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The Questionable case for Auctioning Counsel Positions in Securities Class Actions

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I. INTRODUCTION

This paper analyzes the possibility of auctioning the lead counsel position in securities class action cases. It concludes that the case for using this method of selecting lead counsel questionable.

As I explain below, using competitive bidding to select lead counsel would suffer from two serious problems. I explain in section II that the outcome of competitive bidding would not be generally a good proxy for the outcome that would result if the class could act (as a single and informed principal) and strike an informed bargain. The outcome of competitive bidding might well differ from the one that an informed client would choose for two reasons. First, competitive bidding would tend to put less weight on the non-price, qualitative dimensions of the choice of counsel (including the counsel's fit to the case and to the Lead Plaintiff) than would a fully informed and adequate representative acting for the class. Secondly, even assuming hypothetically that all participants in the competitive bidding were identical in all non-price aspects, competitive bidding might well not serve the interests of the class; because such bidding would not give weight to the need to provide counsel with incentives, the level of fees produced by competitive bidding might be below the one that would be optimal for the class. Both problems indicate that competitive bidding might well operate to reduce the expected recovery in the case.

The second problem that I analyze, in Section III below, is applicable not to the use of competitive bidding in general but to its use in securities cases governed

by the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The PSLRA has sought to strengthen the role of lead plaintiff. Selecting lead counsel by competitive bidding would be inconsistent with this goal in two ways. First, *ex post*, given the choice of a lead plaintiff, competitive bidding would very much diminish the role of the lead plaintiff, by both taking away from the lead plaintiff the critical role of selecting the lead counsel and possibly requiring the lead plaintiff to work with a counsel not chosen by the lead plaintiff. Second, *ex ante*, competitive bidding would discourage potential lead plaintiffs of the type contemplated by the PSLRA from seeking the lead plaintiff position.

The analysis is organized as follows. Section II analyzes the adverse effects of competitive bidding on "quality" and incentives. Section III examines the additional problems of competitive biddings that arise in the context of securities class actions covered by the PSLRA. Section IV concludes that, notwithstanding its superficial appeal, the use of actions to select counsel in securities class action cases, is unwarranted.

II. The Effect of Competitive Bidding on "Quality" and Incentives

A. The Interests of the Class

Those judges that have used competitive bidding have regarded it as a proxy for "the one-to-one lawyer-client agreement in conventional litigation" (*In re Banc One Shareholders Class Actions*, 2000 U.S. Dist. Lexis 6254) or as a process that enables approximating "the attorney selection and fee bargain that the class itself would

strike if it were able to do so" (*In re Wells Fargo Securities Litigation* 15 F.R.D. 223). As will be explained below, however, this is not the case. A competitive bidding process would be unlikely to provide such a proxy or approximation to what the class would do if it could act (as a single and informed principal)– or, equivalently, to what an informed and loyal representative of the class would choose.

From the perspective of the class, it would be desirable to select counsel and a fee schedule so as to maximize the expected net recovery for the class. This expected net recovery is in turn equal to (i) the expected recovery in the case, minus (ii) the expected expenditure on legal representation. The expenditure on legal representation includes both attorney fees and expenses; for simplicity I will focus below on attorney fees.

The argument for competitive bidding focuses on the appeal of reducing attorney fees. It would be in the interest of the class, so the argument goes, to reduce such fees as much as possible. Competitive bidding can push down these fees, and, it is argued, such reduction cannot but benefit the class. The Bidding Group memorandum argues that the fees resulting from the competitive bidding "would cost the class far less than any legal fees that could be expected to be sought in any ordinary end-of-case settlement proceedings or fee application" (p. 9).

Reducing attorney fees would by definition serve the class in hypothetical circumstances in which the expected recovery could be regarded as fixed. Consider an hypothetical situation in which everything that the selected counsel will have to do could be completely specified in advance in every detail, and in which any accepted bid would accordingly produce exactly the same expected recovery. In

such an imaginary situation, the class interest could indeed be reduced to minimizing attorney fees.

The expected recovery in a class action case, however, should not be regarded as fixed. Rather it is likely to be affected by the use of competitive bidding. Thus, whether such bidding would benefit the class would depend not only on its effects on attorney fees but also on its effects on the expected recovery. Competitive bidding might well operate to reduce the expected recovery in two ways. First, by focussing on which bid offers the lowest fee, competitive bidding would likely give insufficient weight to non-price, qualitative dimensions of the contestants. Second, even assuming that all potential bidders are identical in their non-price, qualitative dimensions, the push by competitive bidding toward lower counsel fees could potentially harm, rather than benefit, the interests of the class by reducing the incentives of the chosen counsel to suboptimal level. I will now turn to examine each of these two problems.

B. Qualitative Dimensions of the Choice of Counsel

The expected recovery is likely to depend on many non-price, qualitative attributes of the chosen lead counsel, and I will refer to the set of all these attributes as "quality." The term quality as defined here is clearly very broad and includes more than is captured by the ordinary use of the word "quality." Quality so defined includes not only how experienced and skilled a firm is (in litigation in general and in litigating cases similar to the one at issue in particular) but also all other attributes

that can influence the expected recovery. Thus, for example, quality here includes all the attributes of a firm that could affect its bargaining power, such as reputational capital (as "tough" in bargaining) or financial resources (which again can strengthen one's bargaining position). It also includes all the attributes that affect the "fit" that a selected counsel would have with the lead plaintiff, since such fit might affect the effectiveness of the working relationship between counsel and lead plaintiff.

Clearly, an informed client choosing an attorney for a complex litigation would pay close attention to the above multiple dimensions of quality. Similarly, an informed lead plaintiff with perfect overlap of interest with the class can be expected to give much weight to such considerations.

In contrast, a competitive bidding process would focus primarily on a price comparison. Even Judge Walker who put forward the use of competitive bidding in *Oracle* had to conclude, after trying to have a full comparison of the bids in terms of their non-price dimensions, that the making of such a comparison by the judge selecting the winning bid is not practical (132 F.R.D. 538 (N.D. Cal 1990).

To be sure, a court can, as courts have done in the past, limit participation in the contest to bidders that pass a threshold of qualification. But eliminating unqualified candidates still does not give as much weight to quality considerations as an informed client or informed lead plaintiff would be likely to do. An informed client or lead plaintiff would also attach weight to differences among qualified candidates, i.e., candidates that fall within the substantial range above the threshold of minimal qualification.

Finally, it should be noted that the concern that selection by competitive bidding would not give due weight to quality considerations would not be eliminated if one were to assume or conclude that the two law firms affiliated with the Bidding Group are of good quality. Given that the plaintiff group most likely to be selected lead plaintiff is proposing some other firm as lead counsel, having a bidding contest might be the only way for these two law firms to have a chance of becoming lead counsel. Thus, the willingness of these firms to participate in a bidding contest need not indicate their judgment that such a contest would offer the best method of selecting lead counsel but rather their recognition that it would offer them some chance of becoming lead counsel. Furthermore, because the bidding contest presents these firms' only chance to become lead counsel, they might be willing to participate in the contest, and might prefer having it, even if such a contest might open the door to a victory by another firm of relatively low quality of fit.

Thus, a competitive bidding, whoever proposes it, raises the concern that it would give too little weight to qualitative considerations -- relative to the interest of the class and to what an informed and rational representative of the class would do. Because of this under-weighting, selection by competitive bidding might not produce the most fitting lead counsel, and for this reason such method of selection might not be the one preferred by a lead plaintiff that is well informed and has the class interest in mind.

C. Incentives

Turing now to the second problem with selection by competitive bidding, let us put aside the problem of qualitative attributes by assuming below *ipso facto* that all candidates for the lead counsel position (or at least all those passing the minimal threshold of qualification) are identical in all qualitative dimensions, including their fit to the case and to the lead plaintiff. Even under this assumption, selection by competitive bidding might well not be in the interests of the class. To be sure, the competitive bidding process might lead to a reduction in counsel's percentage of the recovery. But this reduction might be counter-productive rather than beneficial, because, in light of incentive considerations, it might reduce this percentage below the level that would be optimal for the class (in terms of maximizing its expected net recovery).

It is generally recognized that in the context of complex class action litigation, counsel for the class is bound to have substantial discretion (even with monitoring by an effective lead plaintiff) and counsel's incentives are therefore important.[2] In particular, it is important to provide such counsel with strong incentives to make those large investments of time and effort that could be most beneficial as the litigation unfolds. To be sure, ethical constraints (and reputational considerations) would ensure by themselves that counsel would make the investment needed to

[2] See, e.g., Coffee, The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action, 54 *University of Chicago Law Review* 877 (1987); Macey and Miller, The Plaintiff's Attorney Role in Class Action and Derivative

satisfy what is required by professional ethics and reputational concerns. But it would often be desirable to have counsel make investments substantially above the floor established by ethical and reputational constraints. And given that counsel is likely to be best informed about the cost-benefit calculus for such additional investments, a substantial degree of counsel discretion in this matter is inevitable. It follows that to encourage counsel to make investments in the wide range above the floor established by ethics and reputation, the incentives provided to counsel by the fee schedule are highly important.

Essentially, the problem of providing incentives to the counsel for the class is a special case of what economists refer to as the "principal-agent problem."[3] Whenever one party (the agent, and in our context the counsel for the class) must exert effort whose benefits go to another party (the principal), it is important to set a fee schedule that would provide the agent with the appropriate incentives. It is generally the case that no incentive schedule can be expected to eliminate completely the "agency problem" -- that is, the concern that the interest of the agent and the principal will not completely overlap. The question is which incentive scheme would be best in reducing "agency costs" – costs from the agent's suboptimal performance. And the optimal incentive scheme might often be one that would provide the agent with more than the bare minimum needed to have the agent take the position.

Litigation: Economic Analysis and Recommendations for Reform, 58 *University of Chicago Law Review* 1 (1991).

[3] See e.g., Shavell, Risk Sharing and Incentives in the Principal and Agent relationship, 10 *Bell Journal of Economics* (1979).

What competitive bidding would do, and wherein lies its alleged advantage, is to reduce the percentage of recovery that the selected counsel would get. Essentially, a competitive bidding process would reduce this percentage to the lowest level that a law firm could get and still cover the value of its investment. But this low percentage, while reducing the fee that the law firm will get, might be below the optimal level for the class because of the weakened incentives it would provide. And the loss to the class from these weakened incentives and the smaller expected recovery associated with them might exceed the savings from lower attorney fees.

To illustrate this point, let us consider a numerical example. Suppose that all qualified law firms are identical. Suppose further that the case of the class is such that, with a time investment of $150,000 by counsel (an investment which is assumed to satisfy applicable ethical constraints), the expected recovery will be $1,000,000. Suppose further that, with an additional time investment of $250,000 (an "all-out" effort), the expected recovery in the case will increase by $1,000,000 to $2,000,000.

Consider now the outcome of selecting counsel in this case by competitive bidding (assuming for simplicity that bids are in the form of straight percentages of the recovery). The competitive bidding process would push bidders to offer a percentage at the lowest level that would still provide them with compensation for the time they expect to invest. This level in our example is 15%: Contenders would know that if they get the case on a 15% contingency, they will make a time investment of $150,000, and they will get 15% of the expected recovery of $1,000,000 with such an investment.

Note that, with a winning bid of 15%, the selected counsel will not make the additional $250,000 investment involved in an all-out effort. Such an investment would increase expected recovery by $1,000,000 and (given the 15% contingent fee) increase the counsel's expected fees by $150,000 – less than the $250,000 additional investment required by counsel. Thus, we can conclude that, with a competitive bidding process, the winning bid would be one demanding a 15% contingency, the expected recovery would be $1,000,000, and the net expected recovery to the class would be 85% of $1,000,000 or $850,000.

Consider now how the class would fare if the selected counsel were to be given a contingent fee of 25% rather than 15%. In this case, the selected law firm would elect to make not only the $150,000 investment but also the $250,000 investment for an all-out effort. (Given that the firm can expect to get 25% of the extra $1,000,000 in expected recovery produced by the $250,000 additional investment, the firm would expect to be compensated for making the all-out effort.) As a result, the expected recovery would be $2,000,000, and after the 25% fee, the net expected recovery to the class would be $1,5000,000.

Thus, in the case under consideration, compared with a contingent fee of 25%, competitive bidding would reduce counsel's percentage to 15% and counsel's expected fees from $500,000 to $150,000. But this reduction would not overall be in the interest of the class. The expected net recovery to the class would be reduced from $1,500,000 $850,000 (a reduction of about 43%). The competitive bidding process would make the class worse off (compared with setting a fee of 25%)

because, by eliminating the incentive for an all-out effort, it would reduce the expected recovery by an amount exceeding the savings from lowering counsel fees.

The above example, of course, is not intended to imply that 25% is an optimal percentage in any given case (or for cases generally). An article by Bruce Hay develops a systematic economic analysis of the optimal contingent fee that an informed client hiring a contingent fee lawyer would set.[4] Hay shows that such a client would take into account two competing considerations: (i) providing the lawyer with incentives to exert effort, and (ii) reducing any profits to the lawyer above compensation for the lawyer's investment of time (profits that Hay labels the lawyer's "rent"). Any increase in the lawyer's percentage might, on the one hand, improve the lawyer's incentives but also, on the other hand, might increase the lawyer's profit (rent). Trading off these two competing considerations provides the optimal contingency fee which, as Hay analyzes, might depend on the characteristics of the case and thus differ from case to case. In a class action situation, the aim of the lead plaintiff and the court should be to get as close as possible to the optimal fee schedule that an informed principal would set.

The point of the above analysis and illustrating example, then, is simply to point out that the optimal fee is one that gives weight to both (i) savings to the class from reducing attorney fees, and (ii) benefits to the class from providing strong incentives to its counsel. While an informed client or lead plaintiff would give weight to both considerations (i) and (ii), competitive bidding would focus solely on

[4] See Hay, Contingent Fees and Agency Costs, 25 *Journal of Legal Studies* 503 (1996).

(i) and thus might result in a fee schedule that is too low compared with the schedule optimal for the class.

Indeed, in one basic model analyzed by Hay, the optimal contingent fee is generally above the level that leaves the lawyer with no rent and that a bidding contest would produce. There is thus reason to be concerned that the fee level set by competitive bidding would often be below the level that would be optimal for the class. This would be especially likely to happen whenever the consideration of incentives is sufficiently significant and thus whenever the expected recovery is sufficiently influenced by counsel's investment of effort and time.[5]

D. More Complex Auctions

The analysis above assumed for simplicity that the bidding contest would take the form of each firm proposing a straight fee. But the point made above – that the effect of competitive bidding on reducing counsel fees might have significant cost in terms of incentives – would apply as well to other, more complex forms of competitive bidding.

Consider, for example, a format under which bidders are asked to submit proposals for a minimum recovery from which they will not take any fees. In the antitrust suit against Sotheby's and Christie's auction houses, the judge recently asked law firms to state a figure X from which the they are prepared not to take any fees. The winning bidder submitting the highest X would receive no fees from any

recovery up to this submitted X and 25% from any amount recovered above X. See Lead Counsel Auction Plan Revised, *New York Law Journal*, May 19, 2000. Under such a format, the competitive bidding process would push lawyers to raise X – which is essentially to reduce to zero their share of any dollar of recovery below X. Again, while such bidding could lower the selected counsel's total fees, it might produce a cost in terms of adverse incentives that would outweigh the savings to the class from these lower fees.

To see that having a large X might well be a rather mixed blessing, consider a selected counsel that would be committed to taking no fees from any recovery up to $100,000,000 and to getting 25% of any amount exceeding the $100,000,000. The minimum recovery promise might lead to significantly perverse incentives in some situations. Consider the possible scenario under which the case does not proceed well and the expected recovery falls below $100,000,000. In such a case, the minimum recovery feature might eliminate any financial incentive to exert effort that the counsel might otherwise have. Relatedly, the minimum recovery feature makes accepting a settlement offer of, say, $90,000,000 not in the interest of the lawyer even when such acceptance would be in the interest of the class (because, say, a trial would be expected at the time to produce a $150,000,000 recovery with a 50% chance and zero with a 50% chance).

E. Conclusion: Why an Informed and Loyal Lead Plaintiff might prefer not to have Competitive Bidding

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In closing this section, let us consider situations in other contexts in which a principal hires an agent for a task of substantial complexity that cannot be fully specified in every detail in advance. Consider, for example, a venture capitalist (VC) who controls a high-tech start-up and seeks a CEO to manage it in its next stage. The CEO is to be compensated primarily in options on the company's stock. Would the VC likely select the CEO by having competitive bidding among the qualified candidates and hiring the candidate who is willing to take the job for the smallest number of options? Hardly. The reason why a VC in such a situation cannot be generally expected to use such competitive bidding lies in the issues of quality and incentives that were discussed above. First, the VC might wish to give some substantial weight to how the qualified candidates (those passing the threshold of qualifications based on their CV) might differ in the many relevant dimensions of quality, including their fit to the company and to working with the VC. Second, the VC might prefer to have the CEO own more options than the number needed just to induce the CEO to take the job; for providing options beyond this level might be beneficial in providing the CEO with more high-powered incentives.[6]

Similarly, an informed lead plaintiff who has only the interests of the class in mind might prefer not to have the compensation of the lead counsel set at the break-even rate expected to be established by competitive bidding. While such bidding

[6] Similarly, boards of directors that set the options grants to executives of publicly traded companies would be expected to ask not only how much would be needed to keep the executive but also what options grants would be beneficial in terms of providing the executive with appropriate incentives.

might push down the selected counsel's percentage of recovery, it might actually push it to a level below the one that is optimal for the class, and the reduction might be overall counter-prodcutive rather than beneficial.

Supporters of bidding have suggested a plaintiff that does not support selection through competitive bidding cannot be an adequate lead plaintiff and, conversely, that supporting such bidding by a plaintiff provides an indication that this plaintiff would be an adequate lead plaintiff.[7] But the above analysis indicates that this is not the case. The interests of a class could well be ill-served by having selection through competitive bidding, and an informed and loyal representative of the class thus could well hold such a view.

III. The Inconsistency of Competitive Bidding with The Goal of Strengthening the Lead Plaintiff's Role

A. The PSLRA's policy of strengthening the role of lead plaintiffs

B.

It is generally recognized that he PSLRA has sought to strengthen the role of the lead plaintiff. Prior to the PSLRA, the lead plaintiff was often one with insignificant financial holdings and therefore little financial incentive to acquire information and make informed decisions. To ensure that the lead plaintiff is one that has a significant stake, the PSLRA established a presumption that, among the parties seeking to serve as lead plaintiff, the person or group of persons with "the

[7] See, e.g., ….

largest financial interest in the relief sought by the class" is the "most adequate plaintiff" to do so.

The economic rationale behind seeking a lead plaintiff with a significant financial interest is that such a plaintiff would have a substantial incentive to acquire information, to make informed decisions, and to exert effort to monitor. Furthermore, because such a significant financial stake is likely to dominate the considerations of such a plaintiff, the interests of such a plaintiff would be likely to overlap largely with the financial interests of the class. These two effects of having a significant stake make such a plaintiff likely to represent the interests of the class well. To start with, such a plaintiff is likely to make a choice of lead counsel that would be in the interests of the class. And, after a lead counsel is chosen, such a plaintiff is likely to monitor and work with this lead counsel in a way that again would serve the interests of the class.

The value of having a lead plaintiff with a significant stake can also be seen by considering the incentives of a lead plaintiff with an insignificant stake. Such a lead plaintiff is likely to have little financial incentive to make properly informed choices. Alternatively, such a plaintiff might have nonfinancial motivations to get involved and be active. Thus, a lead plaintiff with insignificant stake is much less likely to carry out the lead plaintiff role in a way that would serve well the interests of the class.

The PSLRA sought to take advantage of a special feature of securities class actions. In some areas of the law in which class actions are submitted, no member of the class might have a substantial stake. In contrast, when a class action is filed

against a publicly traded company, some shareholders commonly have significant holdings and thus a significant stake in the outcome of the litigation. And the PSLRA has sought to enlist such shareholders to fulfill the role of a lead plaintiff.

C. The *Ex Post* Effect of Bidding Processes on the Lead Plaintiff's Role

The most critical decision in a class action is perhaps that of the choice of a lead counsel. This is a decision with great importance for the class. Accordingly, this is a decision to which an informed choice by a lead plaintiff with a significant stake can importantly contribute. Indeed, a major benefit from having such a lead plaintiff arises from the contribution that such a plaintiff could make to improving the selection of lead counsel.

Having the selection of lead counsel done by competitive bidding would take away the decision from the lead plaintiff. The selection would be done by the court, based on the court's judgment as to which of the qualified bidders have made the lowest bid. By leaving the lead plaintiff with little say in the selection of lead counsel, competitive bidding would greatly diminish the role of the lead plaintiff.[8]

[8] It might be argued that a bidding contest simply operates as a constraint on the lead plaintiff's choice. The lead plaintiff can make a choice, so the argument goes, provided only that the lead plaintiff's candidate wins a bidding contest. But the constraint metaphor is not an apt one to describe what a competitive bidding would do. Under the proposed bidding contest, the winning bidder would be lead counsel whether or not the bidder was chosen by the lead plaintiff. Accordingly, the lead plaintiff would not be constrained but rather have little say in the choice.

Competitive bidding could also weaken the lead plaintiff's potential role in the litigation following the lead counsel's selection. Letting the lead plaintiff play an important role in the selection would ensure that the relationship between the lead plaintiff and lead counsel would have the elements of confidence and fit that are important ingredients for a successful client-counsel working relationship. Thus, leaving the lead plaintiff little say in the selection of counsel would also operate to diminish the lead plaintiff's role after lead counsel is selected.

All in all, even with a given lead plaintiff with a significant stake, having selection of counsel by competitive bidding would greatly diminish the role that such plaintiff could play and thus the potential benefits that having such a plaintiff could produce. In such a situation, the role of the lead plaintiff would be more akin to that of figurehead lead plaintiffs with insignificant holdings and little involvement – than to the active and controlling lead plaintiff that the PSLRA contemplates.

D. The *Ex Ante* Effect of Bidding on Potential Lead Plaintiffs' Willingness to Serve

There is yet another way in which competitive bidding would operate to undermine the effort of the PSLRA to strengthen the lead plaintiff's role. The preceding discussion took as given the choice of a lead plaintiff, and then focused on how a competitive bidding process would diminish the role of this lead plaintiff. But competitive bidding would also narrow the pool of candidates seeking to obtain the position of lead plaintiff and thus adversely affect the choice of lead plaintiff. In

particular, having competitive bidding would discourage potentially valuable candidates from coming forward and seeking this position.

Since the lead plaintiff is not compensated, the incentive to become an effective and active lead plaintiff in the interest of the class – of the type contemplated by the PSLRA – must arise from the combination of (i) having a substantial stake and (ii) expecting that becoming a lead plaintiff would enable having a significant influence on the conduct of the litigation. Clearly, if a selected lead plaintiff could not expect to influence the litigation by selecting the lead counsel and subsequently working with the lead counsel of the lead plaintiff's choice, then the incentive to become lead plaintiff would very much decrease even for a shareholder with a significant stake. Under such circumstances, becoming a lead plaintiff would lose much of its appeal for a candidate interested in having an influence on the outcome of the litigation.

To be sure, even if competitive bidding were anticipated, lead plaintiffs would be generally found. Some potential plaintiffs would be content with being a figurehead plaintiff or would be willing to serve in this role for motivations other than influencing their financial stake in the class. Note, however, that the PSLRA has sought to move from this type of lead plaintiff to one that is interested in influencing the outcome and has a financial incentive to do so.

All in all, selecting lead counsel by competitive bidding would operate to shrink the pool of candidates vying for the lead plaintiff position. This by itself would reduce the likelihood that this narrower pool would include a lead plaintiff of the type sought by the PSLRA. Exacerbating this effect, competitive bidding could

well discourage especially those candidates that could be otherwise motivated by their interest in influencing the litigation. Both effects of having selection by competitive bidding would operate to reduce the likelihood that the type of lead plaintiff sought by the PSLRA would be available in the pool of candidates for appointment as lead plaintiff.

E. Conclusion: Competitive Bidding and the PSLRA's Goal

The PSRLA makes the lead plaintiff's selection of lead counsel "subject to court approval," and the court has discretion between approving and disapproving the lead plaintiff's choice. The question, of course, is whether using this discretion to move to selection by competitive bidding would be in the interests of the class. As the analysis above indicates, such competitive bidding would be inconsistent with the PSLRA's goal of strengthening the role of lead plaintiff in two ways – first, because it would diminish the role of chosen lead plaintiffs, and, second, because it would discourage potentially valuable lead plaintiffs from coming forward to serve in that capacity.

IV. CONCLUSION

[To be added]