissent).

225. See PAGE, *supra* note 206, at 344; SUNSTEIN, *supra* note 194, at 84–85.

226. PRINCIPLES, *supra* note 34, § 2.07(a)(1)(B).

1. *Putative Class Composition.*—Typical securities-fraud class members run the gamut from individual investors to institutional investors. Institutional investors include mutual funds, hedge funds, private pension funds, public pension funds, insurance companies, and state and local governments (though individuals ultimately own stock held by insurance companies, pension funds, and mutual funds).²²⁷ As outlined in Part I, predictable divides regularly exist between institutions and individual investors. Consequently, this variable gives courts a rough proxy for some additional factors mentioned shortly, such as the decisionmaker's training and experience (institutions typically rely on their general counsel), repeat relationships with counsel, and legal and financial sophistication.

Mixing institutional and individual investors into the lead-plaintiff group encourages them to deliberate over the group's litigation aims. Recall that an institution with a diversified portfolio may rationalize that, in the long run, its gains and losses will be a wash so it makes less sense to incur expensive litigation-related transaction costs.²²⁸ Individual investors, on the other hand, particularly those with less diversified portfolios, may litigate with enforcement, deterrence, and increased compensation in mind.²²⁹

2. *Financial Interest and Risk Preferences.*—Just as they do now, courts should consider which investors suffered significant financial loss and select those with the largest losses. But in choosing a diverse group, they should also factor in risk preferences.²³⁰ Recall that decisionmakers are more willing to take risks when less money is at stake,²³¹ but who counts as a “small stakeholder” in any given case and what counts as “peanuts” depends on how much is at stake vis-à-vis a claimant's overall wealth. Courts can use this “peanuts effect” as a proxy—it suggests that investors with less at stake overall will be less risk averse when litigating and more willing to press forward toward trial and vice versa.²³² Granted, an institution with only

227. See SEC. INDUS. ASS'N, *supra* note 89, at 70–72 (listing equities ownership by type of investor); Choi et al., *supra* note 38, at 877–80 (surveying institutional investor participation in securities-fraud litigation and noting the absence of mutual funds as lead plaintiffs).

228. Fisch, *supra* note 48, at 546.

229. See *id.* (contrasting the litigation objectives of institutional investors and individual investors).

230. For more information on risk preferences and how this factors into adequate representation, see *supra* notes 57–62 and accompanying text.

231. Markowitz, *supra* note 57, at 153–54; Prelec & Loewenstein, *supra* note 57, at 773, 774–75; Weber & Chapman, *supra* note 57, at 31–33.

232. See Gousgounis, *supra* note 58, at 5 (“[A] small claimant would prefer litigation when the probability of winning 100 dollars is 0.1 To the contrary, a large claimant going for 100 million dollars would prefer the settlement (certain value of 10million [sic] dollars).”).

peanuts at stake might not think it worth the time to act as a lead plaintiff. But that sentiment likely changed after the influential articles by James Cox and Randall Thomas suggested that institutions were “leaving money on the table” and thereby violating their duty of care.²³³ Although the Cox and Thomas articles addressed the failure to file securities claims to recover settlement funds, the careful institution may take a more active role.

These risk preferences likewise affect whether a group member would continue investing resources in a failing litigation venture or rationally decide to dismiss the lawsuit. Although both groups and individuals can fall prey to “sunk-cost” effects, groups with strong affective ties who share a task-relevant cognitive framework are more susceptible than cognitively diverse groups.²³⁴ As discussed shortly, allocating more decisionmaking authority to lead plaintiffs as opposed to lead counsel may further diminish sunk-cost risks; when one’s own money is at stake—as is the lead counsel’s when investing in the lawsuit—one may be more likely to make sunk-cost errors.²³⁵ Accordingly, an attorney who has invested heavily in her litigation venture may be less inclined than those she represents to abandon the

233. See James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855, 860–67 (2002) [hereinafter Cox & Thomas, *Money on the Table*] (discussing the duty of various institutions to file claims in settled securities class actions); James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 418–19 (2005) [hereinafter Cox & Thomas, *Slip Through Your Fingers*] (concluding that there is a widespread failure of institutions to file claims in class actions and stating that “institutional investors have a legal duty to file claims in securities fraud class action settlements”).

234. See Beth Dietz-Uhler, *The Escalation of Commitment in Political Decision-Making Groups: A Social Identity Approach*, 26 EUR. J. SOC. PSYCHOL. 611, 625 (1996) (showing a positive correlation between coherent group identity and counterproductive decisionmaking); Christine M. Smith et al., *Investment Decisions by Individuals and Groups in ‘Sunk Cost’ Situations: The Potential Impact of Shared Representations*, 1 GROUP PROCESSES & INTERGROUP REL. 175, 178 (1998) (reviewing literature that discusses the relationship between group affinity and sunk-cost effects); Glen Whyte, *Escalating Commitment in Individual and Group Decision Making: A Prospect Theory Approach*, 54 ORG. BEHAV. & HUM. DECISION PROCESSES 430, 447–48 (1993) (finding that minorities that wanted to escalate the group’s commitment were more influential than majorities that argued against it). Granted, if the plaintiffs are emotionally invested in the lawsuit this may make them more prone to sunk-cost effects.

235. See Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Cost*, 35 ORG. BEHAV. & HUM. DECISION PROCESSES 124 (1985) (suggesting that people may continue to pursue an activity with negative value because they have already invested in that activity); Hal R. Arkes & Peter Ayton, *The Sunk Cost and Concorde Effects: Are Humans Less Rational than Lower Animals?*, 125 PSYCHOL. BULL. 591, 597 (1999) (“Justification plays another role in the analysis of the sunk cost effect. Beginning with a study by Staw (1976), it has been shown a number of times that if the decision maker bears personal responsibility for an initial investment, that person is more likely to ‘throw good money after bad’ compared with the situation in which the decision maker bears no personal responsibility for the initial investment decision . . .”).

endeavor if it proves less fruitful or meritorious than initially expected.

3. *Other Fiduciary Obligations.*—Institutions typically have other fiduciary obligations that may occasionally cause their interests to differ from the rest of the class's interests. For instance, private pension funds owe fiduciary duties to their pensioners through ERISA; public pension funds may owe fiduciary obligations to their pensioners through state, county, and municipal legislative requirements; and mutual-fund managers owe fiduciary duties to their investors through the Investment Company Act of 1940.²³⁶ Keeping these extrajudicial obligations in mind when appointing lead plaintiffs may thwart or counterbalance what could develop into a debilitating intraclass conflict.

4. *Remedies.*—Institutions are more likely than individual investors to continue to hold stock in the defendant company and, thus, to request corporate-governance reforms in their complaint.²³⁷ Therefore, an institution-only lead plaintiff may trade increased compensation for internal reforms, whereas a class member who sold her stock would prefer to maximize her recovery. Part III.C.1 returns to and elaborates on this variable since it may mean that plaintiffs have fundamentally incompatible ends that necessitate subclassing.

5. *Counsel-Selection Process and Repeat Relationships with Lead Counsel.*—To claim that lead counsel plays a vital role in the decisionmaking process is an understatement. They have the expertise, finances, and incentives to sue and thus tend to plot the legal strategy and make day-to-day litigation decisions. They, like some pension funds, are repeat players in the process.

Courts have, from time to time, selected multiple law firms as lead counsel when necessary to protect the class's interests, when assigning a group as lead plaintiff, or where it would further resource sharing and access to particular expertise.²³⁸ Still, a handful of law

236. Cox & Thomas, *Money on the Table*, *supra* note 233, at 860–67 (discussing the duty of various institutions to file claims in settled securities class actions).

237. *See supra* notes 48–56 and accompanying text. This makes them “poorly suited to represent investors who are no longer invested in the company.” Fisch, *supra* note 48, at 546.

238. *See, e.g., In re Lernout & Hauspie Sec. Litig.*, 138 F. Supp. 2d 39, 46–47 (D. Mass. 2001) (appointing three law firms as co-lead counsel); *Vincelli v. Nat'l Home Health Care Corp.*, 112 F. Supp. 2d 1309, 1315–16 (M.D. Fla. 2000) (discussing reasons for appointing multiple lead counsel); *In re Milestone Scientific Sec. Litig.*, 187 F.R.D. 165, 176 (D.N.J. 1999); *Sakhrani v. Brightpoint, Inc.*, 78 F. Supp. 2d 845, 854–55 (S.D. Ind. 1999) (appointing two law firms plus local counsel); *In re Oxford Health Plans, Inc., Sec. Litig.*, 182 F.R.D. 42, 50 (S.D.N.Y. 1998) (appointing three law firms); *In re Advanced Tissue Scis. Sec. Litig.*, 184 F.R.D. 346, 353 (S.D. Cal. 1998) (appointing two firms). On the other hand, courts shy away from multiple

firms dominate the securities-class-action market, which tends to box out new entrants.²³⁹ On the positive side, these firms have a wealth of experience and expertise. But using only the same law firms has a negative side, too: they may be beholden to particular institutions.²⁴⁰ Established law firms may adjust their litigation tactics and the settlement's terms to favor those that they will likely meet again—institutions or one another. Recall that law firms monitor institutions' portfolios, alert institutions to potential litigation in which they could be lead plaintiff, and may employ lobbyists or engage in pay-to-play practices.²⁴¹ There is thus an additional, pragmatic concern over whether such a firm can adequately represent the whole class. Consequently, judges should be open to appointing more than one firm where the situation warrants it.

6. *Decisionmaker's Training, Experience, and Sophistication.*—Cognitive diversity comes directly from training and experiences.²⁴² Training, whether from formal schooling or on-the-job skills, influences which perspectives we accumulate and incorporate into our thinking and how we interpret, categorize, and understand the world around us.²⁴³ Someone trained as a lawyer tends to analyze and solve problems differently than an investment banker, a scientist, or an

appointments when the firms may duplicate services, fail to coordinate, or usurp control of the litigation. See, e.g., *Vincelli*, 112 F. Supp. 2d at 1318–19 (finding that multiple lead counsel would not promote efficiency); *In re Oxford Health Plans*, 182 F.R.D. at 50 (appointing multiple lead counsel on condition that there is no duplication of services or increase in fees). Consequently, consistent with the PSLRA's goal of avoiding lawyer-driven litigation, some courts require a showing that “the lead plaintiff will be able to withstand any limitation on, or usurpation of, control, and effectively supervise the several law firms acting as lead counsel.” *In re Milestone Scientific*, 187 F.R.D. at 177.

239. Choi, *supra* note 100, app. d (listing a handful of law firms that are frequently selected as lead counsel); Coffee, *supra* note 6, at 323–24 (listing market shares within securities plaintiffs' bar).

240. Interestingly, Judge Baer recently reasoned that because the proposed class “includes thousands of participants, both male and female, arguably from diverse backgrounds,” securities class counsel must “make every effort to assign . . . at least one minority lawyer and one woman lawyer” to the case. Class Action Order at 1, *In re Gildan Activeware Inc. Sec. Litig.*, No. 08 Civ. 05048–HB (S.D.N.Y. Sept. 20, 2010), available at http://www.abanet.org/litigation/litigationnews/top_stories/docs/9_20_order_gildan.pdf. While this effort might be commendable for a host of other reasons, it is not clear that identity diversity correlates in a meaningful way to cognitive diversity or interest diversity in the securities class action context (as it might, for instance, in a civil rights or employment discrimination context).

241. See *supra* notes 39–40 and accompanying text.

242. PAGE, *supra* note 206, at 300, 302–05.

243. *Id.* at 302–03. For an overview of the potential biases that might increase or decrease if groups relied solely on experts, see Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 491–508 (2002) (positing that expertise exacerbates the egocentrism bias and overconfidence, but likely mitigates technical errors in decisionmaking, the availability heuristic, and the use of irrelevant information).

engineer. Similarly, our experiences demand that we develop unique knowledge and abilities, which we then use in solving problems. For instance, an investor who lost her savings in the Enron scandal and realized that she might have predicted its collapse by comparing its free cash flow with its net income would likely start doing just that before buying stock in the future. Professional investors know how to read a company's 8K and 10K filings, what constitutes a material event, and how to carefully analyze a 10K filing's Management's Discussion and Analysis ("MD&A") section, whereas less sophisticated investors might prefer to rely on Morningstar ratings. Of course, this does not matter for reliance in open-market fraud, but experience does change how plaintiffs make litigation decisions.

Unfortunately, most lead-plaintiff motions contain relatively little information about the plaintiff although they occasionally discuss business ventures, investments, sophistication levels, and litigation experience.²⁴⁴ Still, as a rule of thumb, if the putative lead plaintiff is an institution, its general counsel typically makes its litigation decisions. Judging from the PSLRA's rationale, we tend to assume that institutions have greater financial and legal sophistication as well as better access to information.²⁴⁵ But individual investors, sometimes even those with undiversified portfolios, can be highly skilled and consistently outperform the market.²⁴⁶ Encouraging experienced investors and institutions to serve as lead plaintiff and giving the judge more leeway to appoint qualified representatives suggests that judges should likewise consider lifting the PSLRA's "professional plaintiff" ban for experienced plaintiffs with good track records.²⁴⁷

244. See, e.g., Memorandum in Support of the Motion of Inter-Local Pension Fund GCC/IBT for Consolidation, Appointment as Lead Plaintiff and for Approval of Selection of Lead Counsel at 2, *Reimer v. Ambac Fin. Group, Inc.*, No. 1:08-cv-00411-NRB, 2008 WL 2073931 (S.D.N.Y. Mar. 17, 2008) (noting experience supervising counsel in complex securities cases); Declaration of Fred Crosetto in Support of the Crosetto Group's Motion for Appointment as Lead Plaintiffs and Lead Plaintiffs' Selection of Counsel at 1, *In re Nature's Sunshine Prods., Inc. Sec. Litig.*, No. 2:06cv00267 TS, 2006 WL 2380965 (D. Utah. Aug. 16, 2006) (describing experience in business ventures).

245. See Fisch, *supra* note 48, at 545. Some courts have suggested that the PSLRA requires sophisticated lead plaintiffs. See, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 201, 266 (3d Cir. 2001) ("[T]he goal of the Reform Act's lead plaintiff provision is to locate a person or entity whose sophistication and interest in the litigation are sufficient to permit that person or entity to function as an active agent for the class . . .").

246. See Webber, *supra* note 45, at 13–19 (comparing and contrasting institutional and individual investors).

247. Congress added the so-called "professional plaintiff" prohibition to the Securities Exchange Act of 1934 as part of the PSLRA. 15 U.S.C. § 78u-4(a)(3)(B)(vi) (2006) (barring someone from serving as a lead plaintiff if she has served in that capacity five times during the

These six factors each have multiple dimensions—institutions, individuals, risk-seekers, risk-avoiders, experienced general counsel, those who want corporate-governance reforms, those who want monetary remedies, you name it. Assembling a small representative group means closely examining the class definition, the complaint, and the plaintiffs' motions to decide which interests require representation. Doing so ensures that dissenting voices are present, but it also requires judges to be flexible and willing to reassess the group's composition if conflicting interests emerge or the class definition changes. This does not mean, however, that a small, diverse group could not represent the class's interests. In fact, enduring social science research consistently demonstrates that small groups with between three and eight members outperform larger ones often because of the same collective-action problems legal academics have already identified.²⁴⁸ Preliminary anecdotal evidence also suggests that appointing diverse lead plaintiffs can result in higher settlements. For example, in *Oxford Health Plans, Inc. Securities Litigation*, the court designed its own lead plaintiff group from three competing plaintiffs' groups to ensure adequate representation, resulting in one of the largest recoveries ever received from an accounting firm.²⁴⁹

Further incentivizing plaintiffs to seek and take on the lead-plaintiff role will help the judge too.²⁵⁰ Currently, lead plaintiffs receive only their pro rata settlement share plus some of their out-of-pocket litigation expenses. Consequently, institutions worry about costly discovery, having to disclose proprietary information, devoting resources to overseeing the litigation, and the time it takes to

preceding three years unless the court approves otherwise). For courts and commentators supporting this position, see *Dees v. Colonial Bancgroup, Inc.*, No. 2:09cv104–MHT, 2009 WL 1285424, at *2 (M.D. Ala. May 7, 2009); *Kuriakose v. Federal Home Loan Mortgage Co.*, No. 1:08–cv–7281 (JFK), 2008 WL 4974839, at *8 (S.D.N.Y. Nov. 24, 2008); *Smith v. Suprema Specialties, Inc.*, 206 F. Supp. 2d 627, 639–42 (D.N.J. 2002); Cox & Thomas, *supra* note 7, at 1638.

248. See MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 53–57 (2d ed. 1971) (citing examples of small group superiority); A. Paul Hare, *A Study of Interaction and Consensus in Different Sized Groups*, 17 AM. SOC. REV. 261, 267 (1952) (reporting that in one experiment a group of five found it easier to reach consensus than a group of twelve when time for discussion was limited); Susan A. Wheelan, *Group Size, Group Development, and Group Productivity*, 40 SMALL GROUP RES. 247, 247, 256–58 (2009) (finding that groups with three to six members were more productive than those with seven to ten or eleven members or more).

249. *In re Oxford Health Plans, Inc., Sec. Litig.*, 182 F.R.D. 42, 44–46 (S.D.N.Y. 1998). Chitwood Harley Harnes, one of the law firms involved in the litigation, lists this as an accomplishment on its website. *Achievements*, CHITWOOD HARLEY HARNES LLP, <http://www.chitwoodlaw.com/practice/achievements.php> (last visited Apr. 4, 2011). There is, however, some anecdotal evidence that the plaintiffs' lawyers in *Oxford* could have settled the case much earlier for the same amount.

250. See *infra* Part III.B.3.

monitor.²⁵¹ Although successful settlements reimburse lead plaintiffs for their out-of-pocket costs, they are not always reimbursed at market rates for in-house staffing hours, which range dramatically from 40 to 100 at the low end to between 250 and 1000 at the high end.²⁵² Accordingly, the better option today is to follow numerous commentators' suggestion of awarding lead plaintiffs more than their pro rata settlement share in addition to their out-of-pocket litigation expenses and costs.²⁵³

2. Promoting a Competitive Selection Process

Creating a competitive lead-plaintiff process will be easier with appropriately incentivized plaintiffs and attorneys who know that judges will appoint both experienced and new entrants into the securities-class-action field. To understand competition's benefits, consider a cautionary tale that partially led Congress to enact the PSLRA. Pre-PSLRA litigation involved management by committee, but attorneys compiled their own committee much as a political convention elects its own platform.²⁵⁴ Nominations and elections weren't based on credentials, but on friendships, brokered deals, and power players within the plaintiffs' bar.²⁵⁵ Accordingly, lawyers had little incentive to trim the fat, encourage competition, or select the most experienced litigators.²⁵⁶ As a result, Congress rejected proposals that would have institutionalized the plaintiffs' steering committee.²⁵⁷ It was concerned that a committee of plaintiffs' attorneys would simply continue the then-current practice.²⁵⁸

251. Cox & Thomas, *supra* note 7, at 1602–10.

252. *Id.* at 1606–07.

253. *See, e.g., id.* at 1637–38 (proposing that courts use a variation on the lodestar method to determine the extra amount lead plaintiffs should receive). Granted, affording too much of a premium can lead to overzealous plaintiffs' attorneys. Thus, the key is to award just enough to incentivize plaintiffs. I do not take a position here on the best method for determining the optimal amount. For articles suggesting the inadequacies of the lodestar method, however, see John Bronsteen, *Class Action Settlements: An Opt-In Proposal*, 2005 U. ILL. L. REV. 903, 911 n.54 (stating that the lodestar method results in excessive collusion); Charles Silver, *Due Process and the Lodestar Method: You Can't Get There from Here*, 74 TUL. L. REV. 1809, 1812–21 (2000) (arguing that the lodestar method is not the best method for minimizing conflicts).

254. Coffee, *supra* note 35, at 418–19.

255. *Id.*

256. *Id.* at 419–20.

257. *See* Securities Litigation Reform Act, H.R. 1058, 104th Cong. § 2(a) (as passed by the House, Mar. 8, 1995) (mandating a steering committee comprised of no less than five members); Private Securities Litigation Reform Act of 1995, S. 240, 104th Cong. (as reported by S. Comm. on Banking, June 19, 1995) (striking five-member steering committee provision).

258. *See* Coffee, *supra* note 35, at 418–19.

Unfortunately, competition post-PSLRA has increased little. Before the PSLRA, five law firms dominated the securities-class-action market, constituting roughly 56.2 percent of the market; post-PSLRA, five firms constitute 52.2 percent of the market.²⁵⁹ This is caused in part by law firms' repeat relationships with institutions, and in part by the PSLRA's restriction on discovery into adequacy as part of the appointment process.²⁶⁰ Although this restriction is meant to prevent the process from becoming "an expensive and abusive sideshow,"²⁶¹ these concerns could be mitigated through protective orders and narrowly tailored discovery. Currently, the restriction inhibits competitors from determining why some plaintiffs and their counsel might have conflicting interests. Would-be competitors are caught in the midst of a circularity problem: the only way to obtain discovery into adequacy is to demonstrate "a reasonable basis for a finding that the presumptively most adequate plaintiff is incapable of representing the class,"²⁶² but that's hard to do without discovery. Reduced competition also means that the judge must take on more of an inquisitorial role, something that most judges trained in an adversarial culture find themselves ill equipped to do.²⁶³

Knowing that judges will select a diverse, representative group is likely to increase competition by opening the market up to less established plaintiffs' firms. A competitive process has several benefits. First, it does not stress group cohesion and cooperation. If group members know they represent a subset of interests and that others' interests vary from theirs, then they are likely to monitor vigilantly. Likewise, competition helps establish dissent as an acceptable and encouraged norm, which, as explored shortly, is critical to better group decisionmaking.²⁶⁴

Second, competition breeds choice both in terms of lead plaintiffs and lead counsel. As Stephen Choi explains, nondominant

259. Coffee, *supra* note 6, at 323–24.

260. 15 U.S.C. § 78u-4(a)(3)(B)(iv) (2006) (implementing a threshold pre-discovery requirement that there be shown a "reasonable basis" for believing that the "presumptively most adequate plaintiff is incapable of adequately representing the class").

261. Weiss & Beckerman, *supra* note 23, at 2109.

262. Gluck v. CellStar Corp., 976 F. Supp. 542, 547 (N.D. Tex. 1997). Courts occasionally allow discovery to determine the presumptive lead plaintiff. See *In re Network Assocs., Inc., Sec. Litig.*, 76 F. Supp. 2d 1017, 1027 (N.D. Cal. 1999) (discussing short depositions of lead-plaintiff candidates).

263. Elizabeth Chamblee Burch, *Procedural Justice in Nonclass Aggregation*, 44 WAKE FOREST L. REV. 1, 33 (2009); see also Howard M. Erichson, *Mass Tort Litigation and Inquisitorial Justice*, 87 GEO. L.J. 1983, 2005–06 (1999) (pointing to "emerging patterns of an inquisitorial justice system" in mass tort litigation).

264. See *infra* Part III.C.3.

law firms “may lack securities class action-specific expertise to fight with larger plaintiffs’ attorney firms,” “have fewer contacts with investors who may potentially act as lead plaintiff,” and are often “smaller in size.”²⁶⁵ Because only a few law firms dominate the market, their repeated interaction may lead to side deals that exclude new entrants.²⁶⁶ Thus, the more courts open up the selection process by appointing diverse representatives, the more competitive the process will become.

Finally, competition and adequate representation have a causal relationship: less competition in the selection process means a weaker legal-services market, which means that there are fewer incentives for attorneys to ignore their own preferences when they conflict with the class’s preferences.²⁶⁷ Plus, the economics literature routinely suggests that players in noncompetitive markets underperform.²⁶⁸ Accordingly, intensifying competition will expand choices and may thereby drive down legal fees, increase quality, and encourage attorneys to act as faithful agents.

3. Ensuring Adequate Representation Throughout the Litigation

Judges have the authority to appoint separate lead plaintiffs and lead counsel when conflicting interests exist.²⁶⁹ Yet, most refuse to do so because they claim, “it is premature to determine before a full class certification hearing whether a Lead Plaintiff fairly and adequately represents the interests of class members.”²⁷⁰ Instead,

265. Choi, *supra* note 100, at 11.

266. *See id.* app. d (listing a handful of law firms that are frequently selected as lead counsel).

267. *See Coffee, supra* note 35, at 412–15 (discussing conflicts of interest between clients and attorneys).

268. *See id.* at 414 (“[W]henver one detects slack or consistently substandard performance in a market . . . it is usually a safe diagnosis to predict that competition is lacking in the relevant market.”); John Vickers, *Concepts of Competition*, 47 OXFORD ECON. PAPERS 1, 1 n.2 (1995) (citing studies that provide evidence of the positive relationship between competition and productive efficiency).

269. *See In re Cendant Corp. Litig.*, 182 F.R.D. 144, 149 (D.N.J. 1998) (appointing a separate lead plaintiff because of conflicts of interests); *Chill v. Green Tree Fin. Corp.*, 181 F.R.D. 398, 402 (D. Minn. 1998) (appointing separate lead plaintiffs and counsel for options purchasers and securities purchasers despite not finding a conflict of interest).

270. *In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427, 446, 451 (S.D. Tex. 2002); *see also id.* at 451 (noting that “well-founded and persuasive arguments for separate representation and classes or subclasses” exist, but putting them off until class certification or trial); *Local 144 Nursing Home Pension Fund v. Honeywell Int’l, Inc.*, No. 00–3605 (DRD), 2000 WL 33173017, at *5 (D.N.J. Nov. 16, 2000) (finding that at the current preliminary stage of the litigation appointment of one lead-plaintiff group was appropriate); *In re MicroStrategy, Inc. Sec. Litig.*,

courts require only a preliminary showing of adequacy and typicality when appointing the lead plaintiff and read the PSLRA as a statutory presumption that “one lead plaintiff can vigorously pursue all available causes of action against *all* possible defendants under *all* available legal theories.”²⁷¹

Ignoring the need for separate representatives until plaintiffs certify the class or reach trial is inconsistent with the trend toward front-loading securities class actions. This trend is evident in three respects. First, securities class actions are increasingly difficult to plead: the PSLRA implements exacting pleading standards and, more recently, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* interprets the PSLRA’s term “strong inference” as requiring the scienter inference to be “at least as compelling as any opposing inference one could draw from the facts alleged.”²⁷² As a result, plaintiffs must thoroughly investigate facts before discovery and include them in the complaint to counter a defendant’s Rule 12(b)(6) motion to dismiss—now the most formidable obstacle to settlement.²⁷³

Second, a spate of appellate court decisions, principally in the securities-class-action context, have encouraged courts to look closer into the merits during class certification.²⁷⁴ Judges now resolve factual

110 F. Supp. 2d 427, 431–32 (E.D. Va. 2000) (proceeding with naming lead counsel only after granting the motions to consolidate); *In re Nice Sys. Sec. Litig.*, 188 F.R.D. 206, 217–18 (D.N.J. 1999) (applying a truncated Rule 23 analysis and presuming the adequacy of the proposed lead plaintiffs in light of lack of opposition, but acknowledging that opposition might have triggered discovery and a fuller hearing); *In re Olsten Corp. Sec. Litig.*, 3 F. Supp. 2d 286, 293–97 (E.D.N.Y. 1998) (same as *In re Microstrategy*); *Gluck v. CellStar Corp.*, 976 F. Supp. 542, 549–50 (N.D. Tex. 1997) (stating that one lead plaintiff best serves the purposes of the PSLRA in most cases).

271. *Aronson v. McKesson HBOC, Inc.*, 79 F. Supp. 2d 1146, 1151 (N.D. Cal. 1999); *see also* *Freudenberg v. E*Trade Fin. Corp.*, No. 07 Civ. 8538, 2008 WL 2876373, at *5 (S.D.N.Y. July 16, 2008) (“At this stage of the litigation, the moving plaintiff must only make a preliminary showing that the adequacy and typicality requirements have been met.”); *Reimer v. Ambac Fin. Group, Inc.*, No. 08 Civ. 411(NRB), 2008 WL 2073931, at *4 (S.D.N.Y. May 9, 2008) (reciting preliminary-showing requirement); *Weinberg v. Atlas Air Worldwide Holdings, Inc.*, 216 F.R.D. 248, 252 (S.D.N.Y. 2003) (same); *In re Enron*, 206 F.R.D. at 451 (“Thus their requests for splintering the action or appointing multiple Lead Plaintiffs to represent specialized interests . . . would undermine the purpose of the PSLRA.”).

272. 551 U.S. 308, 324 (2007). The PSLRA implements heightened pleading requirements. 15 U.S.C. § 78u–4(b)(1)–(2) (2006).

273. *See* *Cox & Thomas, Slip Through Your Fingers*, *supra* note 233, at 418–19 (“The most serious obstacle confronting the class action is withstanding the motion to dismiss.”).

274. *E.g.*, *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 307 (3d Cir. 2008); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007); *In re Initial Pub. Offerings Sec. Litig.*, 471 F.3d 24, 41 (2d Cir. 2006) (holding that a court may certify a class only after it “resolves factual disputes relevant to each Rule 23 requirement”); *Szabo v. Bridgeport Machs., Inc.*, 249 F.3d 672, 676 (7th Cir. 2001) (“Before deciding whether to allow a case to proceed as a class action, therefore, a judge should make whatever factual and legal inquiries are

disputes that relate to class certification by a preponderance of the evidence.²⁷⁵ Moreover, merits-related questions have leached into both the motion-to-dismiss and the class-certification stage.²⁷⁶ For example, the Second Circuit in *In re Initial Public Offerings Securities Litigation* required evidence of an efficient market as part of its certification inquiry,²⁷⁷ and the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo* required proof of loss causation to plead a securities-fraud class action.²⁷⁸ This may account, at least in part, for the increase in precertification dismissals—now between forty-one and forty-four percent.²⁷⁹

Third, most work (and thus the representation) takes place before certification. Most cases settle soon after a judge certifies them.²⁸⁰ Even before Congress passed the PSLRA, courts typically ruled on motions to dismiss and motions for summary judgment before

necessary under Rule 23.”); see also PRINCIPLES, *supra* note 34, § 2.06(a) (stating that a court must resolve questions of law and fact if relevant to the suitability of a class-action treatment).

275. *In re Hydrogen Peroxide*, 552 F.3d at 307 (“Factual determinations supporting Rule 23 findings must be made by a preponderance of the evidence.”); *Oscar Private Equity Invs.*, 487 F.3d at 269 (“We hold hence that loss causation must be established at the class certification stage by a preponderance of all admissible evidence.”); see also PRINCIPLES, *supra* note 24, § 2.06(b) (stating that questions of fact relevant to the suitability of class-action treatment should be resolved by the preponderance-of-the-evidence standard).

276. See Michael J. Kaufman & John M. Wunderlich, *The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions*, 43 U. MICH. J.L. REFORM 323, 323, 330–34 (2010) (discussing case law requiring proof of merits at class-certification stage and noting the effect of *Tellabs* on lower courts’ treatment of motions to dismiss); Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. REV. 97, 136–41 (2009) (discussing the distinction between “necessary law declaration in the class certification context and unwarranted swallowing-up of summary judgment”).

277. 471 F.3d at 42–43; see also Nagareda, *supra* note 276, at 136–37 (discussing the *IPO* case).

278. 544 U.S. 336, 342–46 (2005); see also Nagareda, *supra* note 276, at 137–39 (discussing the *Dura Pharmaceuticals* case).

279. See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2009: A YEAR IN REVIEW 21–22 (2010), available at http://securities.stanford.edu/clearinghouse_research/2009_YIR/Cornerstone_Research_Filings_2009_YIR.pdf (finding an uptick in dismissals and suggesting without concluding that *Dura Pharmaceuticals* is the cause); STEPHANIE PLANCICH & SVETLANA STARYKH, NERA ECON. CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2009 MID-YEAR UPDATE 15–18 (2009), available at http://www.nera.com/ext/Image/Recent_Trends_Report_07_09.pdf (finding a slightly higher likelihood of dismissal after *Dura Pharmaceuticals*).

280. See Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251, 1292 (2002) (“Other empirical studies, although few in number, . . . confirm what most class action lawyers know to be true: almost all class actions settle, and the class obtains substantial settlement leverage from a favorable certification decision.”); Willging et al., *supra* note 27, at 142–44 (finding that, in the districts surveyed, certified cases were two to five times more likely to settle than non-certified cases).

ruling on class certification.²⁸¹ But the 2003 amendments to Rule 23 make this trend more explicit. The changes pushed the certification decision from “as soon as practicable after commencement of an action” to “an early practicable time.”²⁸² This allows the court to delay certifying the class until the parties finish conducting certification-related discovery, put together an adjudication plan, and file motions to dismiss and motions for summary judgment.²⁸³

In sum, most key decisions in all class actions are made before certification, but securities class actions’ unique lead-plaintiff process provides class members extra insurance—if only judges used it as such. Put simply, if pretrial is the new trial, then judges should take steps to ensure adequate representation earlier in the process. Rule 23(g)(3), which was added as part of Rule 23’s 2003 amendments after Congress enacted the PSLRA in 1995, implicitly recognizes this need and addresses it by allowing courts to appoint interim counsel to act in the putative class’s best interests before certification.²⁸⁴ Likewise, judges selecting lead plaintiffs should not turn a blind eye to apparent conflicts by postponing the adequacy inquiry.²⁸⁵

C. Litigation Governance Through Group Decisionmaking

1. Avoiding Diverse Fundamental Preferences Through Subclassing

Subclassing remains an important tool for ensuring adequate representation, but its benefit should be weighed against its potential to create a subclass with little to no settlement leverage. As beneficial as cognitive diversity is for reaching creative solutions and more reasoned decisions, diversity can also lead to significant problems if group members disagree on their background framework. In other words, if lead plaintiffs have fundamentally different goals, then that conflict causes difficulty in decisionmaking. Diverse preferences over *ends*, “fundamental preferences,” are far more troubling than

281. *See id.* at 104–05 (discussing pre-PSLRA data showing that rulings on motions to dismiss and motions for summary judgment often preceded class certification).

282. FED. R. CIV. P. 23(e) advisory committee’s notes.

283. *See id.* (elaborating on reasons for the change in the rule).

284. *Id.* R. 23(g)(3).

285. Judges must also monitor adequacy throughout the litigation, particularly if counsel changes the class definition. Plus, increased rigor at the front end should neither change the plaintiffs’ burden of proving adequacy at certification nor affect the defendant’s right to challenge it.

differences over *means*, or “instrumental preferences.”²⁸⁶ The trick lies in distinguishing one from the other.

It may help to consider a nonlegal example: a corporation’s managers and board of directors may all share a common, profit-seeking goal. They might differ over the means of achieving that goal, but they will all be satisfied when the company makes more money. On the other hand, the company’s retail store manager may not be pleased if management implements a new commission policy that diminishes her take-home pay. The retail manager and company management thus have fundamentally diverse preferences.²⁸⁷

In the securities-class-action context, preferences work much the same way—the plaintiffs’ various interests affect whether a preference is fundamental or instrumental. If, for instance, plaintiffs want different remedies, say corporate-governance reforms versus monetary compensation, is this a conflict over instrumental means or a fundamental end? It might be that all plaintiffs have a desire to hold the defendant accountable and deter others from engaging in fraud, but differ over the best way to go about it. If so, the conflict is an instrumental one about how to achieve their desired result.²⁸⁸ On the other hand, if one lead plaintiff wants corporate-governance reforms not as a means for holding the defendant accountable, but to boost her stock value as a current owner, and another lead plaintiff wants to maximize her compensation or promote accountability and deterrence, then these are diverse fundamental preferences. As such, fundamental preferences require scrutiny to uncover—something that a competitive lead-plaintiff selection process will help do—and, to ensure adequate representation, the judge should subclass or encourage one group to opt out and maintain a separate action. Still, because subclassing has the potential to undermine subgroups’ credible threat against the defendant, it should be used sparingly.

Failing to subclass plaintiffs with diverse fundamental preferences when necessary can cause a host of problems, including an inability to reach consensus, arbitrary choices through group voting, and strategic behavior through withholding consent.²⁸⁹ If the group includes members with diverse fundamental preferences, then lead plaintiffs faced with more than two settlement-design alternatives

286. See PAGE, *supra* note 206, at 11–12 (distinguishing between fundamental preferences and instrumental preferences).

287. Scott Page offers similar examples. *Id.* at 256–57.

288. See *id.* at 250–51 (suggesting that even politicians who have vastly different preferences over how to achieve policy aims still have the same aims—such as better education systems and health care—and are thus instrumental rather than fundamental).

289. *Id.* at 256.

may misrepresent their preferences and manipulate the outcome through strategic behavior.

To illustrate one form of strategic holdout behavior, consider a well-known but semi-speculative example from the asbestos litigation. Before the Supreme Court decided *Amchem*, a plaintiffs' steering committee hit a standstill in negotiating with defendants; neither side could get past "the lowest common denominator on their points of agreement."²⁹⁰ As anyone familiar with the litigation knows, both sides eventually struck a deal for future asbestos plaintiffs (with a side deal for current, "inventory" plaintiffs), which the Supreme Court struck down in *Amchem Products, Inc. v. Windsor*.²⁹¹ The objector bringing the appeal was none other than Fred Baron, who had a seat on the initial plaintiffs' steering committee.²⁹²

To simplify a complex case for the purpose of this example, two things went wrong at two levels. First, the committee itself was comprised solely of lawyers who did not account for the diverse fundamental preferences of their purported clients: inventory plaintiffs with present injuries wanted to maximize their current payout, and those with injuries that might manifest in the future wanted to preserve defendants' assets. Second, but related, a fissure likely existed within the plaintiffs' bar: Fred Baron wanted to continue to litigate asbestos cases and thus preferred not to settle "futures" cases, whereas Joseph Rice and Ronald Motley (of Motley Rice) were ready to move on to the tobacco litigation.²⁹³ Thus, the key plaintiffs' attorneys had fundamentally diverse preferences that, as Richard Nagareda describes it, "form[ed] a blueprint for holdouts."²⁹⁴

Several design lessons emerge from this example. First, when preference differences are fundamental and predictable, like the futures versus the inventory plaintiffs, subclassing may help avoid strategic behavior when one group can succeed only at the other group's expense. It could likewise help to avoid the inadequate representation problems that arise when one representative attempts to represent both groups.²⁹⁵ The caveat is that subclassing diminishes

290. *Georgene v. Amchem Prods., Inc.*, 157 F.R.D. 246, 266 (E.D. Pa. 1994).

291. 521 U.S. 591, 597 (1997).

292. Richard A. Nagareda, *Turning from Tort to Administration*, 94 MICH. L. REV. 899, 966 (1996) (citing Andrew Blum, *Asbestos Counsel*, NATL. L.J., Oct. 21, 1991, at 2).

293. RICHARD A. NAGAREDA, MASS TORTS IN A WORLD OF SETTLEMENT 93 (2007).

294. Nagareda, *supra* note 292, at 966.

295. To be sure, lead-plaintiff groups will likely include many members with diverse instrumental preferences. So long as those interests are represented within the group, members should be able to compromise to reach an acceptable settlement. It is when plaintiffs have fundamentally incompatible ends requiring separate legal representation that subclassing

a subgroup's settlement value by carving it out of the group that creates the credible threat against the defendant. Subclassing the future claimants in *Amchem*, for example, may have alleviated an adequate-representation problem, but it would have likewise divorced future claimants from present claimants—those who held most of the settlement leverage. Depending on the circumstances, the same might be said of smaller investors' litigation stakes compared with an institution's investment. Consequently, subclassing as a matter of course provides an unsatisfactory answer to the adequate representation problem.

The second lesson that emerges from the *Amchem* example is that requiring lead plaintiffs with incompatible ends to achieve unanimity will cause some to withhold consent, vote strategically, or otherwise misrepresent their preferences. Finally, because we mostly trust lead plaintiffs to oversee the litigation and the attorneys, if we give them enough authority, their involvement in decisionmaking and negotiating may reign in attorney-client agency problems and thwart the self-interested behavior that different business strategies caused in *Amchem*.

Although similar problems could emerge when lead plaintiffs have diverse *instrumental* preferences, they are less likely. When people share a common goal, they have weak incentives to misrepresent their preferences.²⁹⁶ Moreover, they have incentives to share information—not hide or distort it.

Whether preferences differ fundamentally or instrumentally affects both when judges should subclass and how they construct broadly representative decisionmaking groups. Using subclasses too liberally could pose a real danger. Subclassing instrumental differences rather than just fundamental ones risks allocating finite resources—attorneys' time and money—too thinly. Plus, over-subclassing dilutes plaintiffs' credible threat against the defendant, which may translate into a smaller settlement and a worse overall outcome.

becomes necessary. Even then, the potential for compromise remains, but constitutional notions of due process (and the practical decisionmaking problems mentioned in this section) require separate representation. See *Amchem*, 521 U.S. at 623 ("Rule 23(e) . . . protects unnamed class members 'from unjust or unfair settlements protecting their rights when the representatives become fainthearted before the action is adjudicated or are to secure satisfaction of their individual claims by a compromise.'") (quoting 7B CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 1797 (3d ed. 2008)).

296. PAGE, *supra* note 206, at 274, 280–81.

2. Lead Plaintiffs' and Lead Counsel's Obligations

Before suggesting how a properly constituted lead-plaintiff group should make decisions, it helps to identify which decisions belong to the lead plaintiffs versus lead counsel and when lead plaintiffs should have input versus decisionmaking authority. Lead plaintiffs' participation and decisionmaking responsibilities are not synonymous. They make some decisions on their own such as selecting counsel and negotiating the fee arrangement, but they participate alongside counsel in key activities such as discovery, litigation strategy, and settlement negotiations.²⁹⁷ For example, Jill Fisch reports that institutions "review pleadings, sometimes making substantial revisions or edits," "discuss litigation strategy," "monitor settlement discussions," review time sheets, and sometimes participate in settlement negotiations.²⁹⁸

Despite pinning a myriad of private obligations and public aspirations on the lead plaintiff, her formal decisionmaking responsibilities are limited.²⁹⁹ Often at counsel's urging, lead plaintiffs file a complaint, review and certify the complaint, and request appointment as lead plaintiff. Ostensibly on their own, they select lead counsel and negotiate counsel's fee arrangement, which is still subject to court approval.³⁰⁰ Their decisionmaking authority in other areas, such as settlement, is less certain. As the Eighth Circuit has noted:

297. See, e.g., Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650, 707 (2002) ("[Institutions] place considerable importance on identifying a firm with which they can develop a good working relationship, and cite joint decisionmaking and regular reporting as important priorities."); Roche, *supra* note 218, at 1 (noting that the law firm "welcomed our involvement in all facets of the litigation from the pleading of the complaint through the settlement negotiations").

298. Fisch, *supra* note 297, at 709.

299. Given the number of responsibilities some courts delineate to class counsel, one wonders what is left for the lead plaintiff to do. See, e.g., *Cortese v. Radian Grp., Inc.*, No. 07-3375, 2008 WL 269473, at *8 (E.D. Pa. Jan. 30, 2008) (requiring counsel to coordinate briefing and arguing motions, written discovery, and witnesses examination as well as appointing a spokesperson, calling meetings of plaintiffs' counsel, conducting settlement negotiations, directing trial preparation, transmitting correspondence to plaintiffs, and supervising "any other matters"); *In re Sterling Fin. Corp. Sec. Class Action*, No. 07-2171, 2007 WL 4570729, *7-8 (E.D. Pa. Dec. 21, 2007) (same); *In re Flight Safety Techs., Inc. Sec. Litig.*, 231 F.R.D. 124, 133 (D. Conn. 2005) (same); *In re Catalina Mktg. Corp. Sec. Litig.*, 225 F.R.D. 684, 687-88 (M.D. Fla. 2003) (same); *In re Cell Pathways, Inc. Sec. Litig. II*, 203 F.R.D. 189, 194 (E.D. Pa. 2001) (same).

300. See 15 U.S.C. § 78-4(a)(2), (3)(B)(v) (2006) (listing the lead plaintiff's responsibilities, including selecting lead counsel); *In re Cendant Corp. Sec. Litig.*, 404 F.3d 173, 199-200 (3d Cir. 2005) ("The paramount goal . . . is to give the lead plaintiff . . . authority over class counsel."); *In re Network Assocs, Inc. Sec. Litig.*, 76 F. Supp. 2d 1017, 1033 (N.D. Cal. 1999) ("The lead plaintiff owes a fiduciary duty to obtain the highest quality representation at the lowest price."). The court still oversees these responsibilities, however. *In re UnitedHealth Grp. Inc. PSLRA Litig.*, 643 F. Supp. 2d 1094, 1102 (D. Minn. 2009).

[The PSLRA] is silent on the other responsibilities and rights that lead plaintiffs have to control, direct, and manage class action securities litigation. In particular, [the PSLRA] says nothing about whether the lead plaintiff must either approve a settlement or be replaced for actions inimical to class interests before a district court may review and approve a proposed settlement. In addition, it says nothing regarding how a district court should deal with a fractured lead plaintiff group that advocates inconsistent positions. . . . Looking at the narrow issue that is presented, namely, what weight a district court must give to objections from a fraction of a fractured lead plaintiff group, we find no guidance in the [PSLRA] . . .³⁰¹

This leads to a curious juxtaposition: we expect so much from lead plaintiffs, but give them little decisionmaking autonomy. Even their discretion to select lead counsel does not give them the authority to fire them. So, if a lead plaintiff decides that the class is better off going to trial or thinks the precedent valuable, but the attorney-as-financier disagrees, there is little the lead plaintiff can do apart from objecting or opting out.³⁰² The rationale is sound: the lead counsel must act in the class's best interests, not just the lead plaintiff's best interests.³⁰³ But up until settlement, courts willingly assume that the lead plaintiff's interests closely align with the class's best interests.

Granted, the disgruntled lead plaintiff has options. She can voice her objections to the court, which has a duty both to listen to those objections and to ensure that the class settlement is "fair, reasonable, and adequate."³⁰⁴ If the court approves the settlement over her objection, then she, like other objectors, could either opt out or appeal the court's settlement approval. But focusing singularly on settlement where the judge enters the picture misses the need for

301. *In re BankAmerica Corp. Sec. Litig.*, 350 F.3d 747, 751 (8th Cir. 2003); *see also* John C. Coffee, Jr., *What Should a Lead Plaintiff Do?*, N.Y.L.J., Jan. 17, 2002, at 5 ("[T]he actual duties of the lead plaintiff are largely unspecified."). At least one court has been more hospitable to a lead plaintiff's objections. *See Moore v. Halliburton*, No. 3:02-CV-1152-M, 2004 U.S. Dist. Lexis 18187, at *13–20 (N.D. Tex. Sept. 9, 2004) (recognizing a lead plaintiff's objection to a settlement agreement as a reason for not approving the agreement).

302. Although there is a chance that the judge will reject the settlement, judges tend to favor settlement because it clears their dockets and may enhance their managerial reputation with the Judicial Panel on Multidistrict Litigation.

303. *See In re BankAmerica*, 350 F.3d at 751 (discussing safeguards that ensure that the interests of the class, and not solely the interests of the lead plaintiff, are represented in the litigation); *Laskey v. Int'l Union*, 638 F.2d 954, 957 (6th Cir. 1981) ("That the class counsel proposed a settlement which the named representatives opposed does not prove that the interests of the class were not protected."); *Pettway v. Am. Cast Iron Pipe Co.*, 576 F.2d 1157, 1176 (5th Cir. 1978) (discussing the class attorney's failure to appeal because he felt that such an appeal would not be in the best interests of the class, not only the lead plaintiffs); *Koehler v. Green*, No. CV 405–367–JFN, 2006 WL 5605002, at *5 (E.D. Mo. Apr. 20, 2006) ("[A] fraction of a fractured lead plaintiff group may not singlehandedly veto a class action settlement to the detriment of the class as a whole."); *Thomas v. Albright*, 77 F. Supp. 2d 114, 122 (D.D.C. 1999) ("Class counsel is required to act in the 'best interests of the class considered as a unit.' ") (quoting *Parker v. Anderson*, 667 F.2d 1204, 1211 (5th Cir. 1982)).

304. FED. R. CIV. P. 23(e).

representative decisionmaking and input along the way in identifying claims, requesting particular remedies, participating in discovery, plotting litigation strategy, and taking part in settlement negotiations. Settlement, after all, typically takes years.

If courts begin appointing truly representative lead-plaintiff groups, then judges and lead counsel should likewise allocate lead plaintiffs more decisionmaking autonomy and give their input more weight. Class counsel should consult and take direction from a richly representative lead-plaintiff group in much the same way that an attorney consults with her client in individual litigation. Usually, lawyers must discuss their client's litigation objectives, keep their clients reasonably informed, ensure that clients "have sufficient information to participate intelligently in decisions concerning the objectives of the representation and the means by which they are to be pursued," "explain the general strategy and prospects of success," and "consult the client on tactics that are likely to result in significant expense or to injure or coerce others."³⁰⁵

In general, clients have the right to make decisions that affect the case's merits, such as whether to waive the right to plead an affirmative defense.³⁰⁶ Given the well-known wedge between class counsel's interests and class members' interests, lead plaintiffs should also review and make critical decisions about pretrial motions and discovery; otherwise, an attorney operating on a contingent-fee basis may be tempted to skimp on cost and quality or could fall prey to sunk-cost effects.³⁰⁷ In short, if lead plaintiffs are to adequately represent class members' interests, monitor the lawyers, and minimize agency costs, then, consistent with the PSLRA's goal of increasing client control, lead plaintiffs should have decisionmaking authority over key decisions as well as decisions that implicate their values and litigation objectives.³⁰⁸

305. MODEL RULES OF PROF'L CONDUCT R. 1.4, cmts. 2, 5.

306. *See id.* R. 1.2(a) (discussing the decisions that the client, as opposed to the attorney, is entitled to make); MODEL CODE OF PROF'L RESPONSIBILITY EC 7-7 (1980) ("[I]t is for the client to decide whether he will . . . waive his right to plead an affirmative defense.").

307. Mark Spiegel, *Lawyering and Client Decisionmaking: Informed Consent and the Legal Profession*, 128 U. PA. L. REV. 41, 124 (1979).

308. *Id.* at 125 (arguing that client decisionmaking "maximize[s] the client's ability to monitor the lawyer and . . . minimize[s] expense") (1979); *see also Koehler*, 2006 WL 5605002, at *5 (noting that the plaintiff played an active role in the previous suit by participating "with class counsel in discovery and the development of legal theories and strategy" as well as in "the mediation with class counsel"). Granted, just because lead counsel should consult the lead plaintiff group on certain decisions, the group can still decide to forgo discussion on tangential matters.

3. Decisionmaking Procedures

How then should groups decide these matters? As evidenced by the few lead-plaintiff groups that actually describe how they decide, decision rules could take multiple forms—consensus, majority voting with a one-vote-per-group-member system, supermajority voting, or even voting based on proportional litigation stakes. And the group may prefer to mix these models depending on the task.³⁰⁹ For instance, discovery and pretrial preferences might be uncontroversial enough for the group to reach consensus, whereas settlement terms might entail a vote.

Regardless of the decisionmaking rule, the process preceding the decision must include opportunities for dissent and information sharing.³¹⁰ Both are critical to adequate representation and fully informed decisionmaking.³¹¹ And recall that dissent is key to avoiding group polarization and confirmation bias. It also improves creativity, performance, and quality by exposing group members to novel views (even when those views are incorrect) and revealing hidden information.³¹² Discussions where members voice dissenting views tend to last longer, to exchange more information, and to produce more alternatives than do those without dissent.³¹³

309. See P.R. Laughlin & A.L. Ellis, *Demonstrability and Social Combination Processes on Mathematical Intellectual Tasks*, 22 J. EXPERIMENTAL SOC. PSYCHOL. 177, 184–87 (1986) (suggesting that groups implicitly prefer different decision rules depending on the task).

310. This means, of course, that the group must make decisions as a group and work together toward that end. If group members simply operate separately, this creates a problem with oversight and hampers other members' ability to monitor class counsel. See Fisch, *supra* note 297, at 717 n.363 (describing the *Laborers Local 1298 Pension Fund v. Campbell Soup Co.* litigation where the court appointed a group and “forced the institution to work with a law firm that it had not selected and with which it had no personal or formal contractual relationship, thus limiting the institution’s ability to engage in . . . ongoing monitoring and control”).

311. On the value of sharing information and participating in group discussion, see Jamonn Campbell & Garold Stasser, *The Influence of Time and Task Demonstrability on Decision-Making in Computer-Mediated and Face-to-Face Groups*, 37 SMALL GROUP RES. 271, 271 (2006); Michael A. Hogg & Scott A. Reid, *Social Identity, Self-Categorization and the Communication of Group Norms*, 16 COMM. THEORY 7, 18–19 (2006) (“There is also evidence that group members who communicate shared information are viewed more favorably than are members who bring up unshared information.”); Edward G. Sargis & James R. Larson, Jr., *Informational Centrality and Member Participation During Group Decision Making*, 5 GROUP PROCESSES & INTERGROUP REL. 333, 343–44 (2002) (finding that group members get the most value from sharing information previously unknown to the other members of the group in making decisions).

312. Schulz-Hardt et al., *supra* note 207, at 150–55; Stefan Schulz-Hardt et al., *Group Decision Making in Hidden Profile Situations: Dissent as a Facilitator for Decision Quality*, 91 J. PERSONALITY & SOC. PSYCHOL. 1080, 1090 (2006).

313. F.C. Brodbeck et al., *Improving Group Decision Making Under Conditions of Distributed Knowledge: The Information Asymmetries Model*, 32 ACAD. MGMT. REV. 459, 461–62 (2007); C.J. Nemeth & J.L. Kwan, *Minority Influence, Divergent Thinking and Detection of Correct Solutions*,

Research suggests that four factors encourage group members to express dissent: participation, dialectical leadership, critical norms, and—more questionable in the litigation context—a unanimous decision rule.³¹⁴ First, participation lies at the crux of several vital dimensions: procedural justice, adequate representation, and compliance with the outcome.³¹⁵ Voicing one's views is the lynchpin for adequate representation and the means for taking part and being heard in the deliberation and adjudicatory process.³¹⁶ Likewise, the more members participate in the decisionmaking process and influence the outcome, the more participating and dissenting become embedded in the group's norms, and the more willing members are to participate in the first place.³¹⁷

Second, research on small groups consistently indicates that successful group deliberations require a clear agenda and a leader who ensures that everyone has an opportunity to share information.³¹⁸ Conversely, unstructured, free-flowing discussions tend to center around information everyone already knows; new information is not presented.³¹⁹ A “dialectical leader” encourages dissent and discussion about ideas and alternatives that run contrary to the majority position.³²⁰

Leadership, however, is a tricky question. Realistically, an attorney from one of the firms appointed as lead counsel is in the best position to facilitate group discussion, subject to some caveats. By having much at stake financially and reputationally, she has the most incentive to lead and, because most information flows through her, will know when critical decisions need to be made. On the other hand, if lead counsel has an ongoing relationship with an institution, then she may bias the discussion in the institution's favor. Plus, the PSLRA took a clear position against lawyer-driven litigation. Yet, if a member feels ignored, then she can lead the charge to opt out, which

17 J. APPLIED SOC. PSYCHOL. 788, 796–97 (1987) (finding that exposure to minority dissent facilitates creative ideas and solutions, whereas majority dissent stifles novel ideas); Schulz-Hardt et al., *supra* note 207, at 156–57, 160–61.

314. Schulz-Hardt et al., *supra* note 207, at 165–67.

315. TOM R. TYLER, WHY PEOPLE OBEY THE LAW 19–39 (2006).

316. See Robert G. Bone, *Rethinking the “Day in Court” Ideal and Nonparty Preclusion*, 67 N.Y.U. L. REV. 193, 269 (1992); Burch, *supra* note 263, at 38–39; Schulz-Hardt et al., *supra* note 207, at 166.

317. Schulz-Hardt et al., *supra* note 207, at 166.

318. SUROWIECKI, *supra* note 195, at 182–83; Garold Stasser, *The Uncertain Role of Unshared Information in Collective Choice* 49, 49–51, in SHARED KNOWLEDGE IN ORGANIZATIONS (Leigh L. Thompson et al. eds., 1999).

319. SUROWIECKI, *supra* note 195, at 182–83; Stasser, *supra* note 318, at 49–51.

320. Schulz-Hardt et al., *supra* note 207, at 166.

ultimately diminishes counsel's contingent fee.³²¹ And external constraints through lead plaintiffs' voting and participation keep the dialectical leader in check. Still, it is best to think of a "facilitator" rather than a "leader." Attorneys-as-facilitators harmonizes with their duties as agents and their clients' role as principals. What's important, however, is that the facilitator—whether lead counsel or a lead plaintiff—emphasize the need for dissent, discussion, and information exchange and avoid suppressing contrary views.

Third, group decisionmaking benefits from a norm in which members value independence, critical thought, and discussion as vital to the group's collective work.³²² Consider the converse: if members are friends tied through their preexisting, cohesive relationships and fear that dissenting, pointing out counterarguments, and objecting will violate the group's norm of conformity, then they will refuse to reveal their private information.³²³ Norms that promote conformity, nondisclosure, and solidarity can lead to the same kind of socially destructive decisionmaking that covered up the Catholic Church's child sex-abuse scandal.³²⁴ Accordingly, by adopting a critical norm that does not shun dissenters as disloyal and values openness, lead-plaintiff groups can improve their decisionmaking and avoid group polarization and confirmation biases.³²⁵

Finally, employing a unanimous decision rule guarantees that the group must listen to dissent to achieve consensus; dissenting and exchanging information are built into the model. But there are stronger countervailing reasons *not* to require group consensus or a unanimous decision rule when considering when and whether to settle. The danger is the classic holdout problem, where one group member withholds consent and threatens to hijack the settlement until the group meets her demands.³²⁶

321. See Richard A. Nagareda, *The Preexistence Principle and the Structure of Class Actions*, 103 COLUM. L. REV. 149, 173–74 (explaining how opting out might encourage competition and thereby bolster adequate representation).

322. Schulz-Hardt et al., *supra* note 207, at 167.

323. SUNSTEIN, *supra* note 194, at 79.

324. *Id.*

325. See Rebecca Mitchell et al., *The Role of Openness to Cognitive Diversity and Group Processes in Knowledge Creation*, 40 SMALL GROUP RES. 535, 536 (2009) (discussing studies that show that there is value to openness surrounding cognitive diversity).

326. See Nagareda, *supra* note 292, at 966 (discussing one such case example); see also *In re BankAmerica Corp. Sec. Litig.*, 350 F.3d 747, 749–50 (8th Cir. 2003) (finding that the district court did not abuse its discretion in approving a class settlement over the objections of three members of a seven-member lead plaintiff group); Mark Seidenfeld, *Empowering Stakeholders: Limits on Collaboration as the Basis for Flexible Regulation*, 41 WM. & MARY L. REV. 411, 422 (2000) (discussing the holdout problem in the context of public interest groups).

Accordingly, a supermajority vote after vigorous discussion maintains most of a unanimous decision rule's benefits while avoiding the holdout problem.³²⁷ Of course, a supermajority vote will vary somewhat depending on group size. For instance, a five-member group might demand an eighty percent supermajority, or four out of five members; whereas an eight-member group might require a seventy-five percent supermajority, or six out of eight members. Although the group might easily achieve consensus on less controversial matters, requiring a supermajority vote after ample time for members to discuss and voice alternatives that they might all be able to agree to can put to rest controversial matters, such as settlement. Likewise, judicially imposed timing deadlines can solve a group's inability to make decisions.

A supermajority vote on a settlement offer or counteroffer should bind class counsel unless the settlement is somehow unethical.³²⁸ Of course, while a vote binds lead counsel, the judge must still independently review the settlement to ensure that it is fair, reasonable, and adequate. This gives the dissenters outside the supermajority ample incentive and opportunity to voice their objections, which makes objections more meaningful.

D. Voice Versus Exit: Why Dissent Works Best

The preceding sections have explained how cognitive diversity and adequate representation go hand in hand and how judges and attorneys can assemble lead-plaintiff groups using these metrics to leverage better decisionmaking to the class's benefit. But, as Part I mentioned, opting out has become a trend. And, as Professor John Coffee has observed, exit has something to commend: it has the potential to "encourage real competition in the market for class action professional services."³²⁹ His hope, in short, is that the trend toward exit will provide an ex ante incentive in future class actions for counsel to adequately represent the entire class.³³⁰ Accordingly, this

327. A supermajority vote also provides the court with clear direction from the lead-plaintiff group. This avoids the problem presented in the *Cendant* litigation, where only one group member appeared to contest the attorney's fee award, but the other group members provided no direction or response. Fisch, *supra* note 297, at 717 n.363. As Jill Fisch points out, this made it difficult for the court to determine the group's position. *Id.*

328. For similar proposals in nonclass aggregation, see PRINCIPLES, *supra* note 34, § 3.17(b) (using a "substantial-majority vote"), and in bankruptcy, see 11 U.S.C. § 524(g)(2)(B)(ii)(IV)(bb) (2006) (employing a seventy-five percent vote).

329. Coffee, *supra* note 35, at 409.

330. Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1536 (2004).

concluding Section responds to his argument by pulling together this Article's themes and explaining how selecting a diverse lead-plaintiff group—a voice-based reform—is a normatively better solution than exit. It does so by considering pragmatic concerns, including due process, adequate representation, and institutional legitimacy; institutional concerns, such as efficiency and fairness; and regulatory concerns, including deterrence. To be clear, I am not suggesting that we should restrict opt-out rights, but rather that the number of institutions opting out is symptomatic of a larger problem with inadequate representation that exit alone cannot fix, but that voice can.

1. Pragmatic Concerns: Strategic Defendants, Exit's Unavailability, and Objectors

Pragmatically, exit presents three concerns. First, defendants will adjust their litigation strategy over time to account for increased opt outs by reducing class settlement amounts or deterring opt outs through coercive settlement design. Second, exit is available only to large investors and institutions that receive individual legal advice, which leaves most individual investors without realistic recourse. Third, opting out makes meaningful objections less likely, removes dissent, makes the fairness hearing less adversarial, and forces the judge to act inquisitorially.

As to the first concern, securities-class-action defendants will likely take a page from mass-tort defendants' playbook to deter investors from opting out. Mass-tort defendants have become adept at pushing the line between creating settlement terms that are just too good to turn down and offers that claimants can't refuse in the Don Vito Corleone *Godfather* sense.³³¹ Tactics include liens on the defendant's assets in favor of the settlement class; walk-away or right-to-withdraw provisions, where the defendant withdraws the settlement offer if too many class members opt out; and most-favored-nation clauses, where the defendant promises to give those remaining in the class the benefits of any deal it makes with the opt-outs (thereby ensuring that it will vigorously defend the opt-out cases).³³²

331. See generally Richard A. Nagareda, *Closure in Damage Class Settlements: The Godfather Guide to Opt-Out Rights*, 2003 U. CHI. LEGAL F. 141, 143 (discussing parallels between class action litigation and *The Godfather*).

332. See, e.g., *In re Inter-Op Hip Prosthesis Liab. Litig.*, 204 F.R.D. 330 (N.D. Ohio 2001) (permitting liens on defendant's assets that were ultimately eliminated in the final deal); Coffee, *supra* note 35, at 437–38 (discussing how defendants can defer opt-outs); Kathryn E. Spier, *The*

Thus, opting out is still available theoretically, but is heavily restricted pragmatically.

Moreover, wise defendants will withhold funds from the class-action settlement to litigate and pay competing claims. Yet, numerous variables make it impossible to accurately predict how much money to set aside. Plaintiffs' attorneys encourage institutions with the strongest claims to opt out, may file in more favorable state-court fora, bring additional claims, and exert more economic leverage over the defendant through shareholder voting power.³³³ This leads to inequitable recovery among claimants.³³⁴ Put differently, if all claimants remained in the class, then an administrator should distribute the settlement's proceeds based on pairwise comparisons, where those with larger losses would receive a proportionally large recovery.³³⁵ Thus, opting out creates inequity. The cost-wise defendant will hold more than necessary in reserve, which means that those with similar claims will receive dissimilar amounts. When outcome inequality becomes clear to all involved, it negatively affects institutional legitimacy.³³⁶

The second, and related, pragmatic concern is that opting out is realistically available only to those receiving individual legal advice. Thus, the opt-out conundrum disadvantages smaller investors: on one hand, opting out isn't a realistic option for them; on the other, when they remain in the class, opt outs reduce their settlement share disproportionately and lead plaintiffs tend not to adequately represent them. As Jill Fisch has pointed out, "to the extent that the [PSLRA] allows small shareholders to file suit but permits institutional investors to take control of the litigation away from the filing plaintiff, it preserves for the small investor only the opportunity to incur the costs associated with drafting and filing a complaint and eliminates meaningful access to the judicial system."³³⁷

Third, because exit has become the norm, few institutions object to the settlement terms at Rule 23 fairness hearings. A recent study of pension funds reported that only five percent objected to the

Use of "Most-Favored-Nation" Clauses in Settlement of Litigation, 34 RAND J. ECON. 78, 78 (2003) (discussing most-favored-nation clauses).

333. See Coffee, *supra* note 35, at 440 ("[B]ecause the typical opt out recovers more than the typical class member, the corporate defendant would need to set the amount of the reduction at a level well above the amount that the opt out would have received under the class action . . .").

334. *Id.* at 409.

335. See H. PEYTON YOUNG, EQUITY: IN THEORY AND PRACTICE 14–15, 76–77 (1994).

336. See *id.* at 146–47 ("An allocation is *transparently unequal* if some claimant's portion contains more of every good than another claimant's portion. A transparently unequal allocation generates envy that is evident to everyone.")

337. Fisch, *supra* note 48, at 547.

proposed settlement, which includes objections on both outcome fairness and inadequate representation.³³⁸ Admittedly, the debate over class objectors and whether they add value or simply delay the process is a long and heated one.³³⁹ Suffice it to say, however, that having a representative lead-plaintiff group incorporates dissent into the litigation process and if one member remains in the minority, she is likely to be an informed, meaningful objector. Because she has participated in the decisionmaking process, she can voice her concerns to the court without needing additional time or discovery, her motives are transparent, and she—not her attorney—is likely leading the charge. Still, there is one troubling aspect: a disgruntled lead plaintiff may not know how the court will rule on her objection until it is too late to opt out, which may tempt her to abandon the endeavor and opt out early. On one hand, in Rule 23(b)(3) class actions, objectors have standing to appeal; in other words, opting out is not their only remedy.³⁴⁰ But once they do opt out, they have no standing to challenge the court's decision.³⁴¹ Accordingly, the best practice is for a court to ensure that the opt-out period ends after it approves the settlement so that unsuccessful objectors still have that option.³⁴²

Professor Coffee has several theories about why these pragmatic, fairness concerns should be less troubling: (1) because public pension fund recipients tend to be poorer retirees and smaller investors are “typically wealthy and diversified,” distributive-justice concerns favor collusive behavior and opting out;³⁴³ (2) exit exerts competitive pressure on class counsel that will, over time, improve class settlements; and (3) courts can lessen the inequality caused by opting out by paying more attention to the potential to collude in the

338. Choi & Fisch, *supra* note 59, at 331–32 tbl.3 (noting that five percent objected to a proposed settlement, but twenty-five percent objected to the proposed attorney fee award). Granted, five percent may still be higher than the average percentage in other types of class actions. One study showed that, on average, “about 1 percent of class members object to class-wide settlements.” Theodore Eisenberg & Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1532 (2004). Eisenberg and Miller did find, however, that “[s]ecurities and antitrust cases have lower objection rates.” *Id.* at 1533.

339. See, e.g., Edward Brunet, *Class Action Objectors: Extortionist Free Riders or Fairness Guarantors*, 2003 U. CHI. LEGAL F. 403 (arguing that enhancing the ability of third parties to present their input in class action litigation can advance fairness and efficiency policies).

340. *Churchill Village, LLC v. Gen. Elec.*, 361 F.3d 566, 572–73 (9th Cir. 2004).

341. *E.g.*, *Feldman v. Google, Inc.*, 513 F. Supp. 2d 229 (E.D. Pa. 2007).

342. See FED. R. CIV. P. 23(e)(4) (allowing the court to “refuse to approve as settlement” unless there is an additional opportunity to opt out).

343. Coffee, *supra* note 6, at 327; Coffee, *supra* note 35, at 441.

fairness hearing.³⁴⁴ There is, however, some room for doubt as to whether these answers fully address fairness concerns.

First, contrary to popular belief, individual investors are underdiversified and hold an average of only four stocks.³⁴⁵ Second, although competition may make settlements more adequate over time, institutions still have ample incentive to free ride on the class's efforts; they can easily opt out later and use the information they've gathered to leverage an even better deal. Plus, relying principally on institutions to serve as lead plaintiff not only disincentivizes small investors from investigating fraud and hiring an attorney, but also diminishes competition among the plaintiffs' bar. In any market where a few big players monopolize the rest, there is little incentive to reduce costs or innovate. Because courts typically select institutions and those institutions tend to select the same law firm, there is less competition, less cognitive diversity, and the very real potential for inadequate representation. Finally, lessons from mass-tort practice suggest that judges are ill-equipped to investigate a settlement's fairness: they are trained in adversarial culture and have few resources to investigate the case on their own, the settling parties have no incentive to produce facts or information adverse to their settlement posture, and judicial self-interest favors docket clearing.³⁴⁶

2. Institutional Concerns: Economy, Legitimacy, and Fairness

Even taking Coffee's suggestions at face value leaves significant institutional concerns. If class actions and consolidation promote judicial economy, exit thwarts it. Granted, our litigation system often prioritizes individual autonomy at economy's expense. Rule 20 permissive joinder is but one example. Forcing all litigants with claims arising out of the same transaction or occurrence to sue together would promote judicial economy, but Rule 20 allows plaintiffs to decide when, whether, and where to sue.³⁴⁷ Although it is significant that opting out undermines judicial economy, it is not a

344. Coffee, *supra* note 6, at 307–08.

345. Barber & Odean, *supra* note 60, at 73; Goetzmann & Kumar, *supra* note 60, at 433–34, 460.

346. Burch, *supra* note 263, at 33–34, 43–45; Macey & Miller, *supra* note 5, at 44–48. Of course, if the lead-plaintiff selection process becomes more competitive, then the competitors will have an incentive to point out why another contender is an inadequate representative. This means that the judge will be better equipped to handle the selection process.

347. FED. R. CIV. P. 20.

decisive factor. More importantly, opting out and inadequate representation can impact judicial legitimacy.

When opting out leads to inconsistent outcomes and staying in means inadequate representation (and thus questionable due process protections), litigants will lose faith in the judicial system.³⁴⁸ Adequate representation isn't just a hurdle to class certification; it is part of the due process litmus test when litigating someone's rights in absentia.³⁴⁹ Securities class actions, like all class actions, afford no individual opportunity to agree to settle. Instead, they hinge on someone else—the lead plaintiff—safeguarding and representing the absentee's rights. And when that representative disregards her fundamental duty, the absentee can challenge the judgment's preclusive effect.³⁵⁰ When conflicts-of-interest routinely threaten this bond and opting out is available in theory only, there is cause for concern about both the class action's and the judicial system's continued legitimacy.

To put this point differently, joinder rules governing class actions and preclusion doctrines work in tandem, like bookends, to minimize outcome inequality between similar cases.³⁵¹ Together, they reflect a broader commitment to fairness through consistency.³⁵² Consistent outcomes reflect, in part, a system that is not arbitrary or biased. A system that repeatedly produces inconsistent outcomes (such as when opt outs consistently fare better than their class-member counterparts) or systematically disfavors certain litigants

348. Courts are unpredictable in finding adequate representation violations, due, in part, to the doctrinal muddle over what adequate representation means and when inadequate representation permits a collateral attack on the settlement. The three judicial opinions in "*Epstein III*" provide a nice illustration. *Epstein v. MCA, Inc.*, 179 F.3d 641 (9th Cir. 1999). In that case, Judge O'Scannlain thought that the only question should be whether there was a full and fair opportunity to raise the question of adequate representation, *id.* at 648–49 (majority opinion); Judge Wiggins asked whether adequate representation was litigated and determined in the first court, *id.* at 650–51 (Wiggins, J., concurring); and Judge Thomas, in his dissent, would allow adequate representation to be relitigated when due process concerns were present. *Id.* at 651–52 (Thomas, J., dissenting).

349. *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 864 (1999); *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591 (1997); *Hansberry v. Lee*, 311 U.S. 32, 45–46 (1940).

350. *E.g.*, *Hansberry*, 311 U.S. at 45–46. The scope of preclusion and how principles of full faith and credit should apply when the previous court has considered and rejected adequate representation challenges are the subject of much debate. *Compare* Issacharoff & Nagareda, *supra* note 63, at 1685–91, *with* Patrick Woolley, *The Availability of Collateral Attack for Inadequate Representation in Class Suits*, 79 TEX. L. REV. 383, 388 (2000); *see also Epstein*, 179 F.3d at 641 (presenting three competing views of how preclusion doctrines should interact with adequate representation).

351. *See* William B. Rubenstein, *The Concept of Equity in Civil Procedure*, 23 CARDOZO L. REV. 1865, 1893–94 (2002) ("A host of procedural design choices and procedural rules, more or less implicitly, attempt to protect against outcome disparities.").

352. The PSLRA mirrors this concern for consistency by requiring courts to appoint the most adequate plaintiff after the actions are consolidated. 15 U.S.C. § 78u–4(a)(3)(B)(ii) (2010).

(like individual investors) threatens an institutional commitment to fairness.³⁵³ In other words, process defects—such as inadequate representation—lead to outcome inequality and thus link outcome equality and procedural fairness. Accordingly, exit—at least as a systemic palliative to structural conflicts-of-interest—may generate more problems than it solves.

3. Regulatory Concerns: Deterrence

The regulatory concern is that opt-outs lead to sub-optimal deterrence by further Balkanizing enforcement, thereby making finality harder for defendants to achieve, adding to overall transaction costs, and increasing informational asymmetries on the plaintiffs' side. To be sure, measuring deterrence and thus quantifying optimal deterrence is nearly impossible; empirical data cannot quantify fraud that's been deterred. But we can hypothesize based on known quantities such as transaction costs and wealth-transfer problems. As Professor Coffee has explained, "securities class actions face a circularity problem; in reality, investors are paid by investors, and often the result is a pocket-shifting wealth transfer among the same diversified investors."³⁵⁴ Opting out fractures enforcement efforts, makes final resolution elusive, and further contributes to this circularity problem by increasing transaction costs.

Recall that the class action, at its core, procedurally enables investors to enforce their substantive rights. Its use should not be divorced from the substantive policies it promotes. Securities class actions supplement SEC regulation and chiefly aim (though some would disagree) to deter fraud and, secondarily, to compensate investors' losses.³⁵⁵ When institutional lead plaintiffs exchange higher

353. See Lawrence B. Solum, *Procedural Justice* 78 S. CAL. L. REV. 181, 189, 257–58 (2004) (“[F]or adjudicative procedure to perform its action-guiding function well, procedures and their outcomes must be regarded as legitimate sources of authority for officials, third parties, and litigants. . . . If the system is seen as illegitimate or without authority, then the system may fail.”).

354. Coffee, *supra* note 35, at 444.

355. Granted, using this logic alone might raise the question of why we should care at all about process so long as the end result is deterrence. But process is an important part of the causal chain. Regulatory responses through the SEC and private class actions seek to deter fraud by holding the wrongdoers (and perhaps too often their employers) accountable; class actions rely on entrepreneurial plaintiffs' attorneys to make this happen; without client oversight and monitoring, the attorney might trade a cheap settlement for steep attorneys' fees and thereby undermine deterrence. If the class action is viewed as an illegitimate mechanism for enforcement, then its availability and viability is threatened, as are the public and private benefits its use generates. For a defense of the securities class action's use in securities enforcement, see Burch, *supra* note 91, at 63.

damage awards for corporate-governance reforms, they may undermine deterrence. To the extent that class actions achieve deterrence by forcing individual actors and the corporation itself to pay an amount that leaves them worse off, corporate-governance reforms are unlikely to deter the officers and directors who can easily—and relatively costlessly—implement them.³⁵⁶

What we emphasize in the now familiar voice-loyalty-and-exit typology should advance the deterrence goals underlying substantive law, but should do so in a way that does not undermine the class action's legitimacy as a form of representational governance.³⁵⁷ It is in this governance structure, where the voices of a few must protect the interests of many, that internal disunity threatens constitutional due process through inadequate representation as well as the institutional arrangement's legitimacy.³⁵⁸ Accordingly, if voice-based reforms through additional representatives and subclassing can alleviate conflicting interests and make opting out less necessary, then voice raises fewer pragmatic, institutional, and regulatory concerns than exit alone.

Appointing cognitively diverse, richly representative lead-plaintiff groups can further private enforcement's substantive aims of deterrence and (secondarily) compensation through horizontal monitoring. In passing the PSLRA, Congress hoped to improve attorney monitoring, which would, in turn, minimize strike suits and thereby make lawsuits a more predictable consequence of bad behavior. If corporate actors cannot adapt their behavior to avoid suit, then lawsuits have little deterrent value.³⁵⁹ Thus, the lead plaintiff's ability to pursue monetary remedies and monitor the attorneys (which thereby prevents strike suits or encourages dismissal) is tied directly to deterrence.

But monitoring is currently a vertical relationship—lead plaintiffs watch the attorneys, but who watches them? As Stephen Bainbridge observes, “A hierarchy of individuals whose governance structures contemplate only vertical monitoring cannot resolve the

356. Webber, *supra* note 45, at 38.

357. Issacharoff, *supra* note 70, at 390. This reference to voice, exit, and loyalty dates to Albert Hirschman's seminal work. HIRSCHMAN, *supra* note 201.

358. See Issacharoff, *supra* note 70, at 340 (arguing that legitimacy is the governance question at the heart of the most troublesome class action cases).

359. See generally Daniel W. Shuman, *The Psychology of Deterrence in Tort Law*, 42 U. KAN. L. REV. 115, 116 (1993) (“Deterrence theory assumes that the psychological linkage between tort law and safer behavior is that people are cognizant of the likelihood of tort sanctions for proscribed behavior and choose safer alternatives to avoid those sanctions.”).

problem of who watches the watchers.”³⁶⁰ When lead-plaintiff groups act as horizontal monitors by watching one another and the class attorneys, they solve this problem. This furthers private enforcement’s principal deterrence goal and preserves the judicial system’s institutional legitimacy by ensuring that the settlement terms and claims-administration process do not favor some claimants over others. While an institution might engage in self-dealing for the reasons already discussed—preferring corporate-governance reforms or making claims filing difficult for noninstitutional investors with less meticulous record keeping—mutual monitoring within the lead-plaintiff group should prevent this from occurring.³⁶¹

Using a horizontal monitoring system likewise mitigates but does not eliminate the possibility that a group member will no longer actively participate in discussions or decisionmaking. Because each group member represents a subset of class interests, this could endanger adequate representation. Moreover, other group members may have weak incentives to socially sanction or otherwise pressure that member to perform since her indifferent behavior makes it easier to push one’s own agenda. There are a few fail-safes: (1) lackadaisical behavior occurs less frequently in smaller groups; (2) lead counsel will likely watch out for the interests that group member represents to avoid opt outs and preserve her litigation investment; (3) the court must still approve any class settlement; and, (4) barring all of these, class members could opt out.³⁶² The strongest fail-safe, however, is that the group member herself has a significant stake in the litigation; if the group contemplates acting adversely to those interests, then she will likely make her interest (and thus the interests of those she represents) known.

CONCLUSION

Representation in securities class actions is no longer adequate. Yet, courts feel quite comfortable certifying these classes—after all, relying principally on federal law and the fraud-on-the-market doctrine avoids sticky questions about choice of law and

360. Bainbridge, *supra* note 192, at 35.

361. *Id.* at 35–36.

362. It is possible, however, for a court to certify a class and not allow a second opt-out period after settlement. FED. R. CIV. P. 23(e)(4) (noting that the court “may refuse” to approve a settlement without new opportunity to opt out, but not requiring a second opt-out period). But, as the advisory committee notes suggest, “a decision to remain in the class is likely to be more carefully considered and is better informed when settlement terms are known.” *Id.* advisory committee’s notes.

individual reliance. So, in practice if not in print, courts define interests in much the same way that Harry Kalven and Maurice Rosenfield did in 1941, when class members opted into rather than out of class actions.

Broadly defining “interests” makes it easier to certify securities class actions and thus promotes private enforcement’s public function by holding the government and corporations accountable. But right now, the public good comes at some class members’ expense—principally those small investors who have no other viable remedy. And adequate representation isn’t a right that can give way in the cost-benefit shuffle; it is an integral part of class members’ constitutional due process. To address this critical shortcoming, this Article has argued that judges should understand their role in appointing lead plaintiffs as one that incorporates qualified representatives into class governance and thus legitimizes the institutional arrangement. This entails appointing cognitively diverse, representative lead-plaintiff groups to ensure adequate representation by fostering information sharing and dissent.

In sum, one might interpret this Article’s recommendations in one of two ways. My broad, ideal view is that given the current and predictable divides between institutional and individual investors, courts should routinely determine whether to appoint additional lead plaintiffs to satisfy due process concerns. This should increase lead-plaintiff groups, which—if carefully constructed to adequately represent the group and ensure cognitive diversity—is a positive development. As such, any resulting settlement would take into account class members’ diverse preferences. Alternatively, one might take these recommendations as a second-best solution to appointing a single institution as the lead plaintiff. In other words, for those who maintain that institutions act as the best attorney monitors and who are less concerned about adequate representation (or who reason that adequate representation follows from monitoring), these recommendations optimize group performance in second-best scenarios where individual institutions decline to serve or the court appoints a lead-plaintiff group.