



Attacking Class Actions and Derivative Lawsuits Based on Inadequate Representative

It is widely recognized that plaintiff lawyers instigate and prosecute securities class action and shareholder derivative lawsuits without effective involvement or oversight by the named plaintiffs, who ostensibly are the plaintiff lawyers' clients. Because this practice is so pervasive, defense counsel and insurers too often view that arrangement as inevitable and acceptable. However, two recent court decisions demonstrate that such an arrangement is not legally permitted and can be a basis to dismiss the class action or derivative lawsuit. Armed with this new case law, defense counsel and insurers should routinely investigate and where appropriate challenge the adequacy of the named plaintiffs in securities class action and derivative lawsuits. Unless the plaintiffs' bar significantly changes their practices, many of these lawsuits appear vulnerable to dismissal based on this new authority.

A. Adequate Shareholder Representative

Rule 23(a) of the Federal Rules of Civil Procedure states that in a putative class action lawsuit a class may be certified only if certain prerequisites are satisfied (i.e., numerosity, commonality, typicality and adequacy of representation). With respect to the adequacy of representation requirement, the Rule states that the representative parties (i.e., the named plaintiffs) must show that they will "fairly and adequately represent the interests of the class." In evaluating this requirement, courts typically examine two questions: (i) do the named plaintiffs and their counsel have any conflicts of interest with other class members, and (ii) will the named plaintiffs and their counsel prosecute the action vigorously on behalf of the class? *Rutter & Wilbanks Corp. v. Shell Oil Co.*, 314 F.3d 1180, 1187-88 (10th Cir. 2002).

A similar requirement exists with respect to shareholder derivative lawsuits. Rule 23.1(a) of the Federal Rules of Civil Procedure states that a shareholder derivative lawsuit "may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders...who are similarly situated in enforcing the rights of the corporation." In evaluating this requirement with respect to derivative lawsuits, courts frequently apply by analogy the case law interpreting the "fair and adequate representation" requirement for class actions. See, *Paplisky v. Berndt*, 466 F.2d 251, 260 (2d Cir. 1972). In either context, courts have ruled that the named plaintiff is not an adequate representative for purposes of prosecuting the class action or derivative lawsuit if the plaintiff has "so little knowledge of and involvement in the [lawsuit] that they would be unable or unwilling to

ONE COLUMBUS

10 W. Broad Street, Suite 2100
Columbus, OH 43215
614.221.3155

KETTERING TOWER

40 N. Main Street, Suite 1250
Dayton, OH 45423
937.223.4701

protect the interests of the class against the possibly competing interests of the attorneys.” *Baffa v. Donaldson, Lufkin & Jenrette Securities Corp.*, 222 F.3d 52, 60 (2d Cir. 2000). However, the named plaintiffs’ knowledge and involvement in the lawsuit need not be extensive. Instead, the named plaintiff is considered an inadequate representative only if the plaintiff’s “participation is so minimal that they virtually have abdicated to their attorneys the conduct of the case.” *Kirkpatrick v. J.C. Bradford & Co.*, 27 F.2d 718, 728 (11th Cir. 1987).

B. Recent Case Law

The following recent court decisions highlight the potential benefits to defendants in attacking the adequacy of the named plaintiffs in securities class action and shareholder derivative lawsuits. Although such an attack may not always be successful (as demonstrated by the recent *Nature’s Sunshine Products, Inc.* decision also summarized below), defense counsel should at least investigate this defensive argument far more frequently than they have in the past.

1. *Egelhof v. Szulik*, 2008 WL 352668 (N.C. Super. Ct. Feb. 4, 2008)

In this case, the Superior Court of North Carolina evaluated whether the named plaintiff in a shareholder derivative lawsuit was an adequate representative of the company for purposes of prosecuting the derivative claims. Based upon deposition testimony of the named plaintiff and plaintiff’s counsel, it was established that:

- The named plaintiff was a Kansas resident who responded to an internet solicitation from a San Diego law firm looking for a plaintiff in a North Carolina lawsuit;
- The named plaintiff was 25 years old, had little investing experience, no experience in litigation, no prior connection with the San Diego law firm, no personal knowledge of the subject company and its operations, and a minor criminal record;
- Prior to defendants contesting the plaintiff’s adequacy, plaintiff’s counsel had never met with the named plaintiff and knew nothing about him;
- The named plaintiff played no significant role in the litigation and plaintiff’s counsel did not communicate with the named plaintiff regarding developments in the case or even the plaintiff’s whereabouts.

Based on this record, the judge concluded that the plaintiff’s counsel:

...treated the lawsuit as its own, made all litigation decisions without input from the client, and failed to keep the client and the court informed of facts which were relevant to [the plaintiff’s] standing to pursue the litigation. While there is no evidence that the firm knew that [the plaintiff] had sold his stock and hid that information, it is clear that they made no effort to stay in touch with him and discern whether anything had happened which would have affected his standing.

As a result, the court dismissed the derivative lawsuit due to lack of an adequate representative and sanctioned the plaintiff law firm by, among other things, barring that law firm from appearing in any North Carolina state court for five years. Most notably, the plaintiff law firm (Robbins, Umeda & Fink, LLP) is one of the leading plaintiff law firms in the country with respect to prosecuting shareholder derivative lawsuits.

2. *In re JPMorgan Chase & Co. Shareholder Derivative Litigation*, 2008 U.S. Dist. LEXIS 71353 (S.D.N.Y. Sept. 19, 2008).

Like the Egelhof case, the court here ruled that the same plaintiff law firm (Robbins, Umeda & Fink, LLP) controlled the derivative lawsuit with “absentee plaintiffs” and therefore dismissed the lawsuit. Deposition testimony by the named plaintiffs established the following facts:

- One of the two named plaintiffs was elderly and did not understand either the nature of a derivative lawsuit nor his duties as the named plaintiff in such a lawsuit;
- The other named plaintiff is a “professional plaintiff whose services are at the beck and call of his friend and fellow attorney;”
- The named plaintiffs never met with plaintiffs’ counsel regarding the litigation prior to defendants’ challenge of the plaintiffs;
- Plaintiffs’ counsel drafted the complaint without obtaining input from or even showing the complaint to the named plaintiffs;
- Plaintiffs’ counsel did not consult with the named plaintiffs about critical events in the life of the lawsuit;
- When plaintiffs’ counsel began to consult with the named plaintiffs following the defendants’ attack as to the plaintiffs’ adequacy, one of the named plaintiffs wanted to withdraw from the case because he doubted that the lawsuit had any merit, although this information was not disclosed to the court;
- Although the “professional plaintiff” was well prepared for his deposition regarding his adequacy as a representative, he was “appallingly ignorant of the many derivative actions that have been filed in his name” in the past, which the court believed to be a “fairer measurement of the diligence with which he will perform his duties than the knowledge demonstrated after intensive preparation for a court-ordered deposition.”

Based on this record, the court concluded the named plaintiffs were not adequate representatives for purposes of prosecuting the derivative lawsuit, and therefore dismissed the lawsuit. In explaining the importance of an active and informed plaintiff, the court cited to the legislative history for the Private Securities Litigation Reform Act of 1995, which was intended to prevent abusive practices by plaintiff lawyers in securities class action lawsuits. The court found that the same need for reform applies to shareholder derivative litigation:

The very abuses that led to the reform embodied by the PSLRA permeate the world of derivative litigation as well. In both contexts, there is a need to have plaintiffs who can adequately represent other shareholders and exercise a meaningful role in critical decisions such as whether to file suit or to settle. Otherwise, it is the attorneys who will completely control the litigation and make these decisions based on their own financial interests rather than the interests of the corporation and its shareholders.

In reaching its decision, the court provided some guidance to plaintiffs’ counsel regarding the extent to which the named plaintiffs should be involved in the litigation in order to be an adequate representative:

To represent fairly and adequately the interests of other shareholders and the corporation in whose name a derivative action plaintiff has filed suit, the plaintiff need not usurp the customary role of attorneys in litigation. But, the plaintiff must be the one to authorize the suit, and must be sufficiently well informed, diligent and independent (with the support where

necessary of appropriate advisors) to protect the interests of the shareholders and corporation from the potentially competing interests of the attorneys.

This decision is particularly noteworthy not only because the court was highly critical of the same leading derivative plaintiff law firm that was criticized and sanctioned by the North Carolina court, but also because this ruling is by Judge Denise Cote of the Southern District of New York, who is a respected and influential jurist.

3. *In re Nature's Sunshine Products, Inc. Securities Litigation*, 2008 U.S. Dist. LEXIS 73790 (D. Utah, Sept. 25, 2008)

As demonstrated by this case, not all class actions or derivative lawsuits are prosecuted in the name of inadequate representatives. Here, the court certified a class in a putative securities class action lawsuit despite defendants' argument that the named plaintiffs were not adequate representatives of the class. Based upon affidavits and deposition testimony, the court determined that the named plaintiffs were sufficiently informed to manage the litigation and did not improperly abdicate the conduct of the case to plaintiffs' lawyers. Among other things, the factual record established that:

- The plaintiffs read the initial complaint and reviewed and authorized the filing of the consolidated complaint;
- The named plaintiffs were aware of the allegations in the complaint, the nature of a class action lawsuit, and the class periods involved in the lawsuit;
- The named plaintiffs understood the lawsuit was in the discovery phase and communicated with plaintiffs' counsel concerning discovery matters;
- The named plaintiffs were aware of their role as a class representative and were willing to undertake that role;
- The named plaintiffs committed to continue their communication with plaintiffs' counsel about the status of the litigation, case strategies, settlement negotiations and other matters pertinent to overseeing the litigation.

As a result, the court determined that the named plaintiffs will adequately represent the interests of the class, and therefore certified the class.

C. Conclusions

Defense counsel and insurers should seek discovery in virtually all securities class action and shareholder derivative lawsuits relating to the background and share ownership of the named plaintiffs, the knowledge and involvement of the named plaintiffs in the prosecution of the lawsuit, and the ability and willingness of the named plaintiffs to adequately discharge their duties as representatives of the class and the company in the litigation. Too often, this potentially important defense is ignored. At least some courts appear to be increasingly critical of plaintiff lawyers controlling these types of lawsuits.

The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.