WRITTEN SUBMISSION OF JUDGE ARLIN ADAMS TO THIRD CIRCUIT TASK FORCE ON APPOINTMENT OF COUNSEL IN CLASS ACTION LAWSUITS

I. OVERVIEW AND ANALYSIS

A. OVERVIEW AND STATEMENT OF THE ISSUES

The class action device serves a number of valuable purposes.[1] Class actions allow large numbers of plaintiffs who have valid causes of action, but lack the resources to make pursuit of their individual claims worthwhile, to do so collectively. They therefore have the potential to bring important claims to the attention of the courts that otherwise might never be resolved. Class actions also serve to aid the courts and our system of jurisprudence by providing an efficient way to handle large numbers of related claims simultaneously, thus reducing duplicative litigation and preventing undesirable inconsistencies in the outcomes of many related cases.

However, class action procedures also dramatically alter the traditional attorney-client relationship, in which an individual client typically has a sufficient stake in the outcome of the litigation to justify close monitoring of the attorney's conduct. The potential divergence of interests created by such a situation are discussed in greater detail in Section B, *infra*.

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[1] These same general purposes are also served by the shareholder's derivative suit, with the primary difference being that the "class" is already built into the corporate structure in derivative litigation. *See* Macey & Miller, 58 U. Chi. L. Rev. at 10.

In an effort to address some of these concerns, courts have experimented with different ways of monitoring compensation for class counsel in ways that may help reduce such agency problems. In the past, these have included using the "lodestar" method of awarding fees at the close of litigation, based on reasonable hourly rates, attorney effort and a multiplier based on the risks involved in taking on the litigation, and the "percentage of the recovery" method. This latter approach mirrors the contingent fee method frequently used in personal injury litigation, but allows the court to modify the award by making upward or downward adjustments at the close of litigation.

Both methods have encountered some criticism, primarily because they can be difficult for courts to apply accurately after the fact, and because they fail to align the interests of class counsel with the interests of the class sufficiently to avoid abuse. These two methods, the rationale employed by the Third Circuit in rejecting the lodestar in favor of the percentage method, and the difficulties raised by both methods are discussed in more detail in Section C, *infra.*

In an effort to refine the percentage of the recovery method so that it more accurately reflects the market, some district courts have begun to experiment with using sealed-bid auctions to select class counsel – and determine the calculation of class counsel's fees – at the outset of class action litigation. Section D, *infra*, will briefly analyze the cases that have implemented the auction method to date and discuss the issues raised by those experiments.

Finally, some general conclusions will be discussed before turning to the specific questions raised by the Task Force.

B. DIVERGENCE OF INTERESTS OF CLASS MEMBERS AND CLASS COUNSEL

Any attorney-client relationship presents certain tensions: the interests of the attorney and client will rarely be perfectly aligned, and monitoring of the attorney may be difficult for clients who are not intimately familiar with the practice of law. In the typical relationship, a variety of mechanisms act to mitigate such tensions, including individual fee arrangements, conflict of interest rules, ethical considerations, and the attorney's concern for his or her reputation. *See* Jonathan R. Macey and 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, 12-19 (1991) (hereinafter "Plaintiffs' Attorney's Role").

These tensions are enhanced by the structure of class action litigation resulting in a "common fund," while the mitigating factors may at times be reduced. *See* Macey & Miller, Plaintiffs' Attorney's Role, 58 U. Chi. L. Rev. at 19-20. The structure of class actions creates a "free rider" problem, in which the attorney for the class – whose role is to represent the interests of the class – is often not held truly accountable for his or her actions, because no individual plaintiff has a sufficient stake to justify investing the time and effort required to monitor the attorney closely. This gives rise to a type of plaintiffs' attorney characterized by a number of scholars as "entrepreneurial":

> Because these attorneys are not subject to monitoring by their putative clients, they operate largely according to their own self-interest, subject only to whatever constraints might be imposed by bar discipline, judicial oversight, and their own sense of ethics and fiduciary responsibilities.

Macey & Miller, Plaintiffs' Attorney's Role, 58 U. Chi. L. Rev. at 7-8. The agency problems inherent in class action representation "allow the plaintiffs' attorney . . . to operate with nearly total freedom from traditional forms of client monitoring." *Id.* at 20. Moreover, as Macey and Miller observe, "keeping clients informed" and encouraging their participation would not be feasible, given the high costs of communicating with a dispersed plaintiff class. *Id.* Some such plaintiffs might not even be aware that the litigation is ongoing until after a settlement is reached. *Id.*

These difficulties also reduce the potential negative impact on the reputation of a plaintiffs' attorney, one of the factors that typically mitigates agency costs in traditional attorney-client relationships. Rather than being concerned with their reputation among their existing or potential clients, who are not likely to know the identity of class counsel, class action attorneys are more likely to be focused on their reputations with the defense bar, other plaintiffs' firms, or the courts. As Macey and Miller observe, while certain kinds of reputations may correlate with the interests of future classes of plaintiffs, others – such as a willingness to compromise with defense attorneys – may not. *Id.* at 21.

These agency problems further expand when it comes to determining appropriate attorneys' fees after a successful recovery for the plaintiff class. At that point, the adversary process breaks down, because defendants are eager to settle the case and those in the class often lack the incentive or means to mount a serious challenge to an award of fees. *See* Third Circuit Task Force, Court Awarded Attorney Fees, 108 F.R.D. 237, 255 (1985) ("1985 Task Force

Report").[2] At that point, the conflict of interest between the class counsel and the class members is in its "most vivid form." Macey & Miller, Plaintiffs' Attorney's Role, 58 U. Chi. L. Rev. at 49. Moreover, this type of conflict can be difficult and undesirable for judges to moderate. *See id.*, 58 U. Chi. L. Rev. at 48 (noting that judges "rarely reject fee petitions presented as part of a settlement" because to do so would leave them "wading through affidavits and time sheets . . . something most trial judges would prefer to avoid"); Randall S. Thomas & Robert G. Hansen, Auctioning Class Actions and Derivative Lawsuits: A Critical Analysis, 87 N.W. U. L. Rev. 423, 433-34 (1993) (citing judges' interest in settlement, lack of sufficient information, and inability to rely on adversary process to provide balanced view of issues). *See also Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 52 (2d Cir. 2000) (criticizing use of "benchmark" percentage as "all too tempting substitute for the searching assessment that should properly be performed in each case"); *In re Oracle Sec. Litig.*, 131 F.R.D. 688, 689 (N.D. Cal. 1990) (Walker, J.) (criticizing lodestar approach because of abandonment of adversary process and difficulty for court of making *ex post* determinations)

As a result, a number of scholars and judges have attempted, over the years, to develop ways to minimize the tensions between attorney and client in the class action context by

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[2] The 1985 Task Force Report drew a distinction between "common fund" cases, in which the attorney's fees will come out of the class' recovery, and statutory fee-shifting cases, in which the defendant will have to pay the attorneys' fees. In the later situation, the losing party (defendant) will have an incentive to defend against a large fee award. However, the same problems can nonetheless arise when defendants seek to settle such cases, for example, by offering a "lump sum" settlement, or offering a settlement contingent on reduced attorneys' fees. *See* 1985 Task Force Report at 266-70.

trying either to devise adequate substitutes for market forces in the class action counsel market, or to better align the interests of the class and its counsel.

C. LODESTAR V. PERCENTAGE: AN OVERVIEW

The overarching considerations behind all methods of resolving the class action attorneys' fees problem used or proposed to date, including the auction method, have been (1) the desirability of simulating market forces as much as possible in order to protect the class, and (2) an overall desire to award "reasonable" fees to, among other things, encourage lawyers to take on this type of litigation. These considerations governed the reliance on the percentage of the recovery approach for many years before the Third Circuit switched to the "lodestar" method explicated in *Lindy Bros. Builders, Inc. v. American Radiator & Std. Sanitary Corp.*, 487 F.2d 161 (3d Cir. 1973), appeal after remand, 540 F.2d 102 (3d Cir. 1976). They governed the application of the lodestar method; and they motivated the return to the percentage of the recovery method following the 1985 Task Force Report. *See* 1985 Task Force Report, 108 F.R.D. at 256 (noting that "[t]he percentage fee agreement should include all of the features normally contained in comparable arrangements that are negotiated directly between counsel and client"). *See also Hensley v. Eckerhart*, 461 U.S. 424, 433 (1983) (seeking "most useful starting point for determining the amount of a reasonable fee" on an "objective basis"); *id.* at 447 (Brennan, J., concurring in part and dissenting in part) (noting that "[a]s nearly as possible, market standards should prevail, for that is the best way of ensuring that competent counsel will be available"); *Blum v. Stenson*, 465 U.S. 886, 895 (noting that base standard for fees was to be prevailing market rate in relevant community); Macey & Miller, Plaintiffs' Attorney's Role, 58

U. Chi. L. Rev. at 50-61; *Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 47 (2d Cir. 2000) ("It bears emphasis that whether calculated pursuant to the lodestar or the percentage method, the fees awarded in common fund cases may not exceed what is 'reasonable' under the circumstances.").

However, the shifts from percentage of the recovery to lodestar and back again were each motivated by a perception that the prevailing method at the time was not achieving these goals. While the lodestar method has been more frequently criticized over the years than the percentage of the recovery approach, both present difficulties as far as achieving the goals of encouraging a competitive market while providing attorneys with "reasonable" compensation.

1. Criticisms of the Lodestar Method

A number of courts, as well as the 1985 Task Force, have articulated criticisms of the lodestar method. Probably the most common complaint is that the process of scrutinizing fee applications is unduly burdensome on the judiciary. *See* 1985 Task Force Report at 246; *Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 49 (2d Cir. 2000) (noting "primary source of dissatisfaction [with lodestar] was that it resurrected the ghost of Ebenezer Scrooge, compelling district courts to engage in a gimlet-eyed review of line-item fee audits," resulting in "an inevitable waste of judicial resources"); *In re Oracle Sec. Litig.*, 131 F.R.D. 688, 689-90 (N.D. Cal. 1990).

As a related concern, the lodestar, while appearing to require adherence to a mathematical formula, is easy to "massage" into a higher or lower number, depending on the

court's individual view of the case, and is therefore insufficiently objective. *See* 1985 Task Force Report at 247.

A second complaint is that the lodestar creates undesirable incentives for lawyers to "run up the number of hours for which they could be paid." *Goldberger*, 209 F.3d at 48. Moreover, many plaintiffs' firms that specialize in class action or contingent fee work do not have a "customary" hourly billing rate, and the rates submitted with their fee applications can therefore be misleading. *See* 1985 Task Force Report at 247.

The incentive to overbill not only manifests itself in the total number of hours or the hourly rates submitted, but also acts as a disincentive to early settlement, since prolonging the litigation might result in little or no increased recovery for the class, but would provide the attorneys a greater opportunity to bill more hours. *See* 1985 Task Force Report at 247-48. Thus, the divide between the interests of the class and the interests of counsel can harm the class at this stage.

2. Criticisms of the Percentage Approach

Although the percentage fee approach has met with less criticism than the lodestar approach, it is worth remembering that the lodestar was initially developed in response to dissatisfaction with the percentage method, and that some of those criticisms remain valid today.

One of the strongest criticisms of the percentage approach is that it fails to simulate the market in a meaningful way. *See, e.g., Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 51-52 (noting that "we cannot know precisely what fees common fund plaintiffs in

an efficient market for legal services would agree to . . . .). Essentially, despite the 1985 Task Force's suggestion that a reasonable fee be negotiated early in the litigation, *see* 1985 Task Force Report at 255 & n.62, the way the fee is typically applied is at the close of the litigation. This is contrary to what market forces would command, since a typical plaintiff "would, among other things, demand in *advance* of the litigation the following information: how much their lawyers will charge . . . and the best available for those services." *In re Oracle Sec. Litig.*, 131 F.R.D. at 692.

Moreover, attorneys in percentage of recovery cases are routinely overcompensated. Many courts simply apply a "benchmark" percentage without engaging in closer scrutiny. As Judge McLaughlin of the Southern District of New York has noted, "it is not ten times as difficult to prepare, and try or settle a $10 million case as it is to try a $1 million case." *In re Union Carbide Corp. Consumer Prod. Bus. Sec. Litig.*, 724 F. Supp. 160, 166 (S.D.N.Y. 1989). Thus, a strict percentage recovery of, for example, 25% in every case would either overcompensate the attorney for the larger settlement or undercompensate the attorney for the smaller settlement.

In addition, there is some evidence that the "risk factor" claimed to be incorporated in the percentages chosen is often inflated. *See* Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497, 578 (1991) (noting that there is "no appreciable risk of non-recovery" in securities class actions); *Goldberger*, 209 F.3d at 52 (quoting Melvin Weiss of Milberg Weiss law firm as stating that losses in such cases are "few and far between"). This is so because class action attorneys are

usually experienced in evaluating potential class claims, and will therefore select cases they believe are meritorious, rather than pursuing those that they know bear a substantial risk of no recovery.[3] Macey and Miller explain this as "a distribution of cases in which one tail – representing cases where the expected payoff to the attorney falls short of the attorney's expected costs – is cut off." Macey & Miller, Plaintiffs' Attorney's Role, 58 U. Chi. L. Rev. at 24.

While the percentage of recovery method undoubtedly works to align the interests of counsel and the class more closely, it may create incentives for class counsel to "cut corners." Attorneys may settle too early, because they may prefer to spend relatively few hours (and thus maximize the amount they are paid per hour), rather than spend more time and increase the plaintiffs' recovery. *See* Macey & Miller, Plaintiffs' Attorney's Role, 58 U. Chi. L. Rev. at 25. For example, "if an additional hour of effort increases the expected proceeds by $500, that effort will not be undertaken if the attorney's hourly cost is $200 and her anticipated additional compensation is twenty percent of the increase in the settlement ($100 in this case)." Thomas & Hansen, Auctioning Class Action and Derivative Suits, 87 Nw. U. L. Rev. 423, 432 (1993). For the same reason, attorneys may choose not to pursue additional claims that are more costly to investigate but could result in a favorable recovery for the class.[4]

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[3] It should be noted that a similar problem arises in connection with the "risk multiplier" aspect of the lodestar method.

[4] Macey and Miller also provide an example:

> [A]ssume that in a jurisdiction with a 25%-of-the-recovery rule a given litigation is expected to generate a fund of $1 million with costs to the plaintiffs' attorney of bringing the litigation of $500,000. This litigation would not be brought because the attorney expects fees of only $250,000. If, on the other hand, the plaintiff

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Thus, while the percentage recovery method does not create the undesirable incentive structures inherent in the lodestar method, it still does not achieve the goal of simulating the market as much as possible. Nor does a strict application of the percentage fee approach ensure that attorneys will always receive a "reasonable" fee. This uncertainty occurs because judges may intervene to make upward or downward adjustments that run afoul of the same difficulties experienced by judges attempting to implement the lodestar method.

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[4](...continued)

> were an individual . . . the litigation would be brought because it would generate an expected profit to the plaintiff of $500,000.

Macey & Miller, Plaintiffs' Attorney's Role, 58 U. Chi. L. Rev. at 60.

D. CLASS COUNSEL AUCTIONS

A number of courts have begun to experiment with a third alternative,[5] that is, auctioning off the position of class counsel. Their experiences, discussed in a series of published opinions on the topic, reveal both the merits and the difficulties of implementing such a program. *See In re Oracle Sec. Litig.*, 131 F.R.D. 688 (N.D. Cal. 1990); 132 F.R.D. 538 (N.D. Cal. 1990); 852 F.Supp. 1437 (N.D. Cal. 1994); 136 F.R.D. 639 (N.D. Cal. 1991); *In re Wells Fargo*

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[5] A fourth alternative, the auction model proposed by Macey and Miller, provides for an auction of the actual *claim*, not just the auction of the position of plaintiffs' counsel. As such, it presents a much more dramatic departure from traditional models, and may raise other types of judicial competence, professional responsibility or due process issues far beyond what the auctioning of the plaintiffs' counsel position presents. Under the Macey and Miller scheme, the court would receive sealed bids from anyone - attorney or not - who wished to submit them. The claim would be auctioned to the highest bidder, and the money collected from that bidder would be treated as the class recovery and distributed to the class (minus expenses, fees paid to the attorneys assisting the court in initially investigated the claim, etc.). The highest bidder would simply succeed to the rights of the plaintiffs. Then, if the highest bidder was the defendant in the case, the case would be dismissed or, if the highest bidder was someone other than the defendant, the case would proceed between the bidder and the defendant, in a manner that would "closely resemble standard litigation between contesting parties." *Id.* at 108.

The authors suggest this mechanism could "overcome the agency costs that plague class and derivative litigation in its current guise"; reduce transaction costs because courts would no longer have to review the substance of fee requests at the end of litigation; direct the "asset" to the individual who values it most highly; and realign the interests in such litigation between the stakeholder and the prosecutor of the claim. *Id.* at 108-110. However, they also recognize difficulties presented by their model, including a possible shortage of bidders with sufficient funds to mount a bid; difficulty ensuring the cooperation of the plaintiffs in prosecuting the claim; how to compensate the plaintiffs' attorney who first identified the claim; and the auction method's inapplicability to cases in which injunctive relief is the primary relief sought. *Id.* at 110-16. In addition, some critics have pointed out that winning bidders will always pay less than what they think the claim is actually worth, such that the class will always recover less than even the defendant believes it is worth. *See* Thomas & Hansen, Auctioning Class Action and Derivative Suits, 87 Nw. U. L. Rev. at 446-48. This problem is enhanced if the defendant is permitted to bid. *See id.* at 448-49. *See also* Jonathan R. Macey & Geoffrey P. Miller, Auctioning Class Action and Derivative Suits: A Rejoinder, 87 Nw. U. L. Rev. 458 (1993), for a response.

Securities Litigation, 156 F.R.D. 223 (N.D. Cal. 1994) (requiring submission of bids), 157 F.R.D. 467 (N.D. Cal. 1994) (designating class counsel); *In re California Micro Devices Securities Litigation*, No. C-94-2817-VRW, 1995 U.S. Dist. LEXIS 11587 (N.D. Cal. Aug. 4, 1995) (confronting difficulty where pre-certification settlement occurs) 168 F.R.D. 257 (N.D. Cal. 1996) (appointing class counsel), 965 F. Supp. 1327 (N.D. Cal. 1997) (certifying class for settlement and approving settlement); *Wenderhold v. Cylink Corp.*, 188 F.R.D. 577 (N.D. Cal. 1999) (ordering competitive bid process), 189 F.R.D. 570 (N.D. Cal. 1999) (extending bidding period), 191 F.R.D. 600 (N.D. Cal. 2000) (appointing class counsel); *In re Amino Acid Lysine Antitrust Litig.*, 918 F.Supp. 1190 (N.D. Ill. 1996); *In re Bank One Shareholders Class Actions*, 96 F.Supp.2d 780 (N.D. Ill. 2000); *Raftery v. Mercury Finance Co.*, No. 97-C-624, 1997 U.S. Dist. LEXIS 12439 (N.D. Ill. Aug. 15, 1997); *In re Mercury Finance Sec. Litig.*, No. 97-C-624, 1997 U.S. Dist. LEXIS 16493 (N.D. Ill. Oct. 17, 1997); *In re Auction Houses Antitrust Litig.*, 197 F.R.D. 71 (S.D.N.Y. 2000); *In re Cendant Corp. Litig.*, 182 F.R.D. 144 (D.N.J. 1998), 109 F. Supp.2d 285 (D.N.J. 2000); *Sherleigh Assocs. LLC v. Windmere-Durable Holdings, Inc.*, 184 F.R.D. 688 (S.D. Fla. 1999).

The judges that have used the auction procedure have so far followed very similar procedures. Generally, they have received sealed bids, disallowed "joint bidding," and asked attorneys to indicate both their qualifications to serve as class counsel and the percentage of the

total recovery they would seek if a successful recovery was achieved.[6] *See, e.g., In re Oracle Sec. Litig.*, 131 F.R.D. at 697.

After considering a series of factors, including which bids offered the best recovery for the plaintiffs under a variety of likely outcomes, any possible disincentives built into the bid structures, the firms' willingness to participate in the bidding process and the qualifications of the firms submitting bids, the court selected and appointed class counsel. In each case, the court retained the discretion to consider applications for modifications of the bids based on unforeseeable events occurring later in the litigation, thus protecting the winning bidder from being bound to its bid regardless of future circumstances.

1. Positive Consequences of the Auction Method

The auction method applied in the various cases resulted in some positive outcomes that addressed many of the concerns with both the lodestar or percentage methods.

First, the bids themselves reflected considerably lower percentages than the firms might have been expected to obtain under a strict percentage of the recovery theory. The *Oracle* bidding process resulted in "a fee schedule that represented substantial savings to the class." *In re Oracle Sec. Litig.*, 852 F. Supp. 1437, 1458. At the close of the litigation, Judge Walker

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[6] Variations on this basic approach have included providing a matrix based on the length of time the litigation should entail and the amount of recovery for the firms to fill in; giving a presumption to the counsel of choice of the lead plaintiff chosen under the Private Securities Litigation Reform Act; and asking putative lead plaintiffs and their counsel of choice to submit bids together. However, the basic elements of the bid applications were the same in all cases.

looked back to the original bids and compared what the four bidding firms would have received under the contingencies (length of case and amount of recovery) that actually occurred, finding that the winner of auction did in fact receive the lowest amount of fees, both numerically and as a percentage of the recovery (19.2%). A cross-check against the lodestar revealed a relatively low risk multiplier of 1.25 to bring the "unenhanced" lodestar figure up to the actual amount awarded counsel. Finally, the court compared the total amount of recovery for the class to the amounts estimated by each side in the litigation, as well as to articles studying typical recoveries in class action cases, and found the recovery to the class in this case "a relatively good class settlement." *Id.* at 1459. Similarly, the successful bidder in the *Lysine* litigation received "something in the range of just 6% of the total class recovery of well over $50 million, "meaning that the class members realized about 94% of what the defendants had ultimately paid in settlement," and that "the plaintiff class was somewhere between $5 million and $10 million better off in pocket than would have been true in the typical . . . arrangement, with scads of lawyers feeding at the trough." *In re Bank One Shareholders Litig.*, 96 F. Supp. 2d 780, 785 n.5.

Second, at least according to the judges themselves, the cases generally seem to reflect a reduced expenditure of judicial resources. It is true that none of the judges had to engage in complicated *ex post* assessments where counsel had been chosen by auction. Judge Walker expressed his satisfaction with the outcome in *Oracle* and went on to apply a similar bidding process in several other cases. Similarly, Judge Shadur cited the success of the *Lysine* auction in implementing it again in *Bank One Shareholders.* However, as discussed *infra*, it is not clear that administering an auction will, in all cases, achieve the desired result and be worth the costs involved.

The auction method does avoid the often-irrational "race to the courthouse" approach to selecting lead counsel. The typical scenario, in which the first to the courthouse – whether it be by minutes or days – is automatically appointed lead counsel does not reflect market forces in any meaningful way. If anything, it reflects which firm is best able to put together a complaint with a minimum of investigation and research. The auction method avoids rewarding such behavior.

Thus, the auction procedure appears to address the most pressing of the major concerns with the lodestar and percentage of recovery approaches: it improves the overall recovery to the class, it reduces judicial involvement in the details of fee calculations, and it rationalizes the process of selecting class counsel in a way that more accurately mimics a competitive market.

2. Potential Risks of the Auction Method

Despite the benefits of the auction procedure as it has been applied in the handful of cases so far, there are a number of difficulties.

(a) Avoiding a "Race to the Bottom"

The auction method may create a risk of encouraging a "race to the bottom," in which firms will submit unduly low bids in an effort to win the position of class counsel, then either cut corners to meet their bidding requirements or rely on the possibility of a later petition to the court to win an additional award. At least two courts noted this risk in their opinions on the auction process. *See In re Oracle Sec. Litig.*, 136 F.R.D. at 647-48 & n.21; *Raftery v.*

Mercury Finance Co., 1997 U.S. Dist. LEXIS 12439 at *8-*9. However, neither opinion offered an entirely satisfactory solution to this potential problem.

If firms do in fact engage in the practice of submitting unduly low bids, it may be difficult for courts to detect it. As noted *supra*, many judges have expressed dissatisfaction with the lodestar method precisely because they were less familiar with the internal economics of the law firms involved than the law firms themselves, and making a fair determination as to what was "reasonable" was therefore difficult. It is not clear how a court would be able to tell whether a bid was "too good to be true" or simply very competitive.

In the end, the auction courts addressing this risk relied on the firms' assumed desire to preserve a good reputation in the community in believing that the bids reflected an honest assessment of the likely costs and not a "low ball" bid designed to win the auction that would ultimately result in cutting corners. *See, e.g., Raftery*, 1997 U.S. Dist. LEXIS 12439 at *8-*9 (finding that "attorneys who over the years have earned a reputation for excellence . . . are not likely to squander it in this situation"). However, it is worth noting that the law firms now thought to be too concerned with their reputations for honesty and fair dealing to submit potentially inaccurate bids are substantially the same law firms (in some cases, literally the same law firms, due to the fairly small size of the plaintiffs' class action bar) that have been accused of padding hours or hourly rates and delaying settlement under the lodestar method, or settling too quickly and cutting corners to protect a high profit margin in "percentage of recovery" cases. *Compare In re Oracle Sec. Litig.*, 131 F.R.D. at 689 ("the lodestar and its variants create incentives for wasteful litigiousness by both sides") *with In re Oracle Sec. Litig.*, 132 F.R.D. at

547 ("the potential adverse reputational consequences . . . of proposing a 'sell-out settlement' are not negligible"). Similarly, some "winning" bids even seem to have built-in incentives for firms to act in their own self interest and not that of the class. For example, in the *Lysine* case, the court selected the only firm that proposed a cap on its total fees.[7] Addressing the concern whether such a structure would set up a disincentive for the firm to do any additional work to achieve recovery over $25 million, the court cited the *Oracle* cases in support of "rejecting any such concern where the firm involved is a regular participant in such litigation," presumably including the risk to a firm's reputation if it engaged in such behavior. *See In Re Amino Acid Lysine Litig.*, 918 F.Supp. 1199. The court went on to state that, in order to dispel any such possible incentive, it would consider an award of a bonus fee or reconsideration of the total award should such events come to pass, but that any such modification would still have to leave the class substantially better off than it would have been under any of the other bids. *Id.* As it turned out, this problem did not come to fruition in the *Lysine* litigation, as the final award to the class was over $50 million. *See In re: Bank One Shareholders, infra,* 96 F. Supp.2d at 785 n.5 (discussing outcome in *Lysine*). However, one wonders whether, if it becomes clear that enough judges are generally unconcerned about such a risk, even specialty boutique firms might be tempted to cut corners at the expense of the class. Cutting corners to keep expenses down in order to gain the maximum award under a capped bid seems no more obviously unethical than the behavior in which plaintiffs' attorneys are widely believed to engage under the traditional models. The auction method does not fully correct for this potential negative incentive.

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[7] The firm proposed to do this by taking 20% of the first $5 million, 15% of the next $10 million, and 10% of the next $10 million, with no additional fee for additional recovery above $25 million.

(b) Analyzing Bids Consistently

Another potential difficulty is how courts should analyze and compare bids in a manner that can be applied consistently across jurisdictions or even from one judge to the next. Inconsistencies are likely to occur with greater frequency while the auction process is still relatively new, but may coalesce into more defined standards over time. However, in the meantime, courts should be aware of the many ways in which subjectivity can be introduced into what otherwise appears to be an objective process – much the way the lodestar method can be manipulated to achieve a desired result.

For example, even looking just at the information sought in the bid applications, different courts may take different approaches. Following his initial experiment, Judge Walker appeared to move towards seeking more specific information from the bidders, including by requiring each bidder to fill out a matrix reflecting different fee percentages for different levels of recovery and different stages of the litigation. *See, e.g., In re California Micro Devices Sec. Litig.*, 1995 U.S. Dist. LEXIS 11587 at *8-*10. In contrast, Judge Shadur specifically did not provide any definite guidelines for the bids in an effort to avoid inhibiting the firms' creativity. *See In re Bank One Shareholders' Class Actions*, 96 F.Supp. 2d at 785. As might be expected, this resulted in very different sets of bids in the two cases.

Similarly, in looking at the substance of the bids, Judge Walker felt that "increased compensation for increased attorney effort" better simulated market forces in *Oracle*, while Judge Shadur placed primary emphasis on the overall fee cap proposed by the winning

bidder in the *Lysine* case. *Compare In re Oracle Sec. Litig.*, 132 F.R.D. 538, 546 (N.D. Cal. 1990) *with In re Amino Acid Lysine Antitrust Litig.*, 918 F. Supp. 1190, 1199 (N.D. Ill. 1996). Thus, depending on the importance given certain factors by some judges but not others, the auction method may be applied in as subjective a manner as the lodestar method or an adjustment to a percentage method.

A difficulty is created by the courts' attempts to include quality of representation as a significant factor in the analysis. While all of the courts using the auction method attempted to consider quality in their assessments, some also admitted difficulty in comparing the many plaintiffs firms that presented impressive backgrounds in that type of litigation. *See, e.g., In re Amino Acid Lysine Antitrust Litig.*, 918 F. Supp. at 1198. Similarly, the court in *In re Oracle Sec. Litig.*, 132 F.R.D. 538, 542 (N.D. Cal. 1990), found the bidders' descriptions of their qualifications "unhelpful" and consisting primarily of "celebrity endorsements."

At least two judges expressed views on issues such as firm size or participation in the geographic market that suggest that some quality-related factors may lead to overly subjective determinations as to who should be encouraged to participate in this type of litigation. For example, in *Wells Fargo*, the court observed, "A joint bid by two or more firms otherwise too small to take on class counsel responsibilities would introduce a new competitor to the selection process; by contrast, to permit a joint bid by two dominant firms . . . might very well eliminate whatever possibility remains in this case of a meaningful competition . . . ." *Id.* at 226. Thus, Judge Walker admitted he would at least consider acting to regulate the field of competition to prevent "dominant" firms from bidding jointly while not ruling out the possibility

of – or the advantages presented by – allowing two less-dominant firms to submit a joint bid. *See also In re Amino Acid Lysine Antitrust Litig.*, 918 F.Supp. at 1200 n.19, for a discussion of Judge Shadur's background as a small-firm lawyer and belief that while he "has no anti-megafirm bias," he is nonetheless "well aware that the quality of legal representation is a function of which lawyer or lawyers are handling a matter – not the size of the legal organization."

Considerations of quality clearly should play some role, and simply awarding bids to the lowest or "cheapest" bidder is likely an undesirable result. However, courts implementing the auction procedure should be aware of the difficulty of making a truly objective determination as to firm quality.[8]

A related problem in analyzing and comparing bids is that doing so may require the court to make some assumptions about the likely outcome of the case. For example, in *Lysine,* several of the bids were so close to one another that the court was required to make what it admitted were "assumptions, with no assertions of certainty," as to the likely duration of the

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[8] This line of argument concerning the bidding process does raise the question, however, of whether courts applying an auction process do in fact select the "best" counsel, or rather, select the least expensive counsel from among a group it has deemed "qualified," regardless of the fact that some in that group may be more qualified (by whatever standards one might choose to apply) than others. It seems the latter is the case, given the various cases' emphasis in the various cases on comparison of the bids themselves and very brief discussion overall of each firm's other qualifications. While such a trend is somewhat understandable, given the courts' obvious desire to apply a measure of objectivity to the process of selecting class counsel, it may not accurately reflect the "market forces" with which proponents of the auction method seem so concerned. Presumably, some clients are willing to pay more for even marginally better representation, and class action plaintiffs should not be assumed to be any different.

case in order to compare the bids properly. *See* 918 F.Supp. at 1198. Thus, although one of the bids could have provided more benefit to the class if the case settled in less than eighteen months, the court found such a scenario "unlikely, given the complexity of the matter and the ordinary course of major litigation." *Id.* Similarly, in *In re Bank One Shareholders Class Actions,* 96 F. Supp. 2d 780 (N.D. Ill. 2000), the court received nine bids, with "crossover points"[9] such that it became "necessary . . . to make some assumptions about the prospects of recovery for the class." *In re Bank One Shareholders Class Actions*, 96 F.Supp. 2d at 788. The court noted that making such assumptions "poses real problems," since "[n]o one is provided a crystal ball for that purpose, and even if one were available there could be no assurance that it was unclouded." *Id.* The court therefore took into consideration the fact that the "best-informed" estimate made available to the court of the potential class recovery if plaintiffs were totally successful was between $4.6 and $4.8 billion, and that the crossover points therefore only made a difference at extremely low percentages of recovery, such as a mere 1.5% of that number. *Id.* While recognizing the "overly simplistic" nature of this analysis, the court noted that the 1.5% figure was "so far below anything that experience teaches" that he felt safe in eliminating bids that were only better for the class at those extremely low levels of recovery. *Id.* at 788 n.11.

Aside from the dangers of speculating (on the record) about the court's view of the difficulty of litigating the claims involved and the length of time the court expects it to take to reach settlement, such assumptions may insert a degree of subjectivity into the analysis of the bids. While a purely objective method of setting fees that also accurately reflects the market and

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[9] "Crossover points" are the points at which different firms' proposals became better for the class based on, for example, the stage of the litigation at which the case settled.

the interests of the class is probably impossible to achieve, and while the auction method may in some cases be the closest possible approximation, courts should be wary as they make such necessary assumptions.

(c) Compensating Losing Bidders

While the auction method does reduce the "race to the courthouse" problem it also reduces the incentive for plaintiffs' firms to investigate potential claims in the first place. Without some certainty that the first firm to investigate and file is likely to be the "winning bidder," even if counsel are compensated for their time in investigating, the incentive may not be great enough to encourage attorneys to pursue such early investigation.

Additionally, the auction method leaves open the difficulty of compensating plaintiffs' counsel if the initial investigator is not eventually selected as class counsel. While some courts required the firms to submit bids that would account for the necessary compensation to the initial plaintiffs' firms, others simply left it to the firms to seek compensation from their individual clients. *Compare In re Oracle Sec. Litig.*, 131 F.R.D. at 697 (specifying that lead counsel will be responsible for payment of fees and costs to firms "assisting" in actions) *with In re Amino Acid Lysine Antitrust Litig.*, 918 F.Supp at 1202 (directing other firms involved to "look to their own clients . . . for all compensation, past and future," with only narrow exceptions). That result may lead to secondary litigation or other difficulties in working out fair fee arrangements among firms, or may serve as a disincentive to firms to get involved if they suspect they may be precluded from recovering any of their costs from the common fund. Alternative ways to handle compensation for work done prior to the appointment of class counsel

should be considered to avoid a chilling effect on plaintiffs' firms and class action litigation generally.

(d) Auctions May Not Be Applicable in All Situations

Despite the merits of the auction method in some cases, there are likely many situations in which the auction method will not be effective. As one example confronted by courts in both California and Illinois, the auction method is not appropriate when there is a pre-certification settlement. For example, in *In re California Micro Devices Securities Litigation,* the leading plaintiffs firms in the case did not mention that they were already engaged in settlement negotiations with defendants, and instead requested two postponements of a status conference to discuss the bidding procedure. *See In re California Micro Devices Sec. Litig.*, 1995 U.S. Dist. LEXIS 11587 at *2. During that time, they negotiated a settlement with defendants. *See id.* at *2-*3. After rejecting several proposed settlements, the court noted the inadequacy of the auction mechanism to "cope with the dangers inherent in a pre-certification settlement," because of the risk of settling early, which had the dual effect of compromising the class and obtaining an edge in the auction. *In re California Micro Devices,* 168 F.R.D. at 262.[10] In response, the court received two proposals, which were not disclosed. Similarly, in *In re Mercury Finance Sec. Litig.*, No. 97-C-624, 1997 U.S. Dist. LEXIS 16493 (N.D. Ill. Oct. 17,

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[10] The court was unpersuaded by the leading firm's attempt to show support for settlement and ultimately appointed a new class representative, an institutional investor that had not previously actively participated but now sought to intervene, and allowed the new class representative to hire its own attorneys. *See id.* at 275-76. Fifteen months later, the court finally approved settlement. *See In re California Micro Devices Sec. Litig.*, 965 F. Supp. 1327 (N.D. Cal 1997).

1997), the court attempted to solicit bids. To the apparent frustration of the court, one of the submissions merely "repackage[d] its earlier-stated and rejected position, proposing merely that it be compensated with a reasonable fee as determined by the court." *Id.* at *3. In the meantime, a settlement agreement had been reached with one of the defendants. Thus, the court, like Judge Walker in *California Micro Devices*, was left with a proposal that was "[o]bviously . . . not what the court had in mind, and the question [was] how to deal with it: confrontationally or practically." *Id.* The court decided that, "[a]s a practical matter, it makes little sense to change pilots at this time, no matter the court's distress at [plaintiffs'] conduct in responding to its order." *Id.* Thus, the court allowed the interim lead plaintiff and its counsel to go forward with the settlement, but found that for the remainder of the case, the presumption in favor of that plaintiff had been rebutted by its "failure to assist the court in determining the reasonable value of counsel's services." *Id.*

A larger concern not directly addressed by either court in their published opinions (although Judge Walker hinted at this possibility in *California Micro Devices*) is the risk that early settlement may become a tool to circumvent the auction procedure. In any event, these cases indicate it may be too difficult, frustrating and costly for courts to try to impose an auction procedure in a case that is progressing very quickly.

As the court in the *Auction Houses* cases noted, the auction method may prove useful only in limited circumstances. The concerns that auctions are intended to address may not be present in every case. For example, where a strong plaintiff with a sufficient stake in the

litigation emerges, as it did in the *California Micro Devices* case, *see* 168 F.R.D. at 275-76, there may be no need for the court to act as a surrogate for the plaintiff class. In such situations, it may be more desirable to allow the ordinary attorney-client relationship to govern fee arrangements to the extent possible.[11]

(e) Risk of Shortage of Qualified Firms / Difficulty of Monitoring Collusion

Not every class action case or "triggering event" results in a race to the courthouse by every major plaintiffs' class action firm in the country. Many cases pose risks that discourage firms from filing lawsuits, or offer too little reward for plaintiffs' firms to pursue the litigation aggressively. When confronted with a complex bidding process at the outset, particularly while the use of the auction method is still relatively novel, some firms may decide that the opportunity cost to them of analyzing the case sufficiently to put together a winning bid is too great, and they may choose to pursue other cases in non-auction jurisdictions instead.

Whatever their reasons, in each of the cases using the auction method to date, several of the firms involved in the litigation early on dropped out of the running at some point between filing the complaint and the due date for the bids. In two cases, this nearly resulted in no qualified class counsel remaining in the suit. In the *California Micro Devices* case, for example, despite the fact that "more than a dozen" plaintiffs' firms had initially been involved, the court received only two bids. The court was disturbed that a number of firms had not submitted bid, and noted:

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[11] Courts must also have confidence that the lead plaintiff will represent the class adequately in negotiations with counsel.

> This suggests an understanding or collaboration among plaintiff firms engaged in securities class action litigation that many would choose not to bid for this litigation in apparent deference to the efforts of Lieff Cabraser in negotiating the proposed settlement. The indicia of such cooperation raises serious doubts about the conditions of competition in this segment of the legal services industry. . . . In any event, it is plain that the plaintiff firms in this case have not competed.

1995 U.S. Dist. LEXIS 11587 at *13-*14. The court again noted the "dubious role" the leading firm had played in "precipitating a premature and unsanctioned settlement," in conjunction with the "deference that firm has secured from other plaintiff lawyers and the resulting elimination of competition," and suggested that "those counsel have proven themselves unfit for the task of class representation and should therefore be disqualified from acting as class counsel." *Id.* at *15-*16. Similarly, in the *Wenderhold* case, despite the fact that six plaintiffs firms had initially been involved, the court received only one bid during the original bidding time. *See Wenderhold*, 189 F.R.D. at 571.

The court therefore rejected that firm's bid as inadequate. However, this left the court with no qualified bid for class counsel. The court thus extended the time to file bids, and made clear both that the rejected firm could resubmit a bid and that the bidding process was open to any interested lawyer or law firm. *Id.* at 573. The second time around, the court received three bids and was able to chose class counsel from among the bidders. *See also In re Mercury Fin. Sec. Litig.*, 1997 U.S. Dist. LEXIS 16493 at *3 (receiving only two bids, one of which was "[o]bviously . . . not what the court had in mind").

Judge Walker's suspicions regarding the potential for behind-the-scenes collusion in *California Micro Devices* and Magistrate Judge Lefkow's similar experience in Illinois raise

another concern, which is how courts can distinguish between cases where there simply are not very many interested plaintiffs' firms and cases where plaintiffs' firms have dropped out of the bidding process due to undue influence or improper collusion among plaintiffs' firms. While it is true that most plaintiffs' firms will probably be sufficiently concerned about their reputations with the courts and other members of the class action bar to refrain from disobeying a court order, it may be difficult for courts to assess what is motivating plaintiffs' firms when they drop out of the bidding process.

(e) Joint Bidding Problems

In each of the cases so far, the courts disallowed joint bidding in order to preserve the integrity of the "competitive bidding" process. There may be situations, however, where joint bids are preferable. Judge Walker suggested that such a situation might arise when two small firms individually lacking the resources or expertise to mount a competitive bid sought to collaborate, and suggested that he would view such a situation differently from a situation where two "dominant" firms sought to submit a joint bid. *See In re Wells Fargo*, 156 F.R.D. at 226.

Thus, courts using the auction method must adopt an "all or nothing" rule regarding joint bidding, or must devise some principled way to govern a process that would allow joint bidding under some circumstances but not others.

E. CONCLUSIONS

The auction approach presents some interesting answers to the difficulties presented by the lodestar and percentage of recovery methods. It addresses the desire to settle

the question of how to determine fees early in the case. To a significant extent, it simulates the market better than a straight percentage-of-recovery will.

However, the auction method is not appropriate in every common fund case. In fact, the auction procedure may be a viable option only in limited situations, where not much pre-filing investigation is necessary, the amount of expected damages is relatively easy for participating firms to estimate, and the expected recovery, media attention, or other circumstances are present that will ensure an adequate number of qualified auction participants.

Even given these conditions, courts choosing to experiment with the auction method must continue to be mindful of the potential costs – both short-term and long-term – of using this approach.