WRITTEN STATEMENT
OF
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TO THE
THIRD CIRCUIT TASK FORCE ON THE SELECTION OF CLASS COUNSEL

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I would like to thank the Third Circuit Task Force on the Selection of Class Counsel and each member thereof for inviting me to testify – it is both an honor and a privilege for me to be able to share my views with you. This statement and my oral testimony represent my personal views and do not necessarily reflect the views and opinions of Cleary, Gottlieb, Steen & Hamilton or any of its partners or clients.

The use of auctions to select lead counsel is a relatively recent judicial innovation designed to bring market forces to bear on lead counsel's fee. In theory, lead counsel auctions simultaneously enable class plaintiffs to retain a greater share of the class common fund and reduce the heavy burden on scarce judicial resources by avoiding *ex post* fee determinations. In practice, however, lead counsel auctions have frequently been implemented in a manner that has been to the detriment of the class members because judges have misunderstood the major goals and objectives of rational, economically sophisticated class plaintiffs. These goals and objectives can be summarized as follows. First, class plaintiffs want to obtain the highest quality legal representation at the lowest possible cost. Second, class plaintiffs want to improve the chances of obtaining high quality legal representation by selecting a lawyer whose interests are most closely aligned with their own. Third, because class plaintiffs are generally incapable of adequately monitoring lead counsel, class plaintiffs want to provide lead counsel with economic incentives to maximize the class common fund net of attorney's fees.

Taken together these goals and objectives reveal that rational class plaintiffs are primarily focused on enhancing the quality of the legal representation provided by lead counsel rather than driving down lead counsel's fee. Indeed, as sophisticated consumers of professional services, class members recognize that theirs is a most unfortunate dilemma: they can either pay the lawyer less and take a greater share of a potentially smaller pie or pay her more and take a smaller share of a potentially much greater pie. Faced with these choices, class plaintiffs realize that their only real option is to attempt to grow the pie by more closely aligning lead counsel's interests with their own.

Notwithstanding class plaintiffs' goals and objectives, most lead counsel auctions to date have focused primarily on driving down lead counsel's fee. To a lesser or greater extent these types of auctions drive a wedge between the interests of the class members and the interests of lead counsel. Lead counsel auctions, however, need not be structured and implemented in such a divisive manner. Lead counsel auctions can - and should - be structured and implemented so as to encourage law firms to submit, and judges to select, bids that align the interests of the class members and lead counsel and that provide lead counsel with sufficient economic incentive to provide high quality legal representation

for the class. Put more simply, there is nothing inherently good or bad about lead counsel auctions – rather it is the manner in which these auctions are structured or implemented that produces good or bad outcomes for class plaintiffs.

There are essentially two ways to arrive at a good outcome when employing an auction procedure for the selection of lead counsel. The first alternative is to rely on the judge to select a bid that rational class members would select if they were able to act for themselves. Judges *qua* auctioneers should select the bid that maximizes the expected class recovery net of attorney's fees and costs. All things being equal, and in the absence of certain unusual circumstances, bids that provide for increasing percentage fees as the level of recovery increases and bids that link lead counsel's compensation to the stage of litigation in which resolution of the claim is achieved are fee structures that judges should receive favorably. Bids that provide for decreasing percentage fees or that link lead counsel's fee to certain pre-determined time periods should be disfavored because they skew lead counsel's incentives and create a divergence between the interests of lead counsel and the interests of the class.

The second alternative involves completely redesigning the auction to provide for the submission of standardized bids. This approach has three significant advantages. First, standardized bids avoid the veritable smorgasbord of fee structures that are typically submitted in lead counsel auctions and greatly simplify the task of evaluating and comparing bids. Second, judges are able to vary the parameters of the bids to be submitted so as to fit the particulars of each case. Third, these parameters can be set in such a way as to simultaneously gauge the price to be charged, and the quality that will be offered, by each law firm.

Judge Lewis A. Kaplan recently utilized one such alternative auction design in the Sotheby's-Christie's antitrust litigation. In that case the auction design was especially notable for its simplicity and ease of implementation. Each bid contained only two numbers; any recovery obtained up to the first number (Point X) would go exclusively to the class, any recovery between Point X and the second number (Point Y) would go exclusively to the lead counsel and any recovery in excess of Point Y would be shared, with the class receiving three-quarters and lead counsel receiving one-quarter. By compensating lead counsel far in excess of her opportunity costs for all recoveries between Point X and Point Y and taxing away some portion of that excess compensation by requiring lead counsel to provide free legal services for all recoveries up to Point X, Judge Kaplan succeeded in sharply curtailing two of the major pitfalls associated with prior lead counsel auctions.

First, the subordination of lead counsel's fee and the payment to lead counsel of one hundred percent of any recovery between Point X and Point Y makes it possible to achieve the optimal resolution of the class claim. The optimal resolution of any claim requires lead counsel (i) to invest in the class claim to the same extent as would be authorized by a single, unitary client in an arm's-length, attorney client relationship and (ii) to have the same incentive as a single, unitary client to negotiate a settlement that is not less than the class members' expected gain from going to trial. Both of these criteria are satisfied when lead counsel is required to internalize the cost of prosecuting the claim

and Point Y is fixed such that it equals or exceeds the class plaintiffs' expected gain from going to trial.

Second, the subordination of lead counsel's fee makes it possible to identify lawyers that intend to sell out the class, that have misvalued the claim or that are simply not able to maximize the class recovery. These lawyers will submit bids with low values for Point X, while high quality and more reliable firms will be able to signal their commitment to serving the class by the submission of a bid containing a high value for Point X. However, it is important to note that not all bids containing low values for Point X are necessarily submitted by low quality lawyers. For example, an attorney might submit a bid that fixes low values for both Point X and Point Y, resulting in a bid that involves less risk for the law firm and less protection for the class but that also provides for a reduced range of recoveries to be applied exclusively for lead counsel's benefit. Indeed, as values for both Point X and Point Y approach zero, bids increasingly begin to resemble straight contingency fee bids.

The outcome of a head-to-head comparison between bids in a Kaplan-style auction turns upon two factors of critical importance to class plaintiffs: (a) How much of the recovery will be paid exclusively to the class, *i.e.*, how high is the value assigned to Point X and (b) what is the exclusive fee that the law firm proposes to charge for taking on the risk specified in (a), *i.e.*, what is the difference between Y and X. By way of example, consider how a court would decide between the following five hypothetical bids:

Bid 1: X = $23 million; Y = $30 million
Bid 2: X = $25 million; Y = $33 million
Bid 3: X = $27 million; Y = $36 million
Bid 4: X = $29 million; Y = $39 million
Bid 5: X = $31 million; Y = $43 million

The court might begin by noting that the risk being borne by the attorney increases as the bid numbers increase, i.e. attorney 5 is taking the greatest risk because he will not be paid anything until the recovery exceeds $31 million. The court would next note that the attorney's fee increases with the level of risk. But does it increase commensurately? And more importantly, which is the best deal for the class plaintiffs?

In order to answer these questions it is necessary to understand how class plaintiffs might select a winning bid if they were able to act on their own behalf. In this regard, it is important to recognize that rational and sophisticated class plaintiffs want to select the bid with the highest possible value for Point X, but that they will not do so at any cost. For example, a bid that offered to pay exclusively to the class any recovery up to $20 million might look good in comparison to other bids with lower X values, but it looks far less appealing if Point Y is fixed at $150 million and the expected outcome at trial is only slightly in excess of $150 million. Similarly, class plaintiffs want to select a bid with the lowest possible exclusive fee, but not if it comes at the cost of a sharp reduction in the range of recoveries that will be applied exclusively for the benefit of the class. For example, a bid that proposes an exclusive lead counsel fee of $2 million might

look good in comparison to other bids proposing to charge far higher exclusive fees, but it looks far less appealing if Point X is fixed at $2 million, such that only the first $2 million would be applied exclusively for the benefit of the class and a straight contingency fee would apply for any recoveries in excess of $4 million. Accordingly, the primary objective of class plaintiffs in a Kaplan-style auction is to strike a balance between these two extremes by selecting a bid that has both a high X value and a comparably low exclusive lead counsel fee. In other words, class plaintiffs want to select a bid that offers the class both meaningful protection from low quality attorneys and a good economic value.

It would therefore be appropriate for a judge employing a Kaplan-style auction to conclude that class plaintiffs might select the winning bid by applying the following three-part test. First, any bid that does not provide the class with an economic value at least equal to the median is discarded. Second, any bid with an X value below the median is discarded. Third, from those bids that remain, the winning bid would be the bid with the highest value for Point X. With respect to the first part of the test, the economic value (EV) of any particular bid can be easily measured by applying the following formula:

$$EV = X / Y$$

Because class plaintiffs are better off as the value of X increases and as the value of Y decreases, bids with higher EV values are preferable to bids with lower EV values.[1] Applying the formula to the hypothetical bids presented above results in the following EV value for each bid:

Bid 1: 0.767
Bid 2: 0.758
Bid 3: 0.750
Bid 4: 0.744
Bid 5: 0.721

The median EV value of these bids is 0.750. Accordingly, Bid 4 and Bid 5 are discarded because they represent economic values that fall below the median, and Bid 1 and Bid 2 are discarded because they have X values that fall below the median X value of 27. As a

[1] Values for EV range from 0 to 1. A value of 1 represents the extremely unlikely situation in which a law firm submits identical non-zero values for X and Y. In such a situation the law firm is essentially offering to provide free legal services up to Point X and to forego any exclusive recovery for itself, opting instead to earn its fee by applying the straight contingency fee. A value of zero represents the highly unfavorable situation from the perspective of the class plaintiffs in which a law firm proposes to provide no free legal services but nonetheless applies a certain amount of the recovery solely for its own benefit. EV will be undefined only in the circumstance where a law firm assigns a zero value to both Points X and Y. In such a case, the law firm is offering to apply the straight contingency fee to all recovery amounts.

result the only remaining bid – Bid 3 – would win this auction assuming the presiding judge applied this particular rule. While Bid 1 represents the best economic deal for the class, it had the lowest value for Point X and since the class wants to protect itself from low quality attorneys it is unlikely to be the bid that rational, sophisticated class plaintiffs would choose. Similarly, although Bid 5 had the highest value for point X, it offered this level of protection at too high a price and offered the class the least economic value. [2]

Alternatively, a judge cognizant of the fact that class plaintiffs will tend to be somewhat less price sensitive and somewhat more quality sensitive, might conclude that the winner of a Kaplan-style auction should be that bid with the highest X value that also has an EV value not more than one standard deviation below the mean EV value. This approach essentially gives the class the protection and quality assurances that it wants at a price that is within a reasonable range of the prices offered by the other competing law firms. For example, using the bids in the above example the mean equals 0.748 and one standard deviation is equal to 0.017. Therefore, the judge applying this rule would select the bid with the highest X value and an EV value above 0.731. Accordingly, the winning bid under this scenario would be Bid 4.[3] In certain circumstances a judge might also decide to combine this approach with that of a Dutch-style auction (also known as a Vickrey auction) in which the highest X bidder would be selected as the winner but would be so awarded at the next lowest bid. The result in this case would be that the law firm that submitted Bid 4 would win the auction, but the applicable X and Y values would be 27 and 36.29, respectively, because the winning law firm would be allowed to

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[2] It is possible that the application of the first two-parts of this test will have the result of discarding all the bids. For example consider the following four bids:

	X	Y	EV
Bid 1	11	20	0.550
Bid 2	15	29	0.517
Bid 3	21	41	0.512
Bid 4	25	50	0.500

The median values for X, Y and EV are 18, 35 and 0.515, respectively. Therefore, Bid 3 and Bid 4 are discarded because they represent economic values that fall below the EV median and Bid 1 and Bid 2 are discarded because they have X values that fall below the X median. Given that class plaintiffs are generally willing to pay as much as is necessary to purchase the protection that they need from low quality attorneys, the best that a judge could do in such a circumstance is to select the bid that has an X value that is both higher than and closest to the median X value. In this case that bid is Bid 3.

[3] Applying this approach to the example in footnote 2 would result in the selection of Bid 4.

retain the benefit of the economic value (0.744) that was incorporated into its winning bid.[4]

Yet another alternative approach in a Kaplan-style auction would be to hold a two-stage auction. In the first stage, the judge would solicit bids for the value to be assigned to Point X. The judge would then use these bids to fix a value for X that he or she determines to be reasonable in light of the bids submitted and the particulars of the class claim. In the second stage, the judge would announce the value that he or she has assigned to Point X and, based thereon, would solicit bids for Point Y. The firm that submits the lowest value for Point Y would win the auction. The main advantage of this method is that it does not require the judge to establish a rule to permit the simultaneous evaluation and maximization or minimization, as the case may be, of two different variables.[5] The main disadvantage of this method would seem to be that it requires the judge to take a more active and somewhat higher profile role in the determination of the values ultimately assigned to Points X and Y.

In conclusion, the recent innovation to auction the position of lead counsel was motivated by certain judges to introduce the power of market forces into the selection of class counsel. Most class counsel auctions, however, have worked to the detriment of class plaintiffs because they have forced fees lower and have left lead counsel without the necessary economic incentives to provide the class with the highest quality legal representation. Judge Kaplan turned that all around and advanced lead counsel auctions to a whole new level by designing an auction that (i) is easy to implement, (ii) makes it possible to optimally resolve the class claim and (iii) can result in the selection of high quality lead counsel. Indeed, when combined with evaluation and implementation techniques such as those presented herein, Judge Kaplan's auction design is not only capable of subjecting lead counsel's fee to the discipline of competition but also ensures that class plaintiffs are not left holding the short stick.

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[4] Dutch auctions are intended to address the problem of the winner's curse and enable participants in an auction to enter bids that reflect their true economic valuations without fear that they will be the bidder who overbids and pays too much. In the context of class counsel auctions, Dutch auctions can actually help the class to avoid selecting a bid that represents an overly optimistic assessment of the economic value of the class claim.

[5] In my article *In Search of Bargained-For Fees for Class Action Plaintiffs' Lawyers: The Promise and Pitfalls of Auctioning the Position of Lead Counsel*, 54 Bus. Law. 763 (1999), I proposed an auction design that was similar to that used by Judge Kaplan. Like the two-stage auction, the cash bid auction that I proposed did not require a judge to simultaneously optimize X and Y. Instead, it fixed points X and Y and required law firms to make cash bids to purchase what was essentially a call option on the class claim. Those firms that valued the fee structure and the class claim more highly would be willing to pay more for the privilege of serving as class counsel and the firm that bid the highest would be selected as lead counsel.