Attorneys Fees in Class Action Securities Fraud Litigation: A Proposal for Addressing a Problem That Has No Perfect Solution

[An Outline of a Work in Progress]

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CAUTIONARY LEGEND

This submission summarizes research that is still in progress. Citations are incomplete, empirical estimates are in the process of revision, and portions of research remain to be completed. The author expects to make significant additions and changes to the research reflected in this draft prior to publication, and cautions readers to not assume that all of the analysis contained in this draft will appear in the final published form of this work.

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Summary

- The court, lead plaintiff and lead counsel owe fiduciary obligations to absent class members to assure that counsel compensation is reasonable.
- "Market standards" are the benchmark for assessing the "reasonableness" of attorney fee awards in class action litigation. Hensley v. Eckherhart, 461 U.S. 424, 447 (1983) (Brennan, J., concurring in part and dissenting in part). Percentage fee and lodestar techniques are methods of approximating a market standard. To the extent that these methods deviate from market standards they are incompatible with the fiduciary obligation to assure that fee awards are reasonable.
- Fee awards during the 1990's in class action securities fraud litigation averaged approximately 30 percent of gross settlements. There is a substantial body of judicial precedent suggesting that fee awards in the range of 25 percent to 33 percent are "reasonable" in class action securities fraud litigation.
- There is, however, substantial evidence that the average 30 percent fee award, and that percentage fee awards ranging from 25 percent to 33 percent, are inconsistent with market standards.
- Recent experience with cases in which lead plaintiffs aggressively negotiate rates, or in which courts use auction mechanisms to select counsel and compensation structures, indicate that market processes regularly identify competent counsel willing to represent classes for fees substantially less than 30 percent. None of these market check cases has resulted in a fee award materially in excess of 20 percent of the gross settlement. A recent $30 million settlement in a fairly standard Silicon Valley class action securities fraud action resulted in a seven percent attorney's fee. An opinion released just yesterday describes bids by five qualified law firms, and selects a firm willing to represent the class for fees ranging from six percent to nine percent of the settlement. Objective data therefore indicate that historical precedent has deviated significantly from the contemporary market standard.

- The mechanism by which the courts have settled on the 25 percent to 33 percent norm also lacks the hallmarks of a negotiated market standard. In the most common form of settlement agreements, the defendant agrees not to object to an attorney fee award provided that it is below a stipulated threshold. The defendant has no economic incentive to challenge counsel's fee request. Members of the class are also rationally apathetic. The courts have an incentive to clear their dockets and not to delve too deeply into a matter as to which no objection has been raised. Thus, when the fee award is submitted for judicial approval it is typically presented in an environment where no one has a significant incentive to engage in searching inquiry.
- As a rough approximation, and subject to several significant qualifications set forth in greater detail in the accompanying outline, the observed fee awards of 30 percent during the 1990's have been very expensive to class members and very profitable to class counsel. Had awards during that decade averaged 20 percent (the <u>maximum</u> observed in market check cases) rather than the 30 percent actually paid, class members would have gained approximately $610 million. Class counsel were correspondingly enriched (at the expense of the class) by $610 million because of the courts' reliance on a precendential norm that was materially higher than a market standard.
- To remedy this situation, courts should more frequently rely on a two-stage "market check" procedure in class action securities fraud litigation. The same process can also be applied in other class action litigation.
- In the first stage, the court should make searching inquiry of the lead plaintiff's ability and willingness to engage in effective arm's-length bargaining with counsel and to shop the litigation among competing counsel. If the lead plaintiff has bargained hard and reached a competitive result, then that arrangement should be respected, subject to judicial review in a form described below. A bargain that simply replicates the historic judicial norm of 25 to 33 percent should not be accepted as a sign of effective negotiation, absent a showing of special circumstances.
- If no lead plaintiff is willing or able to bargain hard on behalf of the class, then the court should be permitted to conduct an auction for the right to represent the class. The auction can and should be limited to qualified counsel. District Courts should be permitted significant discretion in the operation of these auctions. Indeed, it is reasonable to expect a period of learning and experimentation as courts devise optimal auction processes. While the participation of the judge hearing the matter in the auction process should not

be viewed as disabling, all other factors equal, it would be marginally preferable to have the counsel selection process run by a magistrate, special master, or other third party.

- Notwithstanding the results of the counsel selection process, the court retains the authority to order upward or downward adjustments in negotiated or auctioned fee awards in light of subsequent events. Such modifications are common in competitive processes involving long-term and complex executory agreements, such as consulting engagements or construction contracts. These modifications are often structured in the form of “change orders” that can cause upward or downward revisions in fees. However, in order to assure the integrity of the negotiation and auction process, courts should not agree to any ex-post change order absent a showing of a manifest injustice or of a significant and deleterious deviation from a market norm. Further, the court should, as a matter of policy, be far more skeptical of post-hoc requests to adjust fees upward than of suggestions for downward adjustments. Such skepticism is warranted because it is entirely predictable that the same dynamic that has generated clear sailing agreements will cause plaintiff counsel to seek defendants’ support for petitions seeking an upward revision of any previously negotiated rate. Courts must guard against this predictable effort to work around and weaken market standards.

1.0 Fiduciary Obligations, Reasonable Fees, and Justice Brennan's Market Standards

1.1 The court, name plaintiff, and counsel owe fiduciary obligations to absent class members.[1] These obligations require that counsel fees be reasonable. Indeed, the PSLRA specifically instructs that, "total fees and expenses awarded by the court to counsel for the plaintiff class shall not exceed a reasonable percentage of the amount of any damages and pre-judgment interest actually paid to the class." 15 U.S.C. §77z-(a)(6).

1.2 Justice Brennan has explained that when setting a reasonable fee in class action litigation, "as nearly as possible, market standards should prevail." Hensley v. Eckerhart, 401 U.S. 424, 447 (1983) (Brennan, J. concurring in part and dissenting in part.) Because, the "ultimate goal in class action litigation…is to maximize the benefit to the class…"[2] it is "reasonable to assume that given the opportunity, absent class members would try to secure the most qualified representation at the lowest price."[3] This observation is "not an invitation for cheapness of costs resulting from cheapness of quality."[4] The desire for qualified representation at the lowest price is, instead, the expression of rational self-interest on the part of absent class members.

1.3 Thus, if qualified counsel are willing to represent the class for a fee that is materially lower than that demanded by other qualified counsel, then "if the presumptive lead plaintiffs were to insist on their class counsel handling the action on the hypothetically materially less favorable contractual basis, that insistence would effectively rebut the presumption that the putative class representative ... is the class member most capable of adequately representing the interest of class members."[5]

1.4 Put another way, if counsel fees are set without regard to market standards then the possibility arises that fiduciary obligations to absent class members are being violated. As described below, there is material cause for concern that these fiduciary obligations are not being honored as vigorously as they might.

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[1] *See, e.g.,* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 549-550 (1949); In re GMC Pick-Up Fuel Tank Prods. Liab. Litig., 55 F.3d 768, 785 (3d Cir. 1995), *cert. denied,* 516 U.S. 824 (1995); Gersh v. Jepson, 521 F.2d 153, 157 (3d Cir. 1975); Greenfield v. Villager Industries, Inc., 483 F.2d 824, 832 (3d Cir. 1973). 5 Moore's Fed. Practice § 23.25 [4][a] ("Class Representative Stands in Fiduciary Relationship to Members of Class."); McKenzie Const., Inc. v. Maynard, 758 F.2d 97,100 (3rd Cir. 1985) (attorney's obligation); In re Quintus Securities Litigation, No. C-00-4263 VRW (order dated May 31, 2001).
[2] Raferty v. Mercury Finance Co., 1997 WL 529553 (N.D. Ill. Aug. 15, 1997).
[3] In re Cendant Corp. Litig., 182 F.R.D. 144, 150 (D.N.J. 1998).
[4] *Id.*
[5] In re Comdisco Securities Litigation, 2001 U.S. Dist. LEXIS 5173 (N.D. Ill. Apr. 12, 2001).

2.0 Attorney Fee Awards in Class Action Security Fraud Litigation Have Become Disassociated From Market Standards

2.1 The average fee award in 733 federal class action securities fraud cases filed between January 1991 and May 1999 was approximately 30.12 percent of the settlement amount. Thus, of the total $6.1 billion in settlements in these actions, approximately $1.837 billion was paid to class counsel and $4.263 billion was retained by members of the class.[6]

2.2 Courts commonly rely on the presumption that the appropriate percentage fee award is in the range of 25 percent to 33 percent of the recovery pool. *See, e.g.,* In re Pacific Enterprises Sec. Litig., 47 F.3d 373, 379 (9th Cir. 1995) (suggesting 25 percent as a reasonable benchmark and approving adjustments up to 33 percent based on complexity, risk and non-monetary benefits.)

2.3 Two techniques can be used to test whether these fee awards are consistent with market standards. The first is to examine whether the process used to set these fee awards is analogous to a market process. The second is to test whether the magnitude of these fee awards is comparable with the magnitude of fee awards that more clearly comport with a market standard. The observed 30 percent fee award, and the range spanning 25 percent to 33 percent, fail both tests.

2.4 The vast majority of the 733 settlements were presented to the court for approval as part of a settlement package that includes a suggested fee award. The attorney's fee would typically be deducted from the corpus of the settlement fund. Defendants commonly enter into "clear sailing" agreements as part of these settlements, pursuant to which defendants agree not to object to the award of attorney's fees provided that the fees are no greater than a stipulated percentage of the recovery.

2.5 It was also relatively rare for members of the class to step forward to challenge the attorney fee award. This observation should be entirely unsurprising because the same logic that makes it irrational for an individual investor to pursue an open-market securities fraud action on her own also calls into question the incentive to incur personal costs to challenge fee awards. The silence of the class is thus more likely a signal of rational apathy than applause for the attorney's fee being sought by counsel.

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[6] Todd S. Foster, Denise M. Martin, Vinita M. Juneja, Fredrick C. Dunbar, Trends in Securities Litigation and the Impact of PSLRA (VI), August 1999 (Table Captioned "Settlements in Securities Class Action Suits Included in this Study" reporting average plaintiff's attorneys fees of $2.5 million in 733 settlements that averaged $8.3 million each.)

2.6 Therefore, by the time the issue of reasonable compensation is presented to the court, every incentive for vigorous arm's-length bargaining has been carefully bled from the process. The defendant could care less about the size of the fee because the defendant's obligation to fund the pool is fixed by the settlement, and a lower fee award therefore would not provide any benefit to the defendant. To the contrary, a request for a lower fee could only antagonize plaintiff counsel. The absent class members are rationally apathetic and have no cause to object. The court also typically has a busy docket and frequently sees little incentive to delve deeply into an uncontested matter that is being resolved on terms similar to settlements approved in other cases by well-respected jurists.

2.7 Quantitatively, based on my ongoing review of available data, attorney fee awards observed in auction cases and in cases involving hard bargaining by competent, named plaintiff, ranges from a low of seven percent in the recent $30 million settlement in Network Associates[7] to a high of 21.2 percent in the $13.5 million 1995 Wells Fargo settlement.[8] In an order released just yesterday, an auction involving five plaintiffs class action firms, many of which have national brand name reputations, resulted in the selection of counsel willing to charge a range of six percent to nine percent of the settlement pool.[9] Professor John Coffee recently suggested that it was reasonable to assume that "a series of antitrust class action auctions demonstrated that qualified counsel would generally offer to represent the class for fee awards in the ten percent to fifteen percent range."[10]

2.8 The preceding data must, however, be interpreted with caution because: (a) they are based on a small sample of observations (fewer than fifteen cases have employed vigorous market check procedures); and (b) there can be significant variance in the procedures used by individual courts to invoke market discipline.

2.9 Further, opponents of market check procedures can be relied upon to argue that the recoveries in these cases could have been larger had fee awards been more generous. This observation warrants three responses. First, it proves too much. By its own logic, counsel could be paid 35%, 40%, or 50% of the recovery on the argument that the larger award provides a greater incentive for recovery. Second, even if true, it does not suggest that the hypothetical increase in the amount of recovery would have been large enough to offset the higher fee award. Unless such a showing can be made, the net proceeds to the class could still be maximized under

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[7] In re Network Associates, Inc. Securities Litigation, No. C-99-01729 WHA (Notice of Proposed Settlement of Class Action, dated Mar. 14, 2001, N.D. Cal.)
[8] In re Wells Fargo Securities Litig., 157 F.R.D. 467 (N.D. Cal. 1995) (analyzing bids and determining prevailing bid); No. 91-1944 (N.D. Cal. Mar. 31, 1995) (approving settlement and awarding fees).
[9] In re Quintus Securities Litigation, No. C-00-4263 VRW (order dated May 31, 2001, N.D. Calif.).
[10] John C. Coffee, Jr., The PSLRA and Auctions, N.Y.L.J., May 17, 2001 at 5.

the lower fee award. Third, I am unaware of any such allegations having been made in any market check case, other than the Amino Acid litigation. There, I agree that the structure of the incentive mechanism was fundamentally flawed and created and artificial cap on counsel's incentive to negotiate for a recovery. No other court has, however, used a fee structure similar to the 1995 Amino Acid structure.

2.10 On the other hand, proponents of market check procedures can legitimately observe that market check procedures are attracting talented counsel who traditionally did not represent plaintiff classes but who now are willing to represent the class at lower fees (*see, e.g.,* the Boies Schiller & Flexner bid in the Auction Houses litigation). Further, rates appear to be trending downward as more courts adopt competitive processes. Thus as courts and counsel gain additional experience with the market check process, results of that process may well improve.

3.0 Estimating the Cost of the Variation From Market Standards: A $610 Million Gap

3.1 If we assume, for purposes of approximation, and subject to the caveats described in the preceding section, that the average fee award that results from a market check process is 20 percent (roughly the maximum observed to date), and that the use of market check processes would not change the amount of recovery in the average class action securities fraud case, then award of fees at a rate of 30 percent of a total of $6.1 billion in settlements during the 1990's has caused class counsel to receive $610 million more, and the class to receive $610 million less than would have resulted at a 20 percent compensation rate.

3.2 To the extent that market check processes drive the average fee award below 20 percent, the preceding estimate is understated. To the extent that market check mechanisms cause lower recoveries the estimate is overstated. In any event, the possibility of a $610 million wealth transfer from the class to class counsel as a consequence of fee awards that are not reasonable because they do not comport with market standards is cause for inquiry.

4.0 Why Have Fee Awards Diverged From Market Standards?

4.1 It is valuable to observe that in arguing against the use of market check processes, counsel do not contend that the 25 percent to 33 percent norm is itself a reflection of market standards. Instead counsel reason solely by precedent. They contend that if the Court of

Appeals has accepted a rate or a range of rates as reasonable in prior cases, then the same rate or range of rates should be accepted in the case at issue.[11]

4.2 But where do these precedents come from? On what logic are they based? I am currently in the process of tracing back the roots of the 25 percent to 33 percent norm, and have as yet discovered no persuasive argument that the norm was ever a reasonable approximation of the fee that would result from an arm's-length bargain over representation in a securities fraud class action lawsuit. This conclusion should not come as a surprise given the lack of arm's-length bargaining inherent in the settlement process. Further research may, of course, lead me to change this conclusion.

4.3 Moreover, even if the 25 percent to 33 percent norm was once a fair reflection of a market standard, recent events call that assumption into question. First, the independent market check data have never generated fee awards that high. Second, the technology of class action securities fraud litigation has changed dramatically since the 1960's and 1970's — the period during which roots of the 25 percent to 33 percent fee norm appear to have been established. Today, for example, it is not rare for defendants to issue press releases that effectively establish all the elements necessary for plaintiffs to demonstrate liability under the federal securities laws. The only issue open to litigation is then the size of the settlement.[12] Such cases were far more rare in the 1960's and 1970's.

4.4 Professor Coffee has similarly observed that, "precedent has its purpose, but it cannot establish a valid market rate." Coffee, *supra*, §2.7.

4.5 Intriguingly, the process by which the courts have come to rely on the 25 percent to 33 percent norm bears a meaningful resemblance to the process by which the medical profession incorrectly came to believe in the prevalence of a "placebo effect." A recent article published in the New England Journal of Medicine traces the roots of the "placebo effect" to a 1955 paper that relied on statistical techniques that would not be accepted under contemporary scientific standards. The finding of a placebo effect was, however, uncritically repeated for 45 years, until it became the medical equivalent of an urban legend. The application of modern statistical techniques demonstrate, however, that the effect largely does not exist.[13] The medical profession had reason to be comfortable with the notion of a "placebo effect" and little incentive

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[11] *See, e.g.,* In re Colin Barry Hill, petition for Writ of Mandamus filed before the United States Court of Appeals for the Ninth Circuit, May 11, 2001, at 12, arguing that in "this Circuit a 25 percent fee is deemed "reasonable" as a fee "benchmark" *citing* Torrisi v. Tucson Elec. Power Co., 8 F.3d 1370, 1376 (9th Cir. 1993).

[12] *See, e.g.*, In re Cendant Corp. Prides Litigation, 243 F.3d 722 (3rd Cir. 2001).

[13] Asbj? rn Hrobjartsson and Peter C. Gotzsche, Is the Placebo Powerless? 334 N.Eng.J. Med. 1594 (May 24, 2001).

to re-examine the data to determine whether the placebo effect was, in fact, valid.[14] Similarly, active participants in the traditional litigation process have no incentive to challenge accepted precedent regarding the 25 percent to 33 percent fee norm. Inquires of the sort suggested by this panel may therefore play an essential role in causing a re-examination of the fee determination process.

5. A Proposal

5.1 It is important to concede at the outset that, given the nature of the class action process, there is likely no perfect solution to the problem of establishing attorney fees. The objective of any proposal should, I believe, be to construct a workable mechanism that can replicate market standards. The burden on critics of any such approach should be to present a superior technique, and not merely to point out the flaws of any proposal on the table.

5.2 The procedure proposed below is, I believe, fully consistent with the PSLRA and with Rule 23. The procedure is also, I believe, consistent with the courts' and lead plaintiffs' fiduciary obligation to assure that fees are set with reference to market standards. The process can be regularized so that it need not impose a burden on the operation of the court. It can also be made flexible so as to permit for experimentation with a range of market check mechanisms.

5.3 The procedure operates through a two-stage process. In stage one, the court inquires as to the adequacy of lead plaintiff. Notwithstanding the statutory presumption in favor of the selection of the party with the largest losses as lead plaintiff, the PSLRA does not override any provisions of Rule 23. Moreover, the PSLRA presumption is rebuttable, and the selection of counsel and the determination of fee arrangements remain subject to court approval. Thus, if a proposed lead plaintiff cannot fend for himself or herself in tough arm's-length bargaining with class action counsel who earn their living by being skilled arm's-length bargainers, then that plaintiff is not adequate because he or she cannot satisfy a fundamental fiduciary obligation to the class.

5.4 To ascertain whether a lead plaintiff has the capacity to negotiate on behalf of the class, the court could, by way of example, make the following inquiries:

(a) What procedures did the lead plaintiff follow to identify a reasonable number of counsel with the skill and ability necessary to represent the class in the pending matter?

(b) What procedures did the lead plaintiff follow in inviting competent counsel to compete for the right to represent the class?

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[14] Gina Kolata, Putting Your Faith in Science, New York Times, May 27, 2001, Sec. 4, at 2, Col. 5.

(c) What procedures did lead plaintiff follow to negotiate a fee and expense reimbursement arrangement that promotes the best interest of the class?

(d) On what basis can lead plaintiff reasonably conclude that it has canvassed and actively negotiated with a sufficient number of counsel to obtain “the most qualified representation at the lowest cost?” In re Cendant Corp., Litig., 182 F.R.D. 144, 148 (D.N.J. 1998).

(e) Did the lead plaintiff make inquiries into the full set of relationships between the proposed lead counsel, and the lead plaintiff and other members of the class, and did the lead plaintiff reasonably conclude either that there are no such relationships or that they do not affect the exercise of plaintiffs' fiduciary obligations?

If the responses are satisfactory, then the court can approve the counsel and fee arrangement negotiated by the client. *See, generally*, Declaration of Joseph A. Grundfest in Aronson v. McKesson HBOC, Inc., No. C-99-20743-RMW (N.D. Calif.)

5.5 If, however, no candidate for lead plaintiff status has the ability or inclination to bargain hard with potential class counsel, then in order for the court to fulfill its fiduciary obligations to absent class members, the court should step forward and conduct an auction (or other form of competitive process) to select qualified counsel for the class. Only qualified counsel should be considered in the competitive process. The District Court should also be allowed substantial flexibility in the procedures used to conduct these auctions and in the methods used to determine the winning bids. Most courts lack significant experience in conducting these competitive processes, and it is reasonable to expect a period of experimentation while courts search for techniques that can most efficiently and effectively lead to identification of appropriate counsel at an appropriate price. While the participation of the judge hearing the matter in the auction process should not be viewed as disabling, all other factors equal, it would be marginally preferable to have the counsel selection process run by a magistrate, special master, or other third party.

5.6 Notwithstanding the results of the counsel selection process, the court retains the authority to order upward or downward adjustments in negotiated or auctioned fee awards in light of subsequent events. Such modifications are common in competitive processes involving long-term and complex executory agreements, such as consulting engagements or construction contracts. These modifications are often structured in the form of “change orders” that can cause upward or downward revisions in fees. However, in order to assure the integrity of the negotiation and auction process, courts should not agree to any ex-post change order absent a showing of a manifest injustice or of a significant and deleterious deviation from a market norm.

Further, the court should, as a matter of policy, be far more skeptical of post-hoc requests to adjust fees upward than of suggestions for downward adjustments. Such skepticism is warranted because it is entirely predictable that the same dynamic that has generated clear sailing agreements will cause plaintiff counsel to seek defendants' support for petitions seeking an upward revision of any previously negotiated rate. Courts must guard against this predictable effort to work around and weaken market standards.

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