Comments for the Task Force on Selection of Class Counsel

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Please accept the following summary of the testimony I shall present to the Third Circuit Task Force on the Selection of Class Counsel. In this testimony, I propose to present three points:

> I. The overriding concern in the selection of class counsel should be the creation of incentives that will align, to the extent possible, the interests of class counsel with those of the absent and presumably passive class members.
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> II. The auction process carries inherent difficulties that may compromise the objectives of properly selecting class counsel and providing the proper incentives for counsel to best realize the interests of the class..
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> III. There are discrete cases, however, in which the auction process may further the goals of properly selecting class counsel. These are most likely to arise in situations in which issues of liability are independently established and the role of class counsel is primarily addressed to securing the remedial interests of the class.

I. Attracting Loyal Agents.

The attorney-client relation is a subset of what economists refer to as principal-agent relations. It is no exaggeration to say that life abounds with the need to rely on agents to take care of all manner of issues that we cannot attend to ourselves – from daily concerns of food and cleaning, to more specialized needs for medical and other professional services. In all principal-agent relations, there is a fundamental problem. The same forces that compel us to rely on agents

also make it very difficult, if not impossible, to adequately monitor what our agents are doing for us. This leads to the risk of agent opportunism, or what economists would call agency costs.

While the inherent risks in principal-agent relations can never be completely overcome, the trick is to create incentive structures that will attract capable agents who will have an incentive to act in furtherance of the principal's best interest. In legal representation, this process is normally entrusted to the contracts between clients and lawyers that set out the terms of the retention and the arrangements (e.g., hourly billing, premium billing, contingent representation) that are deemed to best align the interests of lawyers and clients. Further, it is presumed that the retention agreement best serves the aim of allowing the client to efficiently monitor the activities of counsel.

The difficulty in class actions emerges from the absence of any contractual relation between attorney and client. The question in the appointment of class counsel is therefor how best to replicate the protections that normally inhere in contractual relations without any realistic ability for a dispersed class to either negotiate terms or monitor the performance of the appointed attorney-agent. Doing so successfully requires, in turn, that the two aims of private retentions be realized as best as possible in the class context: first, providing an incentive for attorneys to take and vigorously prosecute a class action; and, second, providing incentives for the attorneys to remain faithful to the interests of the class and to maximize the return to the class client. Each of these aims is recognized in class action case law.

On numerous occasions, the Supreme Court has recognized that the primary purpose of class actions is to provide economically viable cases such that lawyers would have an incentive to bring such actions. As expressed by the Court,

> The aggregation of individual claims in the context of a classwide suit is an evolutionary response to the existence of injuries unremedied by the regulatory action of the government. Where it is not economically feasible to obtain relief within the traditional framework of a multiplicity of small individual suits for damages, aggrieved persons may be without any effective redress unless they may employ the class-action device.[1]

As the Supreme Court has recognized, class actions "permit the plaintiffs to pool claims which would be uneconomical to litigate individually," and as a result, "most of the plaintiffs would have no realistic day in court if a class action were not available."[2] In turn, this objective can only be realized if there are incentives in place for attorneys to undertake the task of investigating and prosecuting class claims. Thus, the Court observed in *Amchem*:

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[1] *Deposit Guaranty Nat'l Bank v. Roper*, 445 U.S. 326, 339 (1980).

[2] *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 809 (1985) (discussing the need for a class action in the context of claims averaging about $100 per plaintiff class member).

> The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry potential recoveries into something worth someone's (usually an attorney's) labor.[3]

The aggregation of claims addresses only half of the problem in securing proper representation for absent class members. Equally important, particularly after *Amchem* and *Ortiz,*[4] is that the incentives under which class counsel operate insure loyalty to the class. The Court addressed this fundamental concern both through the adequacy of representation requirement of Rule 23(a)(4) and through the due process limitations of the adjudication of claims of absent class members.[5] Of particular significance to the work of this Panel is the fact that the Court in *Amchem* and *Ortiz* focused the adequacy of representation inquiry largely on the way in which class counsel were to be compensated. Moreover, this is an area in which this Court's prior Task Force on attorneys' fees was critically important in reviewing the various incentive structures operating on counsel, class counsel included.

In my view, the central issue is therefore the determination of which manner of selecting and compensating class counsel best attracts skillful lawyers and then best structures the incentives for the faithful representation of the class. The issue is therefore the extent to which auction procedures best advance these goals.[6]

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[3] *Amchem Prods. v. Windsor*, 521 U.S. 591, 617 (1997) (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997)).

[4] *Ortiz v. Fibreboard Corp.,* 527 U.S. 815 (1999).

[5] I develop the argument regarding the due process component of *Amchem* and *Ortiz* at some length in Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions,* 1999 S.Ct. Rev. 187. I do not believe it is necessary to repeat that argument here.

[6] It is not clear to what extent this remains a live issue before this Court. If the auction process is to have any effect, there must be a quasi-contractual expectation that the auction will indeed set the expected terms governing the retention and compensation of class counsel. This has been called into question by *In re Cendant Corp. Prides Litigation,* 243 F.3d 722 (3rd Cir. 2001), which appears to fix compensation for class counsel, regardless of an auction proceeding, according to a lodestar formula. Not only does this call into question the work of this Task Force, it puts in doubt the central conclusion of this Court's prior Task Force of attorneys' fees.

II. The Difficulty With Auctions

The question before this task force is the extent to which auction procedures advance the constitutional and rule-based aims of class actions. In my previous writing on class actions, I have identified four discrete problems with auctions, as reflected in the work of other commentators as well. The first three address the auctioning off of the right to serve as counsel, as has been used experimentally by a few courts thus far. The last goes to the more problematic approach of auctioning off the class claim altogether.

First, in one variant of the auction proposal, and as some courts have tried to implement it, the winning bid is given to the lawyers willing to undertake the representation most cheaply. As with dentistry, there may be some pain associated with delivering yourself to professionals whose chief attribute is their willingness to work you over cheaply, as even the chief proponents of auctions recognize.[7] If we may assume that the interests of absent class members consist chiefly in maximizing the return from the prosecution of their claims, there is no reason to believe that the lowest percentage bidder can realize that goal. The lowest percentage bidder may simply be lawyers with lesser overhead, lesser ambition, or volume discounters.

Second, there is likely to be a systematic bias toward undervaluing class claims because of the lack of information at the pre-discovery auction stage.[8] For reasons similar to the low bidder problem, early bids may reward those who are unwilling to invest in the case. This is compounded when bids are held pre-discovery such that lawyers are bidding for class representation without adequate information about the scope of potential liability. This is particularly problematic since one of the purposes of setting the terms of attorney compensation at the outset of litigation, as suggested by the Manual for Complex Litigation Third, is to lock in attorney incentives for appropriate conduct right from the beginning. Attorneys who become class counsel be bidding low are likely to be unwilling to invest greatly in the prosecution of the claim, particularly at the all important investigatory stage.

Third, because of uncertainty over future control of the class, there will be a systematic bias toward underinvestment in discovery, compounding the problem of the systematic undervaluation

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[7] *See* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1, 113 (1991)(recognizing that "the competence or financial qualification of the low bidder might also be suspect"); *see also* Julie Rubin, *Auctioning Class Actions: Turning the Tables on Plaintiffs' Lawyers Abuse,* 52 Bus. Law 1441, 1455 (1997)(criticizing proposal on these grounds).

[8] *See* Randall S. Thomas and Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 Nw. U. L. Rev. 423 (1993).

of the class claim.[9] Not only does a low bid wins system discourage significant investment in pre-filing investigation, it has the same effect on post-filing discovery. In any system in which counsel advance costs, all investigation is a sunk cost. Such sunk costs are only rationally expended to the extent that they are likely to produce a significant return to the overall investment. But, again, the low bid wins system is likely to reward precisely those attorneys pursuing a strategy of expending the least in prosecution of the claim.

Each of these difficulties counsels caution in the adoption of auctions. Each further indicates that the introduction of competitive bidding may produce a reduction in the fees charged to the class, but at no overall benefit to the class. To the extent that the percentage awarded in a common fund case is reduced, the class does not necessarily stand to gain. A smaller percentage paid out may make the class worse off if the underlying corpus is reduced because of lawyer incompetence or because of incentives not to maximize the amount to be sought in the class action.

This problem is exacerbated if lowest percentage is the driving criterion in the selection of counsel through an auction. As the percentage drops, the risk is that the only lawyers willing to take the case will be those looking for a quick settlement with as little time and money invested in the case as possible. Under these circumstances, the auction would threaten to reproduce the risk that many claim is already present in the appointment of counsel in criminal cases. If the amount paid for criminal representation is low, and if it does not reward greater effort, the risk is that appointed counsel will have not ability to serve as anything but a plea negotiator. In the language of class actions, lawyers without sufficient incentives to prosecute claims do not have leverage against defendants and effectively approach the case "disarmed," in the language of *Amchem* and my colleague, Professor Coffee.

Finally, there are proposals to allow the auction to sell not simply the right of representation but the claims themselves. The great appeal of this proposal is that it offers the possibility of reconciling the principal-agent problems inherent in representation. In effect, the successful bidder for the claims of the class would be both the principal and agent, or at least would have such direct control over the claims as to avoid the problems inherent in the representation of absent class members.

The difficulty with this proposal arises from the issue of who would be the successful bidder. Even assuming that the ethical barriers against such procedures could be overcome, and that it were possible to buy and sell legal claims, who would have an incentive to bid and who would have the resources. The economic literature on auctions includes the concept of the "winner's curse," as popularized in the book of that title by Richard Thaler. The idea is that assuming no inside information, no bidder is better situated than others to accurately gauge the value of a good at

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[9] *See* Thomas & Hansen, *supra*; Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 Law & Contemp Probs. 167, 182 (1997)("the auction has the potential to undercut the incentive to commit resources investigating possible corporate wrongdoing . . . . Because the auction procedure allows an entrepreneurial lawyer to outbid the plaintiff or lawyer who files the initial suit, the financial reward of representative litigation do not go to those who search out wrongdoing.")

auction. Accordingly, bids for an auctioned item are likely to be spread across a distribution of uninformed prices and the winner of the auction is likely to have overpaid. Under this scenario, auctions of claims would likely benefit the class since the price paid would in turn likely overstate the amount the claims are likely worth.

There are two problems, however. The first is that this auction approach requires a robust market of bidders. But this is unlikely to be realized in the mass tort and mass economic harm contexts -- precisely those areas where the one finds the greatest difficulty in contemporary class action practice. The risk is that, the sheer size of the claims at stake would exceed the resources of even the most well-heeled plaintiffs' firms. The only realistic prospective bidders would be the defendants or their insurers. This in turn leads to two further complications. Rather than the "winner's curse," one would expect the "winner's windfall" because the inside bidders would be advantaged by inside information as to the real scope of the potential exposure. Thus, the introduction of the defendants or their allies and agents into the equation would compound the problems of information asymmetries leading to undervaluation of the class claim. Moreover, since the only purpose of a defendant acquiring the rights to the class claims would be to end the litigation, the result would be, in effect, to recreate the problem already addressed in the settlement class context of the class being created through the contrivance of the defendant, rather than through the adversarial process.

III. Discrete Uses of Auctions.

There are, however, areas of law where the use of an auction may be quite beneficial. If the principal drawback of the auction is the underincentive to investigate and ferret out wrongdoing prior to filing, that failing will be least pronounced in cases in which the elements of liability are relatively clear independent of pre-filing investigation. This is most likely to be the case when private enforcement follows some form of independent public disclosure of wrongdoing – as for example when regulatory submissions or governmental criminal prosecution expose the basis for the subsequent civil recovery action. The two most likely areas for the use of such an auction strategy are in securities cases and antitrust actions. Each is an area in which civil enforcement actions routinely overlap with public enforcement actions or may build on regulatory disclosures that occur prior to the emergence of potential class claims.

I will leave for others the statutory debate about whether the lead plaintiff provision of the Private Securities Litigation Reform Act ("PSLRA") forecloses the possibility of auctions in securities cases. It is worth noting that the PSLRA and the auction proposals adopt two distinct approaches to the problem of disciplining agents. The auction attempts to force the attorney agents to reveal the true price of their services by competing with other potential attorney agents. This is a strategy of forcing the party with superior information to reveal market information so as to allow more informed negotiations. The PSLRA, by contrast, seeks to empower an intermediary agent, the lead plaintiff, to speak for the entire putitive class in negotiating the fee arrangement and monitoring the performance of class counsel. The lead plaintiff, in effect, serves as a "superagent" in oversight

of the class's actual attorney agent.[10] Leaving aside the narrow statutory issue whether the PSLRA permits such auctions, it is not clear that the two approaches dovetail.

I will also leave aside the actual structure of how the auctions should be conducted. I would add one consideration that may strike some as counterintuitive. As reflected in this Court's decision in *In re Cendant Corp. Prides Litigation,* 243 F.3d 722 (3rd Cir. 2001), there is an intuitive discomfort with large attorneys' fees. This is particularly the case if the fee award is assessed *ex post* when the benefits of hindsight blur the risks attendant to the representation *ex ante*. If auctions are to be used, and if they are to be used to set the incentive structures for counsel at the outset of litigation, then they should be structured to elicit the best possible performance from class counsel. There is an unfortunate reality, particularly in the settlement context, that the easy dollars come first. The tendency to pare awards as the recovery rises may be ethically pleasing, but it does not necessarily serve the interests of the class. Rather, the class may be best served by a rising percentage recovery rate for the attorneys. This mechanism gives lawyers an incentive to continue struggling for a maximum recovery *and* more significantly provides a counterincentive to the temptation to take the easy, quick settlement that may do little for the class. There may be problems in assessing how the scale should rise or what are the appropriate benchmarks for higher percentages. This may require that a flat percentage be used in many cases. But the more important point is that the class is benefitted most by incentive structures that induce diligent prosecution of class claims, not necessarily by the cheapest fee award to the class attorneys.

[10] The problem of imperfect incentives operating on such "superagents" is discussed in Samuel Issacharoff & Daniel Ortiz, *Governing through Intermediaries,* 85 Virginia L. Rev. 1627 (1999).