No Free Lunch: Court Scrutinizes Coughlin Stoia's Free "Monitoring" of Client Investments

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On May 26th, Judge Jed S. Rakoff of the Southern District of New York declined to appoint the law firm of Coughlin Stoia Geller Rudman & Robbins LLP ("Coughlin Stoia") as lead counsel in a securities case due to concerns over a potentially unethical relationship with its client. In *Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing and Securitization, LLC*,[1] the Court criticized Coughlin Stoia's practice of offering free "monitoring" of client investments. Under this arrangement, Coughlin Stoia reviews portfolios of institutional investors and identifies potential securities class action claims. In return, clients retain Coughlin Stoia on a contingency basis to bring the recommended actions.

This practice, the Court reasoned, produces exactly the type of abusive, lawyer-driven litigation the Private Securities Litigation Reform Act (PSLRA) was designed to curtail. Legal ethics aside, the practice fosters passive clients, who are in no position to assume the responsibility of monitoring complex securities litigation. The Court held that such clients are inadequate to serve as lead plaintiffs under the PSLRA.

The PSLRA

The lead plaintiff provisions of the PSLRA were introduced to curtail lawyer-driven class action securities suits. As the Court explained, "because of the huge potential fees available in contingent securities fraud class actions, [lawsuits] were initiated and controlled by the lawyers and appeared to be litigated more for their benefit than for the benefit of the shareholders they ostensibly represented."[2]

To address this problem, the PSLRA requires that the Court appoint the plaintiff "most capable of adequately representing the interests of class members" as lead plaintiff.[3] Moreover, the PSLRA creates a rebuttable presumption that the plaintiff with the largest financial interest at stake is most capable.[4] The presumption intentionally favors large institutional investors on the theory that such investors would be more motivated to act like "real client[s]," by "carefully choosing counsel and monitoring counsel's performance to make sure that adequate representation was delivered at a reasonable price."[5] Plaintiff's choice of counsel is key, as the law firm representing the chosen lead plaintiff will reap increased legal fees as lead counsel.

The Iron Workers Decision

In *Iron Workers*, the Court consolidated two class actions brought on behalf of investors who purchased mortgage-backed securities. Plaintiffs from both cases, Iron Workers Local No. 25 Pension Fund (the "Fund") and Public Employees' Retirement System of Mississippi ("MissPERS"), sought appointment as lead plaintiff. Accordingly, the two plaintiffs' respective law firms, Coughlin Stoia and Bernstein Litowitz Berger & Grossman LLP, competed for designation as lead counsel.

At an evidentiary hearing in April, the Court initially appeared inclined to appoint both plaintiffs as co-leads because each was a large institutional investor represented by experienced counsel. Questioning by the Court, however, revealed what the Court considered to be a troubling contractual agreement between Coughlin Stoia and the Fund, which cast into doubt the Fund's adequacy as lead plaintiff.

Under the agreement, Coughlin Stoia conducts free "monitoring" of the Fund's investments. In return, if Coughlin Stoia recommends bringing a securities class action and the Fund approves doing so, the Fund retains Coughlin Stoia on a contingency basis to bring the claim.[6] The Fund employs no outside advisers to independently assess Coughlin Stoia's recommendations. Nor is the Fund itself sophisticated in evaluating and monitoring securities class actions. As the Court noted, the Fund administrator "had only a rough idea of what

this lawsuit was all about."[7]

This arrangement, the Court found, goes "far beyond any traditional contingency arrangement."[8] The very structure of the agreement "creates a clear incentive for Coughlin Stoia to discover 'fraud' in the investments it monitors" and bring abusive suits.[9] In other words, "it fosters the very tendencies toward lawyer-driven litigation that the PSLRA was designed to curtail."[10] Moreover, the Court questioned whether the agreement created conflicts of interest in violation of legal ethical prohibitions.

In its defense, Coughlin Stoia relied on ethics expert Professor Geoffrey C. Hazard, Jr. of Hastings College of the Law, who opined that experienced securities class action firms would almost never be motivated to bring abusive lawsuits. Moreover, Coughlin Stoia argued that "monitoring" agreements are commonplace, and, in fact, confer a "special benefit" on clients in this time of economic hardship.[11]

The Court, however, was unconvinced. Without ruling on potential ethics violations, the Court found that the Fund was not capable of fulfilling the "enhanced responsibilit[ies]" of lead plaintiff.[12] Not only had the Fund failed to take steps "to assure itself that the advice it is getting from its monitors is disinterested," it had not even made the effort to "find out much about the lawsuit it is being asked to oversee."[13] Reminding counsel of the "ever-applicable adage that there is no such thing as a free lunch," the Court ruled that the Fund was inadequate to serve as lead plaintiff.[14]

In so ruling, the Court was aware that the alternative lead plaintiff, MissPERS, also has monitoring agreements with class action firms. The Court, however, saw several advantages to appointing MissPERS. First, MissPERS engages 12 different monitoring firms, who compete to represent MissPERS in any given litigation.[15] Second, MissPERS engages outside counsel to independently evaluate and oversee litigation brought by monitoring firms.[16] Finally, in this particular case, the claim was not brought to MissPERS's attention by any of its monitoring firms.[17] Hence, although an imperfect choice, the Court ruled that MissPERS was the most capable of adequately representing the class.[18]

Implications for Securities Class Actions

Iron Workers supports a heightened standard for appointment of lead plaintiff under the PSLRA. Following Judge Rakoff, courts may examine institutional plaintiffs more closely to determine whether they have the capacity and willingness to act as "real clients." In particular, courts may ask plaintiffs to demonstrate that they independently evaluated the merits of a claim. Similarly, courts may inquire whether plaintiffs were proactive in selecting counsel and negotiating a fee arrangement.

The reasoning of *Iron Workers* may also influence courts at the class certification stage. Plaintiffs who succeed in being appointed lead plaintiff must still demonstrate that they and their counsel will "fairly and adequately protect the interests of the class" under Federal Rule of Civil Procedure 23. Similar to the lead plaintiff provision of the PSLRA, the adequacy requirement of Rule 23 demands more than simply having competent counsel. A plaintiff who defers completely to class counsel and is "alarmingly unfamiliar" with the action cannot serve as class representative.[19] Hence, plaintiffs who rely exclusively on monitoring firms to bring and litigate securities claims may also face increased scrutiny at the class certification stage.

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ENDNOTES

[1] --- F.Supp.2d ----, 2009 WL 1444400 (S.D.N.Y. May 26, 2009).
[2] *Id.* at *1.
[3] 15 U.S.C. § 77z-1(a)(3)(B)(i).
[4] 15 U.S.C. § 77z-1(a)(3)(B)(iii)(I)(bb).
[5] 2009 WL 1444400, at *1 (*quoting In re Razorfish, Inc. Sec. Litig.*, 143 F.Supp.2d 304, 307 (S.D.N.Y. 2001)).
[6] *Id.* at *2.
[7] *Id.* at *4.
[8] *Id.* at *2.
[9] *Id.* at *2.
[10] *Id.* at *2.
[11] *Id.* at *2-4.
[12] *Id.* at *1.
[13] *Id.* at *4.
[14] *Id.* at *2.
[15] *Id.* at *4.
[16] *Id.* at *4.
[17] *Id.* at *4.
[18] *Id.* at *5.
[19] *Koenig v. Benson*, 117 F.R.D. 330, 336 (E.D.N.Y. 1987); *see also Welling v. Axley*, 155 F.R.D. 654, 659 (N.D. Cal. 1994).

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