Lawyers on the Auction Block: Evaluation and Selection of Class Counsel by Auction

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LAWYERS ON THE AUCTION BLOCK: EVALUATING THE SELECTION OF CLASS COUNSEL BY AUCTION

Jill E. Fisch*

The lead counsel auction has attracted increasing attention. Auction advocates argue that auctions introduce competitive market forces that improve the selection and compensation of class counsel. The benefits of the auction, they claim, include lower legal fees and better representation.

Careful scrutiny reveals that auction advocates have overlooked substantial methodological problems with the design and implementation of the lead counsel auction. Even if these problems were overcome, the auction procedure is flawed: Auctions are poor tools for selecting firms based on multiple criteria, compromise the judicial role, and are unlikely to produce reasonable fee awards.

Although the existing record is insufficient to permit rigorous empirical evaluation, early results raise concerns. This Article therefore considers an alternative: negotiation by an empowered lead plaintiff. The Article analyzes recent developments under the Private Securities Litigation Reform Act to demonstrate that client empowerment is a more effective way of incorporating market forces into the selection and compensation of class counsel. The Article concludes with interpretive guidance on further development of the model and its extension beyond securities litigation.

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* Professor of Law, Fordham Law School. Sloan Visiting Professor of Law, Georgetown University Law Center (2001-2002). I am grateful to Geoffrey Miller and Gideon Pardewm'sky for comments on prior drafts, to Steve The! for helpful discussions, to Simon Wilkie and Robert Wilson for explaining the fundamentals of auction theory, and to Barbara Hart and Fred Burnside for access to unpublished litigation materials. I presented earlier versions of the Article to the faculty of Northwestern University School of Law, the Federalist Society Third Annual Faculty Division Conference, the Law, Economics & Organization Workshop at the University of Southern California, and the Law & Economics Workshop at the University of Michigan Law School and received many useful comments at each session.
The lead counsel auction has recently achieved increased visibility for several reasons. Judge Lewis Kaplan's decision to use an auction in the prominent *Auction Houses* antitrust case was described as highly successful. After a number of years in which Judge Vaughn Walker's pioneering auction in *Oracle* attracted few imitators, several other judges have begun to experiment with the auction procedure. Those responsible for reforming class action procedures, from the Advisory Committee on the Federal Rules of Civil Procedure to the Third Circuit Task Force on the Appointment of Counsel in Class Actions, are seriously assessing

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the potential of the auction to address perceived problems in class action litigation.  

Under the auction model, a court selects class counsel by soliciting bids from prospective plaintiffs’ firms. On the basis of these bids, the court determines which firm will represent the plaintiff class, as well as the price and structure of the eventual fee award. Supporters of the auction approach, including judges who have used lead counsel auctions, claim that the lead counsel auction introduces competitive market forces into the selection process, and that these forces can address many existing problems with class action procedures and the jurisprudence of fee awards. The benefits of the auction, they claim, include lower legal fees and better representation.

These claims have not been subject to careful scrutiny. Indeed, auction advocates have made several fundamental and erroneous assumptions about the operation of lead counsel auctions and have overlooked substantial methodological problems with their design and implementation. Even if these problems were overcome, limitations of the auction procedure hamper its ability to function as an effective method of selecting class counsel.

Among their shortcomings, lead counsel auctions do not address agency problems or the difficulties inherent in drafting an appropriate contract for legal services in a class action; auctions are unlikely to produce reasonable fee awards; and auctions reduce counsel’s accountability. Auctions also compromise the judicial role. A court’s reliance on auction results may lead to undue complacency and cause the court to approve an unreasonable settlement or fee award. Moreover, by casting the judge as auctioneer, the auction exacerbates existing structural problems in the class action mechanism. Accordingly, to the extent that existing procedures for selecting and compensating class counsel are deficient, auctions are not a promising solution.

This Article therefore proposes an alternative: selection and retention of lead counsel by an empowered lead plaintiff. Relying on a variety of client-centered materials, including interviews with institutional investors, this Article assesses the developing experience of institutional investors as lead plaintiffs under the Private Securities Litigation Reform Act of 1995 (PSLRA). Institutional investors are developing competitive market-based procedures to select counsel and negotiate fee agreements.


8. See, e.g., In re Cendant Corp. Prides Litig., 243 F.3d 722, 742-44 (3d Cir. 2001) (holding that trial court’s use of lead counsel auction did not excuse court’s failure to determine, at conclusion of case, that resulting fee award was reasonable).

This Article argues that the lead counsel model is superior in precisely those cases in which courts have used auctions. The Article concludes by describing the circumstances under which the lead plaintiff model can be extended beyond securities litigation.

Part I briefly describes the existing regulatory framework and identifies the selection of counsel issues that have led courts to explore the auction alternative. Part II explains the methodology of the lead counsel auction and describes recent auction cases. Part III formalizes the auction model. Part III.A explores the rationale for using an auction. Parts III.B, C, and D then consider constraints in the auction procedure that limit its ability to meet the identified objectives. This analysis includes an examination, in Part III.D, of the auction theory literature, which suggests that lead counsel auctions are unlikely to produce competitive prices or lead to the selection of the most qualified firms. Part IV introduces the empowered lead plaintiff alternative and considers its advantages as well as guidelines for implementation. Finally, Part V proposes criteria for determining when the lead plaintiff model can appropriately be extended beyond securities litigation.

Several introductory caveats are in order. First, this Article does not take a position on the extent to which class litigation is desirable. Second, the auction model addressed in this Article is an auction of the lead counsel position, not an auction of the underlying claims. This Article does not address the academic proposal of a claims auction, although some of the discussion is relevant to that proposal. Third, this Article

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10. The Article operates from the premise that class litigation can be defended on both deterrence and compensation grounds. See generally Jill E. Fisch, Class Action Reform, Qui Tam, and the Role of the Plaintiff, Law & Contemp. Probs., Autumn 1997, at 167, 170-76 [hereinafter Fisch, Qui Tam] (describing compensation and deterrence rationales). To the extent that one rejects victim compensation as a valid litigation goal, the evaluation of attorneys’ fees becomes less significant and collapses into an evaluation of the total recovery generated by the litigation. However, as discussed below, see infra Part II.B, if the incentives created by particular selection methods or fee structures reduce the recovery, they reduce litigation’s deterrent effect. See, e.g., Hugh Gravelle & Michael Waterson, No Win, No Fee: Some Economics of Contingent Legal Fees, 103 Econ. J. 1205, 1206-07 (1993) (observing that anticipated costs of settlement affect defendant’s level of care).


does not address the consistency of lead counsel auctions with existing law. Finally, this Article does not attempt to formulate a comprehensive solution to the selection and compensation of class counsel. Class litigation varies tremendously with the context; this Article focuses primarily on litigation areas in which courts have used or considered auctions, such as securities and antitrust litigation.

I. THE REGULATORY STATUS QUO

A. The Role of Lead Counsel

Class litigation is increasingly conducted through a form of centralized management in which the court designates a firm or group of firms to act as lead counsel and assume primary responsibility for the case. As complex litigation has evolved, the position of lead counsel has grown in importance. Initially, the role of lead counsel was created primarily to coordinate the work efforts of the various attorneys. Recent decisions have given lead counsel greater power. Lead counsel now has authority to run the case, to make litigation decisions, to negotiate settlement, and to determine the extent to which litigation responsibilities will be shared among other law firms. Although compensation for lead counsel varies, the lead counsel position carries with it the opportunity to garner the lion's share of the eventual fee award.

At first, those law firms that had filed the original complaints in the case prior to consolidation or those that had representation relationships with specific individual plaintiffs selected lead counsel cooperatively. In exchange for supporting the appointment of one or more firms as lead counsel, other firms would be allocated a share of the work in the case and, as a result, would share in the eventual fee award. As the power
and financial rewards associated with the position increased, however, firms found it more difficult to resolve the issue. In particular, the allocation of the fee award between the lead counsel and other participating attorneys became increasingly complex. Courts also became reluctant to approve the appointment of lead plaintiff consortia, citing fears that appointment of multiple firms would result in duplicative work and excessive fees. Moreover it was difficult to distinguish between cooperation and collusion in assessing the effect of voluntarily-created ad hoc firms on competition for legal services. In keeping with the dominant characterization of the class action judge as a fiduciary, some courts also began to consider the lead counsel appointment as a way to exert greater control over the conduct of class litigation.

As a result, district courts have increasingly taken for themselves the responsibility of appointing lead counsel. Selection of lead counsel differs somewhat depending on the nature of the case. In mass tort litigation, the court commonly appoints a lead counsel consortium or plaintiffs' steering committee. In more traditional common fund cases, such as securities and antitrust class actions, the lead counsel is more likely to be a smaller group or even a single firm. The lead counsel appointment typically restricts the activities of nonlead counsel and, although as a practical matter other firms may continue to participate, their roles are determined by lead counsel. Because firms are compensated in accordance with their contributions to the case, the selection of lead counsel effectively allocates the economic rewards of the litigation.

18. See, e.g., In re Fine Paper Antitrust Litig., 751 F.2d 562, 572-73 (3d Cir. 1984) (expressing regret over duplicative effort resulting from prior decision to appoint large Plaintiffs' Executive Committee).

19. See John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 609, 709 n.111 (1986) (hereinafter Coffee, Understanding) (describing the resulting "hastily organized political convention at which log-rolling tactics and patronage agreements were used to secure the election of the lead counsel").

20. See Curtis & Resnik, supra note 17, at 431 n.14 (describing judicial selection of lead counsel as "illustrative of the trend toward increasing judicial managerial control").


22. See, e.g., Vincent v. Hughes Air W., Inc., 557 F.2d 759, 773 (9th Cir. 1977) (upholding trial court's power to appoint lead counsel and restrict the activities of nonlead counsel even though this resulted in lead counsel being entitled to the bulk of the fee award).

23. See, for example, In re Thirteen Appeals Arising out of San Juan, 56 F.3d 295, 309-10 (1st Cir. 1995), in which the court stated that it was
Despite the economic significance of the appointment, courts have developed little jurisprudence addressing the selection decision. Although courts pay lip service to the proposition that counsel must provide representation of sufficient quality to satisfy the requirements of Fed. R. Civ. P. 23, courts rarely go beyond superficial efforts to assess quality. Nor do courts attempt to appoint counsel on a competitive basis. Indeed, the most widely applied rule for the selection of lead counsel is the “first-to-file” rule, under which courts favor the firm that has filed the first complaint in the case. Although this rule, which leads to the infamous race to the courthouse, has been extensively criticized, little academic attention has been devoted to the selection of lead counsel. Few commentators have scrutinized the scope of judicial inquiry into attorney qualifications or the risk that appointment decisions may be made on the basis of favoritism rather than merit. Perhaps most troubling is the lack of transparency in the selection process. Most courts offer little if any explanation of their selection decision.

The judge’s role as decisionmaker is also problematic. There are reasons to question the judge’s ability to act effectively as agent for the class. The court may unwittingly favor its own interests and be influenced by considerations such as docket management. As a result, the court may select an attorney who is likely to negotiate a quick settlement rather than the attorney likely to obtain the highest recovery for the class. In addition to forcing a representation relationship upon unconsenting clients, the appointment of lead counsel may leave class members powerless and unable to monitor litigation decisions. See Paula Batt Wilson, Note, Attorney Investment in Class Action Litigation: The Agent Orange Example, 45 Case W. Res. L. Rev. 291, 323 (1994).


25. In addition to forcing a representation relationship upon unconsenting clients, the appointment of lead counsel may leave class members powerless and unable to monitor litigation decisions. See Paula Batt Wilson, Note, Attorney Investment in Class Action Litigation: The Agent Orange Example, 45 Case W. Res. L. Rev. 291, 323 (1994).


29. See, e.g., John C. Coffee, Jr., Class Wars: The Dilemma of the Mass Tort Class Action, 95 Colum. L. Rev. 1343, 1454 (1995) (observing that a trial court “bent on settlement” is unlikely to choose a lead counsel with a reputation as a tough negotiator). Indeed, the preference of many judges for prompt settlement has created the opportunity for collusion between plaintiffs’ attorneys and defense counsel. See, e.g., Rhonda Wasserman, Dueling Class Actions, 80 B.U. L. Rev. 461, 472 (2000) (explaining that, by
tion, the absence of judicial inquiry into price considerations is troubling. The combination of the class action mechanism and the lead counsel role creates a monopoly position for class counsel, leaving market forces powerless to check the trial court’s appointment discretion. As one court explained, “the power to appoint lead counsel gives the trial judge an unusual degree of control over the livelihood of the lawyers who practice before the court.”

B. Judicial Determination of Fee Awards

In addition to appointing lead counsel, the trial court is responsible for determining counsel fees in class litigation. Unlike traditional litigation, in which price competition may play a role in the selection of counsel, the compensation and selection decisions in a class action are typically independent. The court appoints lead counsel at the outset of the case but generally decides both the price and structure of the fee award at the conclusion of the case.

Courts have developed an extensive jurisprudence of fee awards. Two methods of calculating fees dominate—the lodestar method and the percentage of recovery method—although some courts use a combination of the two or a third alternative. The lodestar method compensates counsel on the time expended and instructs judges to calculate the fee award by multiplying a reasonable hourly rate for the attorneys’ services by the number of hours worked. The percentage of recovery method resembles the traditional contingency fee and calculates the law-

proposing a cheap early settlement, a prospective lead counsel can obtain the support of defense counsel and frequently secure appointment as lead counsel to the detriment of the plaintiff class.

30. In re Thirteen Appeals Arising out of San Juan, 56 F.3d 295, 310 (1st Cir. 1995).

31. See Judith Resnik et al., Individuals within the Aggregate: Relationships, Representation, and Fees, 71 N.Y.U. L. Rev. 296, 336–37 (1996) (explaining that courts control fee awards “either because Congress has said so . . . or because courts have found their own authority”). In most class actions, judicial authority over fee awards is based on the common fund doctrine. See, e.g., Janet Cooper Alexander, Contingent Fees and Class Actions, 47 DePaul L. Rev. 347, 348–49 (1998) (describing common fund cases). The alternative source of judicial authority to award attorneys’ fees is statutory. See, e.g., id. at 348 (identifying alternative of statutory fee shifting).


34. See, e.g., infra notes 65–66 and accompanying text (describing percentage of recovery method with lodestar cross-check).

35. A number of state courts use various types of multifactor balancing tests. See, e.g., Sugarland Indus. v. Thomas, 429 A.2d 142, 149–50 (Del. 1980) (adopting multifactor test).

yer’s fee as a percentage of the recovery provided to the plaintiff class as a result of the litigation.37

Common law development of each method has provided judges with a variety of principles for setting an appropriate fee. For example, courts using the lodestar method typically adjust the hourly fee to reflect various factors such as the degree of success, the novelty or complexity of the issues, the quality of representation, and the risk associated with the litigation.38 Courts employing the percentage of recovery method often apply similar factors in determining the applicable percentage.39

Although both the lodestar and percentage of recovery methods look to the market for legal services as a source of guidance for various factors, the court’s fee determination is properly characterized as a regulatory approach. The need for judicial fee regulation arises from a combination of the monopoly created by the class action and failures in the market for legal services.40

More specifically, fee awards in class action litigation are a form of rate regulation.41 The fee determination is remarkably similar to the process by which rates are set, for example, for public utilities, although the regulatory guidelines in the case of counsel fees are the result of common law rather than legislation or agency rulemaking.42 The common law principles described above are the basis by which the court, at the conclusion of the case, determines the appropriate rate of payment for counsel’s services. Importantly, as with rate regulation in the context of public utilities, the regulatory guidelines do not instruct the court to attempt to replicate the market process in determining compensation—indeed, the absence of a viable market process is the justification for regulation.43

38. See, e.g., Johnson v. Ga. Highway Express, Inc., 488 F.2d 714, 717–19 (5th Cir. 1974) (listing twelve factors that have been widely used in adjusting the lodestar calculation).
40. See Susan P. Koniak & George M. Cohen, Under Cloak of Settlement, 82 Va. L. Rev. 1051, 1095 (1996) (explaining that absence of competition among plaintiffs’ counsel is due, in part, to the monopoly created by the class action).
43. Regulation is typically justified on the basis that it has the potential to reduce costs (by reducing waste), reduce rents to the supplier, or both. See Laffont & Tirole, supra note 41, at 13. Public utility regulation is typically based on a fixed price approach, in which the firm is the residual claimant for its cost savings or a cost of service (or cost plus) approach, in which the firm is compensated for its costs. See id. at 6–7, 14–18; see also
Rather, the court’s task, in applying the factors described above, is to determine a reasonable fee. The regulatory structure allows courts to consider the social value of the litigation and to adjust fee awards in an effort to optimize litigation levels, although instances in which courts explicitly consider the social costs and benefits of litigation in awarding counsel fees are rare.

C. Evaluating the Status Quo

The existing methodology has been extensively criticized. Courts and commentators have identified problems with both the lodestar and percentage of recovery approaches. Critics fault the lodestar method for its heavy reliance on hours worked rather than value produced. Use of the lodestar may thus create poor incentives by penalizing lawyers who


45. See, e.g., Developments in the Law—The Paths of Civil Litigation Attorneys’ Fees in Class Action Litigation, 113 Harv. L. Rev. 1755, 1831 (2000) (explaining that fee awards should reflect goal of optimizing social benefits of litigation, which include deterrence and tort insurance).

46. See Judith Resnik, Money Matters: Judicial Market Interventions Creating Subsidies and Awarding Fees and Costs in Individual and Aggregate Litigation, 148 U. Pa. L. Rev. 2119, 2128 (2000) (arguing that courts have typically sought “to avoid imposition of value-laden assessments of the utility of forms of litigation” in setting counsel fees). But see, e.g., Peter H. Schuck, Agent Orange on Trial 196 (1986) (recounting Judge Weinstein’s comments in setting counsel fees in Agent Orange class action that he wanted to encourage “the legal profession . . . to think at least twice before initiating sprawling, complicated cases of highly questionable merit that will consume time, expense, and effort . . . in a degree vastly disproportionate to the results eventually obtainable” (quoting Judge Weinstein)); Mark Hamblett, Lawyers’ Fees Cut in Class Action, N.Y. L.J., June 22, 2001, at 1 (reporting court’s conclusion in In re Dreyfus Aggressive Growth Mutual Fund Litig., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,505 (S.D.N.Y. June 21, 2001), that a higher fee was unnecessary to attract counsel to this type of litigation).

47. See, e.g., In re Sumitomo Copper Litig., 74 F. Supp. 2d 393, 397 (S.D.N.Y. 1999) (“Courts increasingly have come to recognize the shortcomings of the lodestar/multiplier method as a universal rule for compensation.”); Macey & Miller, Plaintiffs’ Attorney’s Role, supra note 12, at 50-54 (criticizing lodestar method); Andrew K. Niebler, In Search of Bargained-For Fees for Class Action Plaintiffs’ Lawyers: The Promise and Pitfalls of Auctioning the Position of Lead Counsel, 54 Bus. Law. 763, 770-71 (1999) (explaining how lodestar method distorts counsel’s incentives).


work efficiently and rewarding lawyers who delay or provide unnecessary services. In addition, the lodestar method is administratively unwieldy, requiring courts to scrutinize counsel’s billing records.

The percentage of recovery method attempts to tailor the fee award more closely to the benefit provided, but the value produced by the attorneys’ efforts is not necessarily correlated with the amount of the recovery. The attorney who settles a strong case involving a large class may receive a windfall. The attorney who undertakes a challenging case that, although successful, yields a relatively smaller recovery may be undercompensated. Percentage awards create incentive problems, including the risk of a cheap early settlement. In addition, critics argue that in utilizing the percentage of recovery method courts place undue reliance on benchmark percentages and invest insufficient effort tying compensation to attorney performance in a particular case.

At the core of the problem is uncertainty about what constitutes a “reasonable” fee award. Even outside the class action context, it is unclear whether attorneys are appropriately compensated based on their effort, the value they provide, or some combination of the two. Analyzing fee awards in terms of market-based hourly rates may be misleading. Few trial lawyers are compensated on a traditional hourly basis. The fee awarded to class counsel, like the standard contingency fee, reflects payment for the lawyer’s assumption of risk and cost of financing the litigation, as well as payment for legal services. At the same time, institutional constraints may limit the court’s ability accurately to assess the benefit generated by the litigation; courts may also be unduly reluctant to penalize counsel with low fee awards even where such awards are appropriate.

A review of judicial practice, however, suggests that critics may be overstating the problem. William J. Lynk’s empirical analysis of fee awards in class litigation, the most extensive analysis of the subject, considered the extent to which fee awards reflect lawyer effort and recovery

50. See, e.g., Lapointe, supra note 37, at 845 (describing percentage method as tending “to promote excessive fee awards”).
51. See, e.g., Fisch, Aggregation, supra note 13, at 59 & n.39 (describing judicial reliance on benchmark percentages).
52. See, e.g., In re Synthroid Mk’g. Litig., 264 F.3d 712, 718 (7th Cir. 2001) (rejecting trial court’s use of megafund cap and instructing court to determine reasonable fee by “estimat[ing] the terms of the contract that private plaintiffs would have negotiated with their lawyers, had bargaining occurred at the outset of the case”).
53. See, e.g., Charles Silver, Due Process and the Lodestar Method: You Can’t Get There from Here, 74 Tul. L. Rev. 1809, 1824–27 (2000) (arguing that hourly rates should not be used as the standard of reasonableness for contingent representation).
54. See, e.g., Chandler, supra note 11, at 21 (suggesting that, although the percentage of recovery fee can, in theory, be adjusted to account for different factors, judges seemingly feel constrained by past practice, precedent, etc., to award fees within a fairly limited range).
Lynk concluded that, regardless of the fee methodology purportedly applied by the court, fee awards consistently reflected both factors.\textsuperscript{55}

To the extent that class action fee awards are based on benchmarks, those benchmarks appear to be lower than the standard “voluntary” contingency fee of 33% to 40%.\textsuperscript{56} Moreover, although some courts continue to rely on benchmarks, other courts in recent high profile class actions have awarded much lower fees.\textsuperscript{57} In the \textit{Drexel Burnham} class action, the court awarded plaintiffs’ counsel a mere 4%, justifying the low recovery on the relative absence of risk in the case.\textsuperscript{58} The award was upheld on appeal.\textsuperscript{60} In the \textit{Prudential} case, the court awarded plaintiffs’ counsel just 4.8% of the recovery, despite characterizing the decision to take on the world’s largest insurance company and its sophisticated team of experts as involving “extraordinary risk.”\textsuperscript{61} And in the \textit{NASDAQ} antitrust case,\textsuperscript{62} in which the court described the recovery as “the largest antitrust class action recovery to date,”\textsuperscript{63} the court awarded counsel 14% percent of the recovery.\textsuperscript{64}

Courts are also increasingly evaluating the reasonableness of their fee calculations by using the percentage of recovery method and then cross-checking their results with the lodestar method.\textsuperscript{65} This process insures that the fee award reflects both the size of the recovery and the attorney input.\textsuperscript{66} The results under the current approach are not dra-


\textsuperscript{56} Id. at 209.

\textsuperscript{57} See, e.g., Goldberger v. Integrated Res., Inc., 209 F.3d 43, 51 (2d Cir. 2000) (finding that district courts typically use a benchmark of 25%); Fisch, Aggregation, supra note 13, at 59 n.39 (describing prevailing benchmarks in class action litigation); Thomas E. Willging et al., An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges, 71 N.Y.U. L. Rev. 74, 155 (1996) (finding that median rates of recovery ranged from 2.7% to 3.0%).


\textsuperscript{59} See Goldberger, 200 F.3d at 46–47 (describing fee applications and Judge Kram’s fee award, which was based on the lodestar method).

\textsuperscript{60} Id. at 56–57.

\textsuperscript{61} See \textit{Prudential}, 106 F. Supp. 2d at 735–36. Indeed, depending on the method of calculation, the award could be described as reflecting only 3.7% of the settlement. See id. at 732.


\textsuperscript{63} Id. at 470.

\textsuperscript{64} Id.

\textsuperscript{65} See, e.g., \textit{Prudential}, 106 F. Supp. 2d at 732 (concluding that the lodestar multiplier would be less than 2.13); In re Sumitomo Copper Litig., 74 F. Supp. 2d 393, 399–400 (S.D.N.Y. 1999) (finding that lodestar with “reasonable” multiplier of 2.5 yields same result as percentage of recovery).

\textsuperscript{66} See \textit{In re Sumitomo Copper}, 74 F. Supp. 2d at 400 (explaining that, because both the lodestar and percentage of recovery methods supported counsel’s fee petition, the “blanket criticisms of attorneys’ fees in the tobacco cases are wholly inapplicable to the facts and circumstances in this case”).
matically out of line with hourly billing rates outside the class action context. Moreover, any disparities can be justified by a variety of factors. An appropriate hourly rate for class action litigation must reflect the contingent nature of that work and the financing costs associated with delaying the attorneys' compensation until the conclusion of the case. In addition, to the extent that the appointment of lead counsel creates a tournament among plaintiffs' firms, tournament theory suggests that competitors must anticipate the prospect of receiving an above-market wage to be induced to compete.

There are also reasons to expect that even a functioning market for legal services would produce a natural floor for the attorney's percentage of the recovery. A minimum percentage of the recovery may be necessary to induce sufficient attorney effort. Rudy Santore and Alan Viard have demonstrated that, because attorney effort is unobservable, litigation clients face a moral hazard problem. They explain that contingency fees partially address this problem by providing incentives for attorney effort, but that competition will not reduce contingency fees below a certain rate, at which attorneys will continue to earn positive profits. Lucian Bebchuk and Andrew Guzman's work also indicates that too low a contin-

67. Based on the court's lodestar analysis, for example, the fee award in Sumitomo translates into hourly compensation of $664. See id. at 398. The fee award in Ikon Office Solutions, which generated objections because it reflected almost 30% of the recovery, yields an hourly rate, based on the court's lodestar figures, of $678. See In re Ikon Office Solutions, Inc. Sec. Litig., 194 F.R.D. 166, 197 (E.D. Pa. 2000). These figures can be compared to the bills submitted by Weil Gotshal & Manges in the investigation of the Maricopa Investment Fund, in which the firm charged as much as $615 an hour for Miami-based lawyers. See Julie Kay, Expensive Search: Feds want accounting giant, law firm to slash $1.8 million bill that could consume assets owed to defaulted investors, Miami Daily Bus. Rev., Sept. 11, 2000, at A1. Significantly, the Maricopa case did not involve the delay or risk associated with contingency fee litigation. See id.

68. See Patricia M. Hynes, Plaintiffs' Class Action Attorneys Earn What They Get, 2 J. Inst. for Study Legal Ethics 243, 244–46 (1999) (explaining that large scale class actions impose greater risks on class counsel because of need for counsel to commit substantial fraction of the firm's resources to a single case for an expended period of time and the inability to diversify away this risk).


70. See Rudy Santore & Alan D. Viard, Legal Fee Restrictions, Moral Hazard, and Attorney Rents, 44 J.L. & Econ. (forthcoming 2001) (manuscript at 3, on file with the Columbia Law Review).

71. Santore and Viard observe that this problem, which is, in effect, an agency problem, could be eliminated if the ethical rules permitted a lawyer to purchase a client's claim. Id. at 32–33.
gency fee may impede settlement negotiations. In general, the contingency fee structure enhances a plaintiff’s bargaining position because the plaintiff does not bear additional litigation costs by rejecting an unduly low offer. If the fee percentage is too low, it will not cover counsel’s full litigation effort, and he or she cannot credibly threaten to go to trial. In addition, a structure in which the fee percentage increases at later stages of the litigation may weaken the plaintiff’s bargaining position because the plaintiff bears additional costs by delaying settlement.

Finally, rate regulation gives courts the ability to reflect nonfinancial factors in fee awards. In particular, both the lodestar and percentage of recovery methods allow the court to consider the general social value of the litigation in addition to the monetary benefits it confers on the plaintiff class. Class suits may confer positive externalities when they clarify an unsettled issue of law or contribute to general deterrence of misconduct; they may confer negative externalities when strike suits cause decisionmakers to be unduly risk averse. To the extent that courts make a genuine effort to tie attorney compensation to performance, their evaluation of performance may include those factors that would otherwise remain outside the incentive structure contemplated by the pure entrepreneurial model. By signaling their willingness to reward socially desirable litigation through higher fee awards, courts can create appropriate incentives for plaintiffs’ counsel. To the extent that enforcement of certain legal rules requires vigorous entrepreneurial activity by plaintiffs’ counsel, a regulatory regime allows courts to reward this activity.

Nonetheless, the ambiguity inherent in the concept of a reasonable fee has led courts and commentators to search for an alternative. The most creative efforts have focused on moving from an “ends approach,” which relies on standards for ex post judicial review, to a “means approach,” which relies on procedural mechanisms for determination of the fee to lead to a reasonable result. The traditional methodologies described in this Section all reflect ends approaches. The lead counsel auction, described in Part II, and the use of an empowered lead plaintiff, described in Part IV, are both examples of means approaches.

73. Id. at 60.
74. See, e.g., Resnik, supra note 46, at 2127–29 (advocating that judges consider societal goals in setting fee awards).
75. See Weiss & Beckerman, supra note 26, at 2122–23 (describing potential ways in which class litigation can confer broader social benefits).
76. See generally Fisch, Qui Tam, supra note 10, at 171 n.22 (citing literature examining the potential divergence between private and societal costs and benefits of litigation).
77. Chandler, supra note 11, at 5–6 (distinguishing between “ends” and “means” approaches).
78. The lead counsel auction and the empowered lead plaintiff are the only means approaches that have been used to date, but commentators have suggested other such
II. THE AUCTION ALTERNATIVE

A. The Auction Model

The lead counsel auction is one alternative to traditional fee determination methods. The auction approach was first used in 1990 by Judge Vaughn Walker in the Oracle Securities Litigation. The Oracle auction was structured as a first price sealed bid auction. The court ordered prospective counsel to submit bids reflecting the compensation they sought, as a percentage of the total recovery, for the services of conducting the litigation on behalf of the plaintiff class. The court also requested information on the bidders’ qualifications. The court then selected a winning bid, appointed the winning bidder as lead counsel, and announced that counsel’s compensation would be determined in accordance with its bid.

Although the Oracle decision attracted considerable attention, it was not widely imitated. Recently, however, a growing number of courts have experimented with the use of lead counsel auctions. Selection of counsel issues, triggered by the reforms of the PSLRA, have led several courts to use auctions in securities fraud class actions. Courts


80. Id. at 697.
81. Id.
83. See, e.g., Melvyn I. Weiss, Shareholder Litigation—Reform Proposals to Shift Fees: Limit “Professional Plaintiffs” and Cap Punitive Damages, in 1 Practicing Law Institute, 26th Annual Institute on Securities Regulation, 683, 696–97 (1994) (“Although Judge Walker’s bidding approach has been discussed and debated in the area of class actions (including by Arthur Levitt, Chairman of the Securities and Exchange Commission), other courts have rejected the Oracle bidding approach.”).
84. Judge Walker followed his own example by conducting an auction in In re Wells Fargo Sec. Litig., 156 F.R.D. 229, 228–29 (N.D. Cal. 1994). Apparently no other judge imitated the auction approach until 1996. See In re Amino Acid Lysine Antitrust Litig., 916 F. Supp. 1190, 1192 n.6 (N.D. Ill. 1996) (stating that court was unaware of any judges, other than Judge Walker, who had used an auction procedure to select lead counsel).
have also used auctions in two antitrust class actions. Although the validity of the auction procedure has not been addressed at the circuit court level, dicta in a recent Third Circuit opinion characterized auctions favorably and recommended that district courts consider their use. 

Courts have refined the auction procedure somewhat from Judge Walker’s original structure. Although details vary, most auctions conducted to date have been similar. Every lead counsel auction has been structured as a first price sealed bid auction. Consistent with recent trends in fee jurisprudence, and perhaps recognizing the difficulty of comparing bids that use different methodologies, most courts have indicated a preference for the percentage of recovery method of determining counsel fees. Many courts have also recognized the difficulty of evaluating bids. In a further effort to facilitate comparison of bids, several courts have instructed bidders to use a litigation milepost grid, which is divided into a number of blocks representing different recovery amounts and litigation stages. The grid used by the court in Sherleigh Associates is typical.

submission of bids to be reviewed by lead plaintiff and the court); In re Network Assocs., Inc. Sec. Litig., 76 F. Supp. 2d 1017, 1033-34 (N.D. Cal. 1999) (instructing lead plaintiff to conduct sealed bid auction and submit two winning bids to court); Raftery v. Mercury Fin. Co., No. 97-C624, 1997 U.S. Dist. LEXIS 12439, at *9-11 (N.D. Ill. Aug. 7, 1997) (ordering auction which was subsequently abandoned when case settled); In re Cal. Micro Devices Sec. Litig., 168 F.R.D. 257, 259-60 (N.D. Cal. 1996) (court unsuccessfully ordered competitive bidding but did not select counsel through the process).


87. But see In re Cendant Corp. Litig., 264 F.3d 201, 286 (3d Cir. 2001) (holding that district court erred by using an auction to determine legal fees in PSLRA case).

88. Gunter v. Ridgewood Energy Corp., 223 F.3d 190, 202 n.6 (3d Cir. 2000) (“Another approach is for the district court to determine the fee arrangement in advance through competitive bidding . . . This device appears to have worked well, and we commend it to district judges within this circuit for their consideration.”). The Seventh Circuit has also observed that lead counsel auctions can provide a benchmark for determining reasonable legal fees. In re Synthroid Mktg. Litig., 264 F.3d 712, 720-21 (7th Cir. 2001).

89. The one court to use a substantially different bid structure was the Auction Houses court. See infra Part III.B.3 (describing bid structure).

90. Cf. In re Wells Fargo Sec. Litig., 156 F.R.D. 223, 227-29 (N.D. Cal. 1994) (giving counsel three choices for the bid structure and, based on counsel’s response, selecting the percentage of recovery method).

The grid enables counsel to specify differing percentage bids for each of the designated contingencies. Thus a firm using such a grid can vary the percentage of the recovery payable as attorneys’ fees as a function of the total recovery and the stage of litigation at which that recovery occurs.

Courts have required increased disclosure from bidders, including bidders’ qualifications, experience, malpractice coverage, and willingness to post a completion bond. In some cases, firms have been asked to submit information on the expected recovery and to defend their bid structure in terms of agency issues. Some courts have emphasized litigation costs and required bids that specify the treatment of costs or that internalize costs.

Courts have also limited joint action by bidders. In most cases, courts have required bidders to submit their bids under seal and prohibited bidders from disclosing their bids or consulting with others during the bidding process. Some courts have disclosed the bids and bid-
der identities in connection with the announcement of the winning bid; other courts have delayed disclosure of the bid details until the conclusion of the case. Indeed, even after the resolution of the Cendant litigation, the court did not disclose the identities of the auction participants and provided only limited information about the submitted bids. Most courts have prohibited the submission of joint bids, seemingly in an effort to increase competition, although they have indicated that the winning bidder may subsequently contract out a portion of the legal services.

B. Results of Lead Counsel Auctions

It is difficult to judge lead counsel auctions by the results in recent cases. Current experience with auctions is limited; many cases involve flawed auction design or limited competition. The absence of comparable control groups makes it impossible to identify the extent to which auctions reduce legal fees or, more problematically, whether any fee savings are the result of reduced attorney effort, poor attorney quality, or both. Although it is tempting to make the facile claim that auctions have reduced fees from the traditional 25% or 33% “benchmarks,” the claim is misleading; as described above, courts have awarded fees far lower than

(3) the proposal was prepared without direct or indirect consultation with other firms that have filed actions on behalf of the proposed class in this matter, or entered an appearance in any fashion.

184 F.R.D. at 697.


99. See In re Cendant Corp. Litig., 191 F.R.D. 387, 387 (D.N.J. 1998), partially unsealed by the court on Apr. 7, 2000; see also Shenleigh Assocs., 184 F.R.D. at 688 (stating that the “bids may be permanently sealed or redacted thereafter to protect proprietary information”); Wenderhold v. Cylink Corp., 191 F.R.D. 600, 601 (N.D. Cal. 2000) (court disclosed competing proposals to bidding firms prior to bid evaluation hearing “to provide each an opportunity to argue the relative strengths of its bid and weaknesses of the others”).

100. See In re Cendant, 191 F.R.D. at 387.

101. The desirability of restricting joint bids is beyond the scope of this Article. It should be noted, however, that the effect of joint bids on competition is a complex question. See, e.g., Sandra Campo et al., Asymmetry and Joint Bidding in OCS Wildcat Auctions 3, 24 (June 2000), available at http://www-scf.usc.edu/~scampo/Joint2.pdf (on file with the Columbia Law Review) (recounting economic justifications for permitting joint bidding and concluding that joint bidding in OCS Wildcat auctions has been beneficial in increasing revenues from the auction process).

102. Some courts have also attempted to increase competition by opening the auction to all interested bidders, including firms that have not previously appeared in the case. See, e.g., In re Lucent Techs., Inc. Sec. Litig., 194 F.R.D. 137, 157 (D.N.J. 2000) (inviting submissions from any law firm “including those presently unconnected with this litigation”); Wenderhold v. Cylink Corp., 189 F.R.D. 570, 573 (N.D. Cal. 1999) (opening extended bidding period to “all comers”).

103. But see In re Cendant, 191 F.R.D. at 387 (describing submission of bids by nineteen firms, “jointly and singly”).
these benchmarks in many nonauction cases. At the same time, it is hard to assess the reasonableness of fees in auction cases—the fee in *Cendant*, for example, was only 8.275% of the recovery, but totaled approximately $10,861 per hour.\(^\text{104}\)

More importantly, as will be described in Part III.B, fee structures in auction cases have created troubling incentives for plaintiffs’ counsel. The risk that these incentives will lead to reduced recoveries cannot be assessed by focusing on the single factor of counsel’s fee in percentage terms. Moreover, empirical analysis cannot readily determine whether auctions sacrifice net recovery to the plaintiff class in favor of reduced fee awards.\(^\text{105}\)

I have previously described troubling results in several auction cases.\(^\text{106}\) More recent data is also problematic. At the time it conducted the auction in *Bank One*, for example, the court estimated the likely recovery at $4.6 to $4.8 billion.\(^\text{107}\) Indeed, the court rejected a competing bid that was superior at a recovery of $65 million, reasoning that the prospect of such a low recovery “defies reality.”\(^\text{108}\) Notwithstanding the court’s optimism, it subsequently approved a settlement for $45 million, an amount reflecting less than 1% of the recovery as estimated by the court.\(^\text{109}\)

The recently proposed settlement in *Network Associates*\(^\text{110}\) is similar. In *Network Associates*, the original institutional lead plaintiff refused to serve after the court required that counsel be selected through a competitive bidding process focused primarily on price.\(^\text{111}\) Although the court

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105. In addition to the near impossibility of objectively quantifying plaintiffs’ damages, see Willard T. Carleton et al., Securities Class Action Lawsuits: A Descriptive Study, 38 Ariz. L. Rev. 491, 491-92 (1996), securities fraud settlements are often constrained by the firm’s assets and the availability of insurance. See Todd S. Foster et al., Trends in Securities Litigation and the Impact of PSLRA 8 (Working Paper, 2001) (on file with the *Columbia Law Review*).

106. See Fisch, Aggregation, supra note 13, at 86–88.


108. Id. at 788 & n.11.


111. See id. at 1034 (ordering competitive bidding and emphasizing price); In re Commtouch Software Ltd. Sec. Litig., No. C 01-00719, at 7 (N.D. Cal. June 28, 2001) (order defining selection and approval criteria for class counsel) (describing selection of low bidder in *Network Associates*); CA Judge Picks Lone Investor for Lead Plaintiff After Pension Fund Baiks, Pension Fund Litig. Rep., Jan. 17, 2000, at 6 (describing the Board of
did not estimate damages, the stock price during the relevant period dropped from $67 per share to between $13 and $16 per share, and the alleged losses of one proposed lead plaintiff group alone totaled more than $33 million.\textsuperscript{112} Nonetheless, the case settled for $30 million,\textsuperscript{113} reflecting damages of approximately $0.35 per share.\textsuperscript{114}

Although no generalizations can be drawn from this small sample, the results suggest caution in evaluating the claim that lead counsel auctions are beneficial for plaintiffs. In particular, there are reasons to question the ability of courts, through the auction model, to generate a truly competitive bidding process. To date, auctions have generated limited bidder participation.\textsuperscript{115} Moreover, the range and variation in the resulting bids\textsuperscript{116} seem more likely to result from uncertainty about the auction process or informational disparities among bidders than from market-based competition.\textsuperscript{117}

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\textbf{Pensions of the City of Philadelphia’s refusal to proceed as lead plaintiff if required to select counsel by auction).}
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112. In re Network Assocs., 76 F. Supp. 2d at 1019.
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113. In re Commtouch Software, No. C 01-00719, at 7 (order defining selection and approval criteria for class counsel) (describing settlement in Network Assocs.).
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115. See, e.g., In re Comdisco Sec. Litig., 150 F. Supp. 2d 943, 946, 951-52 (N.D. Ill. 2001) (describing as “unfortunate” the participation of only three bidders). Only four firms submitted bids in Oracle, despite the fact that the court solicited bids from “a large number of leading plaintiffs’ class action law firms.” In re Oracle Sec. Litig., 852 F. Supp. 1437, 1456 (N.D. Cal. 1994). The number of participants has been limited, even when two or three dozen firms originally entered appearances. For example, Judge Walker unsuccessfully attempted to conduct an auction in In re California Micro Devices Securities Litigation, but although seventeen firms had appeared in the case, just two submitted bids, and the court characterized only one of those as “serious.” 168 F.R.D. 257, 259-60 (N.D. Cal. 1996). See generally In re Comdisco, 150 F. Supp. 2d at 946-48 (speculating as to reasons for reluctance of firms to bid). Auctions do not appear to have attracted bids from a broader range of firms than other selection methods; most bidders are from the traditional plaintiffs’ bar. See, e.g., In re Cendant Corp. Sec. Litig., 109 F. Supp. 2d 285, 300 (D.N.J. 2000) (describing auction bids as “most[ly] from law firms national in practice and prominent in the field”), vacated and remanded, 264 F.3d 201 (2001). If anything, auctions may discourage participation from some of the smaller and less experienced plaintiffs’ firms due either to the costs of participation or the perception that less known firms cannot compete based on the selection criteria. See In re Quintus Sec. Litig., 148 F. Supp. 2d 967, 975 (N.D. Cal. 2001) (viewing Beatie & Osborn’s relative youth and lesser experience in class actions as qualitative deficiencies).
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116. Firms have submitted bids ranging from 1% to 45%. The range in any given case has been substantial. See, e.g., Coffee, Untangling, supra note 1, at 4 (describing winning bid in Auction Houses as more than twice that of closest competitor). Bid structure also varies substantially. See Niebler, supra note 47, at 783-802.
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A. Why Use an Auction?

In evaluating the long term potential of the auction model, it is necessary to formalize the objectives of the lead counsel auction. Is the primary goal of the auction to reduce fee awards? Is this an appropriate and realistic goal? What are the costs of achieving this goal? Alternatively, can auctions provide other types of benefits?

Courts have offered limited reasons for using auctions. In Oracle, Judge Walker explained that his goal was to bring a market-based mechanism to the selection and compensation of class counsel.118 Similarly, in Auction Houses, Judge Kaplan stated that the auction “approximate[d] an efficient market.”119 The Seventh Circuit also requires courts to use a “market-mimicking” approach to determine legal fees in class actions.120 Defending auctions in terms of market simulation, however, is unsatisfactory.

First, it is unclear what market the auction is supposed to replicate. The market for legal services is not unitary; individuals seeking a lawyer to write their wills do not participate in the same market as corporations seeking counsel in connection with a public securities offering. Measured by traditional economic standards such as efficiency, different segments of the market for legal services are qualitatively different.

Second, the extent to which the market for legal services is efficient or well functioning is questionable.121 Commentators have criticized market function in many segments, citing problems such as inadequate competition and asymmetric information.122 Studies find evidence of possible market failures, including the downward stickiness of contin-

118. See In re Oracle, 852 F. Supp. at 1457 (explaining that auction process “adequately simulated the market for legal services”).
120. In re Synthroid Mktg. Litig., 264 F.3d 712, 719 (7th Cir. 2001).
121. Analysis of the economic efficiency of contingency fees in tort cases is particularly ambiguous. Compare James D. Dana, Jr. & Kathryn E. Spier, Expertise and Contingent Fees: The Role of Asymmetric Information in Attorney Compensation, 9 J. L. Econ. & Org. 349, 349-50 (1993) (concluding that contingency fees optimize attorneys’ incentives regarding decision whether to proceed with litigation), with Winand Emons, Expertise, Contingent Fees, and Insufficient Attorney Effort, 20 Int’l Rev. L. & Econ. 21, 30-31 (2000) (demonstrating that contingency fees may lead to inefficient levels of attorney effort).
gency fees. Some commentators have called for increased regulation, rather than a free market approach, in an effort to address these market failures. On occasion, courts have found sufficient evidence of market failure to interfere with negotiated fee agreements in traditional litigation.

Third, reliance on the free market, rather than a regulatory approach, sacrifices some of the potential benefits of regulation, such as the ability of courts to tailor fee awards in order to create the incentive for socially optimal litigation levels. Accordingly, to the extent that fee awards in class litigation can be used to serve broader social goals or to direct the commitment of litigation resources, greater reliance on market-based incentives limits this potential.

Judge Walker may have had in mind the corporate legal market, which, within the broader market for legal services, appears to operate relatively efficiently. Two attributes of the corporate legal market are attractive. First, sophisticated corporate purchasers are generally capable of identifying their needs and obtaining relevant information about lawyer price and quality. Second, lawyers compete to provide legal ser-

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123. See, e.g., Brickman, supra note 122, at 100 (criticizing persistence of standard 33% contingency fee, despite “a dramatic increase in the average amount of awards and a dramatic decrease in the risk of nonrecovery”); Herbert M. Kritzer, The Wages of Risk: The Returns of Contingency Fee Legal Practice, 47 DePaul L. Rev. 267, 285–90 (1998) (relating survey results finding prevalence of contingency fees around the level of 33%).

124. See, e.g., Brickman, supra note 122, at 111–14 (suggesting greater ex post judicial scrutiny of contingent fees); Resnik, supra note 46, at 2127–30 (calling for increased judicial regulation of attorneys’ fees in mass tort litigation); Painter, supra note 122, at 3 (arguing for regulation of contingency fees through adoption of the “New American Rule”).

125. See, e.g., In re Swartz, 686 P.2d 1236, 1243 (Ariz. 1984) (concluding that contingency fee of one third was unreasonable in individual case).

126. See, e.g., John F. Grady, Reasonable Fees: A Suggested Value-Based Analysis for Judges, 184 F.R.D. 131, 132 (1999) (suggesting courts look to value produced rather than total size of recovery in determining reasonableness of fee award); Resnik, supra note 46, at 2164–65 (describing wide variety of public and private benefits that lawyers can create through litigation).

127. See, e.g., Herbert M. Kritzer, The Professions Are Dead, Long Live the Professions: Legal Practice in a Postprofessional World, 33 Law & Soc’y Rev. 713, 731–32 (1999) (describing market for corporate legal services). In the corporate legal market, an informed and sophisticated purchaser evaluates lawyer credentials, negotiates price, and makes a selection decision on the basis of all relevant facts. Until fairly recently, of course, not even corporate clients behaved in this manner. In the white shoe era, corporate clients seemingly selected a firm primarily on the basis of reputation, which was gleaned, in part, from inspection of the firm’s client list. The retention decision was not based on price; the client expected to pay and did pay the firm’s going rate. More recently, corporations have become increasingly sophisticated purchasers of legal services. See id. (explaining evolution of the market).

128. See, e.g., Ronald J. Gibson, The Devolution of the Legal Profession: A Demand Side Perspective, 49 Md. L. Rev. 809, 902–03 (1990) (arguing that corporate clients have found effective ways to reduce informational asymmetries).
services. Corporate clients increasingly utilize "beauty contests" in which they compare firm proposals on price and quality criteria. Corporations also monitor lawyer pricing and demand that their lawyers offer competitive prices and pricing alternatives.

It is not sufficient to identify an appropriate benchmark, however, because auctions do not simply replicate the market. Rather, auctions are a stylized process for addressing two problems that contribute to market failure: lack of information and inadequate competition. These are problems that may contribute to nonoptimal pricing, allocational inefficiency, or both. Accordingly, lead counsel auctions should be evaluated based on their ability to address the problems that may result from market failure: excessive fees, selection of poor quality counsel, or both. Defining the auction goals in terms of price and, to a lesser extent, monitoring lawyer pricing and demand that their lawyers offer competitive prices and pricing alternatives.

129. See, e.g., David B. Wilkins, Do Clients Have Ethical Obligations to Lawyers? Some Lessons from the Diversity Wars, 11 Geo. J. Legal Ethics 855, 884 (1998) (describing beauty contests and consequent conditions imposed upon competing firms, including lower fees and more extensive supervision by corporate clients).

130. Id.

131. Cf. Robert D. Cooter & Edward L. Rubin, Orders and Incentives as Regulatory Methods: The Expedited Funds Availability Act of 1987, 35 UCLA L. Rev. 1115, 1174–75 (1988) (distinguishing between market perfecting, market displacing, and market simulating responses to market failure). Use of lead counsel auctions is based on the premise that they are market simulating. See, e.g., In re Oracle Sec. Litig., 852 F. Supp. 1437, 1457 (N.D. Cal. 1994) ("[T]he court is convinced that competitive bidding adequately simulated the market for legal services and has resulted in 'reasonable' fees."). According to Cooter and Rubin, a "market simulating statute is based on the premise that the market's operation can be restored, but only by imposing governmental rules. For such rules to restore, rather than displace, the market they must mimic some aspect of the market's operation that has been eliminated by the market failure." Cooter & Rubin, supra, at 1174–75.

132. See, e.g., Daniel L. Rubinfeld & Suzanne Scotchmer, Contingent Fees for Attorneys: An Economic Analysis, 24 RAND J. Econ. 343, 343–44 (1993) (identifying information asymmetries in market for legal services to include clients' superior information about case quality and lawyers' superior information about their abilities).

133. See Eric Rasmusen, Games and Information 245 (1989) (explaining that "auctions are stylized markets with well-defined rules"). There are several reasons why the market for class counsel may be imperfectly competitive. The economics of class representation may limit the ability of firms to enter the market and create a natural monopoly. Courts may restrict entry by limiting lead counsel appointments to specific firms, such as those with a proven track record in the field. Plaintiffs firms may act collusively. Perhaps the most important factor, however, is that under the current system in which the selection and compensation decisions are separate, price competition simply does not play a role in the appointment of lead counsel.

134. Auctions respond to the problem of asymmetric information by forcing buyers to reveal information through their bids. See id. at 323. Accordingly, in the situation in which buyers have superior information than the seller about the auctioned item's value, an auction can produce a superior price.

135. In the traditional auction model, allocation of the auctioned item in accordance with the bids is efficient, because the highest bidder is the buyer who values the auctioned item most highly.

136. See, e.g., Grundeit Declaration, supra note 7, ¶ 27 (describing lead counsel auction as a "method of selecting the highest quality representation at the lowest price").
tent, quality, is consistent with traditional auction analysis—price analysis dominates the auction mechanism, and the primary rationale for using an auction is price optimality.

Auctions can also be used to achieve process goals. In situations in which collusion or favoritism can taint the selection process, an auction offers the potential for greater objectivity. Auctions are used in government contracting, for example, to limit the discretion of public officials, increase transparency, and reduce the potential for corruption and collusion. Poorly structured auctions, however, are vulnerable to various forms of cheating that undermine these goals.

Importantly, lead counsel auctions do not address the agency problems that arise in the class action from the divergence between the interests of the plaintiff class and those of counsel. A number of commentators, most notably Jonathan Macey and Geoffrey Miller, have proposed auction mechanisms to deal with these agency problems. The Macey and Miller auction involves the sale of the claims, not the lead counsel position. By eliminating the plaintiff class, the proposal eliminates the problematic agency relationship between the class and counsel. The lead counsel auction does not eliminate the plaintiff class or the agency relationship. Indeed, in some cases, the incentives created by fee structures used in the auction process may increase the conflict of interest, exacerbating the agency problem.

The process question of whether to use an auction should also be distinguished from complex issues about contract design that the auction does not resolve. Designing an appropriate contract for legal services,

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137. See, e.g., Samantha M. Cohen, Note, “Paying-to-Play” is the New Rule of the Game: A Practical Implication of the Private Securities Litigation Reform Act of 1995, 1999 U. Ill. L. Rev. 1331, 1354 (1999) (arguing that competitive bidding procedures should be used to select class counsel in order to prevent lawyers from “buying business” through political contributions).


139. See, e.g., Lengwiler & Wolfstetter, supra note 138, at 1-2 (describing corruption as "well documented" in "many government procurement auctions").

140. See Macey & Miller, Plaintiffs' Attorney's Role, supra note 12, at 6.

141. Moreover, an auction is not a unique solution to the agency problem addressed by Macey and Miller. Any procedure that unites financial interest and decisionmaking responsibility, such as a market-based sale of the claims, will achieve a similar result. See, e.g., Peter Charles Choharis, A Comprehensive Market Strategy For Tort Reform, 12 Yale J. on Reg. 435, 443-44 (1995) (suggesting a tort claims market as a solution to the class action problems in the mass tort context).

142. The use of the auction procedure should be distinguished from the decision to appoint lead counsel and from issues about the most appropriate representation structure. Although the appointment of a single firm as lead counsel may create cost-saving efficiencies, a court need not use an auction to appoint a single firm. Even when the court appoints lead counsel, most class actions involve delegation of legal services to multiple...
a subject that is beyond the scope of this Article, raises a variety of complex issues, including the appropriate valuation of legal services and minimization of conflicts between lawyer and client interests. Existing auction methodology does not address these issues and instead incorporates flawed contract design into the auction procedure. Despite these flaws, use of auctions may lead courts to be unduly complacent about the resulting contracts.

In conclusion, the reasons for using auctions include lower fees, better selection decisions, and a more objective selection process. Evaluating the lead counsel auction requires determining whether the auction mechanism can realistically achieve these goals. The remainder of this Part addresses that question.

B. Bid Evaluation and Comparison

1. Evaluation of Competing Bids. — Because the auction selects a winner by comparing competing bids, bid evaluation and comparison are central to its operation. In the typical auction, comparing prices is easy because bids are submitted in fixed monetary amounts. Bid structures in lead counsel auctions are more complex.

This complexity does not result from the use of percentage of recovery bids rather than fixed prices or hourly rates, but rather from the propensity to use bid structures in which the fee award varies in accordance with various contingencies such as the amount of the recovery, the stage at which the litigation is concluded, and the duration of the litigation. The purpose of these structures, which reflect existing limitations in the design of legal services contracts, is twofold: to tailor fee awards to attorney effort and the value of the services provided, and to address agency problems in the lawyer-client relationship.

Unfortunately, the inclusion of even one contingency in a bid creates a significant evaluation problem. Consider two competing bids. Bid A seeks 8% of the recovery if the case settles prior to trial, and 15% if the case goes to trial. Bid B seeks 10% of the recovery if the case settles, and 12% if it goes to trial. The price of each of these bids depends on the likelihood of a specified contingency—in this case, the likelihood of a

plaintiffs’ firms. See, e.g., Sherleigh Associates LLC v. Windmere-Durable Holdings, Inc., 184 F.R.D. 688, 695 (S.D. Fla. 1999) (indicating that firms selected as lead counsel may refer work to other law firms). Lead counsel auctions may also mask issues concerning the appropriate division of responsibility and fees in connection with these structures. Tournament theory offers guidance as to the consequences associated with the designation of lead counsel, which rewards a limited percentage of the lawyers who initiate a case. See supra note 69 and accompanying text (describing tournament theory).

143. The selling price need not be the bid submitted by winner. Auctions use a variety of methods to set price. The selling price may be the highest bid, the second highest bid, or, less commonly, some other function of the submitted bids.

144. See, e.g., Paul R. Milgrom, Auction Theory, in Advances in Economic Theory Fifth World Congress 1, 2 (Truman F. Bewley ed., 1987) (describing several essential features of auctions including the “explicit comparison made among bids”).
At trial, the relative superiority shifts from Bid A to Bid B. Accordingly, the event of trial is a crossover point. Neither bid can be classified as objectively superior, and only by predicting the likelihood of a trial can the court compare the two bids.

Competing bids may have a number of crossover points such that one bid is lower in the event of certain outcomes and another bid is lower under different circumstances. If competing bids present the court with one or more crossover points, no single bid will be superior over all possible litigation outcomes, and the court cannot choose the better priced bid without predicting the future course of the litigation, the amount of the recovery, or both.

Bid evaluation is further complicated by the use of three different approaches to the specification of price as a function of recovery: fixed percentage of recovery bids, declining percentage of recovery bids, and increasing percentage of recovery bids. Consider the example in the chart below. Bid 1 seeks a flat 20% of the recovery, Bid 2 is an increasing percentage bid which seeks 10% of the first $20 million of recovery and 30% of any amount over $20 million, and Bid 3 is a declining percentage bid which seeks 30% of the first $20 million and 10% of any amount over $20 million.

### Attorneys Fees

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<thead>
<tr>
<th>Gross Recovery</th>
<th>Bid 1—flat 20%</th>
<th>Bid 2—increasing percentage</th>
<th>Bid 3—declining percentage</th>
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<td>$20 Million</td>
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As the chart demonstrates, the relevant crossover point in comparing the bids is a $40 million recovery. If the recovery is less than $40 million, Bid 2 is superior. If the recovery is above $40 million, Bid 3 is superior. Bid 1 is somewhere between the two at all recovery levels. The competing bids require the court to predict whether the recovery is likely to exceed $40 million; absent that prediction, there is no way to choose the best bid.

Additional variations in bid structure further complicate the task. In the Oracle case, for example, Bid 2 is structured as a calendar-based contingency fee; counsel fees decrease with the passage of time. \(^\text{145}\) Bid 4 is a stage of litigation contingency fee; fees increase with the stage of litigation. \(^\text{146}\) A superficial review of the two bids suggests that Bid 2 is superior; it proposes a fee that ranges from 10% to 30%, as opposed to Bid 4,

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146. Id. at 549.
which ranges from 24% to 37% of the recovery. Selecting the better bid, however, requires both identifying comparable circumstances and eliminating unlikely contingencies.\textsuperscript{147} Only a fairly accurate estimate of the likely recovery and litigation process will enable the court to identify the superior bid.\textsuperscript{148}

It is fair to question whether courts can predict case results with sufficient accuracy to permit meaningful bid pricing and comparison. Under existing law, limited judicial ability to evaluate case quality hampers judicial analysis of proposed settlements. Critics observe that judicial monitoring of settlements is often ineffective because, in the absence of a full trial and without a truly adversarial proceeding, courts cannot determine the strength of the case.\textsuperscript{149} Nonetheless, courts do not approve settlements until after the record has been developed through discovery, motion practice, and so forth. In contrast, an auction takes place at the outset of the case, usually before the defendant has even filed an answer. This exacerbates the information deficiency. Case evaluation is further complicated in securities fraud cases by limitations on the court's ability objectively to determine the plaintiffs' losses,\textsuperscript{150} the frequency with which cases settle for a small percentage of the losses claimed,\textsuperscript{151} and factors unrelated to the merits that may limit potential recovery such as the defendants' assets and insurance coverage.\textsuperscript{152}

Most courts have failed even to recognize the implicit estimation involved in their selection of the winning bid.\textsuperscript{153} Thus, the Cendant court

\textsuperscript{147} Comparing the bids for a comparable recovery amount, such as $30 million to $50 million (and ignoring differences such as the treatment of litigation expenses), Bid 2 starts out costing the class more than Bid 4, but may become the superior bid if a) the case goes to trial; or b) the case settles after at least twenty-five months of litigation. Alternatively, if the case reaches the deposition stage and settles within nineteen to twenty-four months, the two bids are equivalent. The court's elimination of unlikely contingencies, however, such as resolution of the case on appeal or a recovery in excess of $200 million, can narrow this range and improve the comparison.

\textsuperscript{148} Hindsight reveals that, based on the settlement amount of $25 million, Bid 4 was superior to Bid 2. This conclusion ignores the potential that the recovery would have been different, under the incentives provided by either Bid 2 or Bid 4 than under the bid structure selected by the court. See Niebler, supra note 47, at 808-09 (arguing that Bid 1, the winning bid, should have been rejected, in part because Firm 1 may have mistakenly undervalued the claim).

\textsuperscript{149} See Fisch, Aggregation, supra note 13, at 58; Macey & Miller. Plaintiffs' Attorney's Role, supra note 12, at 44-48.

\textsuperscript{150} See, e.g., Carleton et al., supra note 105, at 492 (identifying difficulty in measuring damages directly).

\textsuperscript{151} See, e.g., Foster et al., supra note 105, at fig.13 (finding that securities class actions from January 1991 through June 1999 settled for an average of 8.75% of investor losses).

\textsuperscript{152} See, e.g., id. at 8; Frederick C. Dunbar et al., Shareholder Litigation: Deterrent Value, Merit and Litigants' Options 33-34 (NERA, Working Paper, Oct. 1995).

summarily rejected the Sirota bid which sought 1% to 2% of the recovery as unrealistically low, describing the bid as “quasi philanthropic” and claiming that the bid did not make “professional sense.” As it turns out, based on the actual settlement, the bid would have yielded a fee of approximately $60.4 million, a fee, which, although substantially lower than the fee awarded by the court, is still 7.5 times the lodestar figure provided by the lead counsel.154

The Bank One decision was one of the few to consider bid estimation and comparison issues carefully. The court in Bank One recognized both that competing bids contained crossover points and that it was necessary to predict the likely recovery in the case in order to choose among the competing bids.155 Accordingly, the court made a “best-informed” estimate of the potential class recovery as in the $4.6 to $4.8 billion range156 and selected the firm whose bid produced the lowest fee for a recovery within that range.157

The Bank One court, however, had an unusual quantity of information available at the time it evaluated the auction bids. Unlike most lead counsel auctions, the Bank One auction was held after the court denied defendants’ motion to dismiss.158 The court also received detailed estimates from counsel regarding the likely recovery. Despite this information, the court recently approved a settlement for $45 million,159 describing it as “highly favorable.”160 This suggests that either the court’s estimation in Bank One was seriously deficient or the selected fee structure had a deleterious effect.161

The complexities of bid evaluation and comparison suggest several reasons for concern. First, it is not clear that the court will be able to identify the low bidder. Second, the judgments associated with bid evalu-
ation reduce the transparency and objectivity of the auction process. Third, and perhaps most important, deficiencies in evaluation may impact the subsequent progress of the litigation. If the court selects a bidder that has evaluated the case improperly, the plaintiff class may bear the brunt of this decision by receiving a lower recovery.

2. Bid Structure and Incentive Issues. — The incentive effects of the various compensation structures add an additional level of complexity. Unlike the typical product auction, in which the successful bidder, as owner of the auctioned item, has an incentive to exploit it most profitably, the efforts of the winner of a lead counsel auction are expended primarily for the benefit of the plaintiff class. The fee structure dictates the extent to which the bidder will share in the recovery, but the auction leads to the standard lawyer-client agency relationship. The lawyer’s incentives, and thus the results in the case, are affected by the structure of the legal services contract. Accordingly, in evaluating competing bids, the court must consider the incentives they create.

Incentive problems may arise under a variety of different bid structures. Because it fails to align counsel’s interests with those of the plaintiff class at high levels of recovery, a declining percentage of recovery fee structure is especially likely to create a significant moral hazard problem. The last dollars of a recovery are generally the most costly to produce, limiting counsel’s motivation to pursue them. The incremental value to counsel of additional dollars recovered is particularly small when counsel will receive a very low percentage of those dollars. As Santore and Viard explain, if a contingency fee structure provides lawyers with insufficient incentive to devote additional effort to a specific case, they will choose to invest the effort elsewhere where it will be rewarded more highly. At the same time, a low level of recovery often produces the highest return to effort for counsel, if it results from an early settle-

162. The Macey and Miller proposal advocates selling the entire underlying claim at auction to eliminate this agency problem. Macey & Miller, Plaintiffs’ Attorney’s Role, supra note 12, at 108-09. Unlike the claims auction, the lead counsel auction does not unite the interests of the class and its counsel and, as a result, does not address the agency problem.

163. Any contingency fee of less than 100% creates a potential moral hazard problem. In most litigation, however, the effort required by counsel increases as the case proceeds through discovery and to trial at a much higher rate than the expected recovery. See, e.g., Bruce L. Hay, Contingent Fees. Principal-Agent Problems, and the Settlement of Litigation, 23 Wm. Mitchell L. Rev. 43, 46-47 (1997) (describing illustrative hypothetical). Accordingly, a declining percentage fee structure is likely to create a larger disparity than other fee structures between the marginal reward for counsel’s additional expenditure of effort and the expected return to counsel for that expenditure.

164. See, e.g., ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 94-389 (1994) (stating “everyone would agree that it is the last dollars, not the first dollars, of recovery that require the greatest effort and/or ability on the part of the lawyer”).

165. See Santore & Viard, supra note 70, at 3-4. A nominally higher fee in percentage terms may increase attorney effort and ultimately result in a higher net recovery to the class.
ment. Thus, under typical litigation conditions, the declining percentage fee may produce a windfall return to counsel while, at the same time, shortchanging the plaintiff class.

The effect is greatest for “capped” fee structures, because the cap effectively eliminates any incentive for counsel to pursue a recovery level beyond the point at which counsel fees are capped. For example, it is possible that the fee cap in Bank One at a recovery level of $25 million had some impact on counsel’s decision to propose a settlement for $45 million, rather than litigating further in hopes of achieving a result closer to the court’s predicted recovery of $4.6 to $4.8 billion.

The increasing percentage bid structure better addresses the moral hazard problem. By increasing the reward to counsel, increasing percentage bids reduce the incentive for cheap settlements and motivate counsel to pursue high levels of recovery. Increasing percentage bids can lead to very large fees, however, in cases involving large recoveries, causing some courts to view them with skepticism. Increasing percentage bids are particularly problematic in cases in which the court cannot readily predict the recovery at the time it selects counsel. In Cendant, for example, it appears that the recovery greatly exceeded the court’s predictions, resulting in a fee award that was very high if measured in terms of attorney effort. Increasing percentage bids may also distort the true economic structure of the litigation and, in some cases, create an incentive for counsel to pursue overly risky litigation strategies.

Fixed percentage fees obviously fall somewhere between the two, creating less of a moral hazard problem than declining percentage fees, but failing to generate the same incentive for continued attorney effort as increasing percentage fees. Moreover, fixed percentage awards may appear crude to the extent that they do not appear sensitive to recovery levels. Nonetheless fixed percentage fees offer two advantages: They facilitate bid comparison and they reduce the importance of predicting recovery for pricing bid proposals.

Bids that vary in price to reflect litigation duration or various litigation contingencies have similar incentive effects. Early settlement bonuses, for example, exacerbate the moral hazard problem associated with declining percentage fee structures by rewarding counsel for a quick

166. See, e.g., Hay, supra note 163, at 46 (demonstrating this result with hypothetical).
167. By some accounts, the capped fee structure in In re Amino Acid Lysine Antitrust Litig., 918 F. Supp. 1190 (N.D. Ill. 1996), had this effect. See Fisch, Aggregation, supra note 13, at 86–87 (describing fee structure and litigation result).
168. See supra notes 107–109 and accompanying text (describing Bank One estimate and settlement result); see also Kramer v. Scientific Control Corp., 534 F.2d 1085, 1092 (3d Cir. 1976) (observing that to assert that counsel would not take into consideration amount of expense for which there may not be any reimbursement “is to argue against reality, against the vagaries of human nature”).
169. See, e.g., Niebler, supra note 47, at 790–91 (describing negative judicial response to increasing percentage bids).
cheap settlement. In addition, early settlement bonuses can give defendants additional leverage in negotiating a cheap settlement by creating a time-based discontinuity in the returns to effort of plaintiffs’ counsel. Furthermore, the percentage of recovery method already provides sufficient incentives for counsel to expedite the settlement process. Unlike the lodestar method, a percentage of recovery fee gives counsel little reason unnecessarily to prolong the litigation.

In contrast, duration-based fee structures, including both those with calendar and litigation stage contingencies, create a problematic incentive for litigation delay. Although it may appear that prolonged litigation justifies a higher fee award and that duration-based structures counteract the incentive for cheap early settlements, delay is not closely correlated with attorney effort or increased recovery. In addition, the duration of litigation is largely within the control of plaintiffs’ counsel. It is difficult for courts to monitor the progress of the litigation to uncover unnecessary delay; defendants are unlikely to oppose it, and defense counsel typically benefit from protracted litigation. As a result, duration-based structures create the potential for higher fees and delayed recovery, neither of which is in the interests of the plaintiff class.

These incentive effects also apply when litigation milepost grids are used to structure auction bids. Although the stage of recovery is more closely correlated with attorney effort than the simple passage of time, and succeeding stages of litigation do entail increasing amounts of effort for counsel, each discontinuity in the grid creates an opportunity for counsel to trade a higher fee against a lower total recovery. Increasing the fee with the litigation stage encourages unnecessary work and need not produce greater recoveries.

At the same time, litigation grids unnecessarily complicate both the bidding process and the evaluation of competing bids. Calculating the likelihood of and desired return for each contingency is costly. Bidders in Sherleigh Associates, for example, were required to propose bids for twenty-eight different scenarios.170 Many scenarios are of marginal relevance. For example, virtually all class actions are settled, making it unreasonable to give substantial weight to the sections of the grid that propose fees for resolution of the case after trial or on appeal. Similarly, it will seldom be appropriate for counsel to settle a case prior to conducting some discovery.171 As a result, those sections of the grid that address resolution prior to discovery or prior to the resolution of the motion to dis-

170. For each scenario, the bidder must consider innumerable variables relating to the cost of litigation at that stage, such as the potential need for input by senior lawyers or specialized trial counsel if the case goes to trial. The bidder must then determine the percentage of the recovery that is necessary to provide compensation at market rates. See supra note 92–93 and accompanying text and chart.

171. In rare cases, government investigation or collateral proceedings may result in a sufficiently developed factual record to permit an earlier resolution; these circumstances are likely to be apparent at the time the auction is conducted.
miss, which in some types of litigation has become virtually automatic, are of limited value in the selection decision. If marginal contingencies should be eliminated, and the court’s analysis limited to one or two sections of the grid, judicial reliance on grids is misplaced.\textsuperscript{172}

Finally, although several courts have focused on the treatment of litigation costs in analyzing bid structures,\textsuperscript{173} the requirement that lawyers internalize or cap litigation costs can also lead to inappropriate litigation decisions. First, any limitation on counsel’s ability to recover non-lawyer costs creates an additional conflict between counsel’s interests and those of the plaintiff class. Such limitations may discourage counsel from incurring expenditures that increase the size of the recovery. John Coffee has argued that the cost cap in \textit{Oracle} produced precisely this result, observing that the case settled at precisely the point at which counsel hit the cap on expenses, and suggesting that counsel was unwilling to continue to litigate once it began to bear the cost of additional expenditures.\textsuperscript{174}

Second, as Andrew Niebler has demonstrated, the requirement that attorneys internalize non-lawyer costs will not lead attorneys to select the optimal mixture of lawyer and non-lawyer inputs.\textsuperscript{175} Instead, this structure creates an incentive for lawyers to attempt to maximize their own profits through the management of non-lawyer costs.

The foregoing exemplify the incentive problems presented by bid structures in recent auction cases. Because of the dynamic relationship between the fee structure and the net recovery, and because the court should be seeking to maximize the net recovery to the plaintiff class rather than to minimize the fee award, the court cannot select a winning bid on the basis of price alone, but must attempt to evaluate the incentive effects of competing bids. An auction that minimizes counsel fees in either percentage or absolute terms at the cost of reducing class recovery cannot be viewed as more than a cosmetic success.

\textsuperscript{172} Reliance on the grid may also lead the court astray if the court’s prediction of the likely recovery is substantially inaccurate. In such a case, the grid may focus the court’s analysis on differences in fee structures that are ultimately trivial in light of a more realistic assessment of the recovery. In \textit{Lucent}, for example, the court’s bidding grid topped at a recovery of $25 million. Accordingly, the grid was poorly suited to allow the court to evaluate differences in bids for substantially higher levels of recovery. The unrealistically low estimates in the grid were brought to the attention of the court. See Letter from Wendy A. Weiss to The Honorable Alfred J. Lechner (May 29, 2000), at http://www.ca3.uscourts.gov/classcounsel/Witness\%20Statements/weiss.pdf (on file with the Columbia Law Review) (warning that $25 million represented a recovery of less than 0.75 cents for each dollar of alleged losses).


\textsuperscript{174} See John C. Coffee, Jr., \textit{Securities Class Actions}, Nat’l J., Sept. 14, 1998, at 9 (describing \textit{Oracle} as looking “much like a case that the winning bidder could not afford to carry further”).

\textsuperscript{175} Niebler, supra note 47, at 798–802.
3. The Auction Houses Example. — In the Auction Houses case, Judge Kaplan used a unique auction structure designed to address the estimation and comparison problems described in Subsections 1 and 2 above. By some accounts, the auction was a great success. In light of the foregoing discussion, it is worth considering the extent to which Judge Kaplan was successful in limiting these problems.

Judge Kaplan structured the Auction Houses fee award as follows. The class would receive 100% of a recovery amount designated as X. Counsel would receive 25% of any recovery in excess of X. In effect, this amounted to an increasing percentage contingency fee with an initial rate of zero. Firms were instructed to bid by specifying the value of X pursuant to which they were willing to serve as lead counsel.

The resulting bidding procedure successfully eliminated the bid evaluation and comparison problems described in Subsection 1 above by providing a single bid structure. Firms were essentially competing on the basis of the highest level of recovery for which the bidder was willing to forgo attorneys' fees.

More significantly, Judge Kaplan sought to address agency and incentive problems. The structure was designed to eliminate the incentive for a cheap early settlement by providing a minimum recovery level for the plaintiff class before the lawyer receives anything. By requiring counsel to commit the effort level necessary to obtain a recovery of at least X, the structure prevented a low quality lawyer from submitting an inappropriately cheap bid and then selling out the class. At the same time, Judge Kaplan reasoned that counsel would receive increasing marginal returns to effort as the recovery exceeded X, creating an incentive for counsel to litigate aggressively.

Despite these advantages, there are problems with the Auction Houses fee structure. One problem is that it subjects bidders to substantial

177. See, e.g., In re Auction Houses Antitrust Litig., No. 00 Civ. 0648 (LAK), 2001 U.S. Dist. LEXIS 1713, at *77 (S.D.N.Y. Feb. 22, 2001) (stating that “the result of the lead counsel auction in this case was exceptionally beneficial to the class”); Hamblett, supra note 2, at 1 (describing the bidding procedure as a “success”).
178. Judge Kaplan initially chose a more complex three-tiered bidding structure, in which the first tier of the recovery would go entirely to the plaintiff class, the second tier would go entirely to counsel, and any additional recovery would be split between counsel and the class according to a 25:75 ratio. Bidders were instructed to specify the size of the first two tiers. See In re Auction Houses, 197 F.R.D. at 73 (describing initial structure). The proposed design raised a variety of evaluation and other problems. See Affidavit of Jill E. Fisch at 3–23, In re Auction Houses Antitrust Litig., 2001 U.S. Dist. LEXIS 1713 (No. 00 Civ. 0648 (LAK)) (describing bid evaluation and comparison problems and potential conflicts of interest under three-tiered bidding structure).
180. Id.
181. In addition to the problems described in this Subsection, the Auction Houses procedure is also subject to the problems described in infra Parts III.C and D. Part III.C identifies concerns about the predominance of price considerations and about the effect
risk. A firm that erroneously estimated the likely recovery and specified too high a threshold faced the possibility of receiving no fee award. Firms had an incentive to discount their bids, that is, to reduce the threshold $X$ at which they were willing to accept the lead counsel appointment, in order to reflect this risk. \footnote{Firms were likely to further discount their bids to address the risk that they would overpay due to a winner’s curse problem. See infra Part III.D.1 (describing winner’s curse).} Substantial discounting diminishes the effectiveness of the threshold as a barrier to a cheap settlement.

At the same time, the Auction Houses structure creates an incentive for some firms to overbid, that is, to specify an unreasonably high threshold in hopes of obtaining the lead counsel appointment. The high profile nature of the case generates pressure to overbid. An unduly high bid could create dramatic conflicts of interest between counsel and the plaintiff class. When a firm learns that the case is unlikely to result in a recovery of greater than $X$, it may sacrifice class interests by pursuing a high risk, high reward litigation strategy, such as rejecting a reasonable settlement offer in favor of an unproductive trial, in hopes of salvaging some compensation. Alternatively, the firm may choose to minimize its losses by shirking, reducing its efforts to the minimal level necessary to conclude the case. Because the firm will be indifferent to variation in recovery levels below $X$, it has no incentive to invest further resources to maximize recovery to the plaintiff class within that tier.

Finally, the fee structure creates an incentive for counsel to manipulate the structure of the settlement in order to maximize its fee award. Arguably the settlement obtained in the case, although generous, reflects this incentive. The settlement provided a cash payment to the plaintiff class of approximately $412 million, with an additional $125 million in discount coupons for future transactions with the defendants. \footnote{See, e.g., In re Auction Houses Antitrust Litig., No. 00 Civ. 0648 (LAK), 2001 U.S. Dist. LEXIS 1713, at *77 (S.D.N.Y. Feb. 22, 2001).} Although it is difficult to determine the value of any noncash compensation, courts have frequently been criticized for overvaluing coupon-based settlements. In this case, the court determined that the coupons were worth at least 80\% of their face value. \footnote{Id. at *72 n.88.} Accordingly, the court valued the entire settlement at $512 million and awarded counsel a fee of $26.75 million. \footnote{Id. at *74. This fee was 25\% of the difference between the total settlement value of $512 million and the Boies bid of $405 million. Id. The fee, 5.2\% of the total recovery, was to be paid in the same proportion of cash and coupons as that received by class members. Id at *78. The court also awarded approximately $600,000 in additional fees to interim lead counsel in the case. In re Auction Houses Antitrust Litig., No. 00 Civ. 0648 (LAK), 2001 U.S. Dist. LEXIS 1889, at *15 (S.D.N.Y. Feb. 23, 2001) (awarding fees to interim lead counsel out of settlement fund).} Notably, in the absence of the coupons, which the defendants
were presumably far more willing to provide than additional cash, the Boies firm would have received a fee of less than $2 million.

Other factors counsel caution in applauding the results of the Auction Houses case. First, it is difficult to evaluate the fee award in terms of reasonableness. Although the fee represents only 5.2% of the total recovery, which is quite low in percentage terms, $26.75 million is fairly generous compensation for approximately six months’ work on a case in which the private litigation was preceded by a Department of Justice antitrust investigation. By the time Judge Kaplan ordered the auction in May of 2000, one defendant, Christie’s, had publicly admitted wrongdoing and acknowledged that it was cooperating with the investigation. Subsequently, Sotheby’s chief executive, Diana Brooks, agreed to plead guilty and provide testimony. Accordingly, the Auction Houses case did not present a serious risk of nonliability; it was rather more, as Judge Kaplan described it, “like finding a pot of gold in the middle of the sidewalk.”

Second, the range of bids submitted in the case demonstrates the serious risk that inadequate competition in a lead counsel auction will lead to excessive fee awards. Although a fairly substantial number of firms submitted bids, the bid by the Boies firm was a significant outlier. More than twice that of the next highest bid, it was characterized by some as “daring.” Presumably Boies, Schiller could have submitted a bid of $205 million and still been awarded the lead counsel position. Alternatively, if the Boies firm had not participated, the auction would have produced a winning bid of $205 million. Such a bid, assuming the same settlement, would have yielded lead counsel a far less reasonable $77 million fee.

Finally, the feasibility of Judge Kaplan’s approach remains subject to the analysis in subsequent Sections of this Article. In particular, Section C below identifies concerns about the relationship between the auction procedure and the judicial role, and Section D further explains why lead counsel auctions may not produce reasonable fee awards.
C. Auctions and the Judicial Role

Current experience with the lead counsel auction raises questions about judges’ effectiveness as auctioneers. As detailed in the preceding Sections, recent cases reveal problems with judicial analysis of bid structure, bid evaluation, and incentive effects. In short, courts are making mistakes in structuring and conducting lead counsel auctions.

This conclusion is not fatal. Judicial experience with lead counsel auctions is limited, and continued experimentation is likely to improve the auction process. As the Auction Houses case demonstrates, judges are capable of understanding the flaws in current practices and responding through innovation.

Structural problems in the lead counsel auction are more problematic, however, than problems in implementation. This Article identifies three such problems, the multidimensional nature of the lead counsel auction, the effect of the auction on judicial neutrality, and the judge’s role as agent in the auction process. These problems both limit the effectiveness of the auction model and reduce its procedural advantages.

1. The Multidimensional Nature of the Auction. — Despite the focus of Part III.B on bid price, price is not the only relevant consideration in the selection of class counsel. Because the court is choosing a firm that will subsequently perform legal services on behalf of the plaintiff class, the court must also consider bidder quality. The relevance of quality to the selection decision causes the lead counsel auction to differ from most traditional auctions in which non-price bidder characteristics, other than ability to pay, are irrelevant.

Traditionally, clients decide to retain counsel on the basis of both price and non-price factors. As in many markets, price and quality are closely related; indeed, price is often a function of quality. Higher quality lawyers can command a higher price for their services. Lower quality lawyers charge a lower price. Lawyer quality is likely to affect both the likelihood and the amount of plaintiffs’ recovery.

This poses several problems for the judge as auctioneer. First, a lead counsel auction cannot select among competing bids solely on the basis of price. Such a process may select a poor quality lawyer precisely because of the likely correlation between price and quality. Second, in order to evaluate competing bids, the court must evaluate lawyer quality.

193. See also Fisch, Aggregation, supra note 13, at 86–88 (describing problems with judicial use of lead counsel auctions in recent cases).

194. This Article will generically denote non-price factors as quality considerations.

195. Alternatively, price dominance can create a “race to the bottom” by encouraging bidders to minimize cost and fee estimates in order to obtain the appointment. Subsequently the winning bidder will have an incentive to minimize its litigation efforts in order to maximize profits. See Securities Litigation Reform: Hearings before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce, 103d Cong. 159 (1994) (statement of Arthur Miller, Professor of Law, Harvard University) (warning of this problem).
Third, the court must develop a decisionmaking structure that enables it to consider both price and quality.

Outside the auction context, most courts prefer a negotiated solution to the selection of lead counsel to a careful assessment of lawyer quality. Recent auction decisions suggest continued reluctance to evaluate quality. Auction analyses do not differ markedly from the superficial quality evaluations conducted elsewhere. Courts rarely solicit writing samples, investigate counsel’s familiarity with the facts or relevant legal principles, review detailed proposals for litigation strategy, or evaluate prospective counsel by means of face-to-face “beauty contests.”

Instead, even those courts that have purported to consider quality factors have relied on unhelpful and self-serving information such as firm resumes. Naturally, the results have been poor. Thus, in Oracle, although Judge Walker solicited quality information from the bidding firms, he subsequently found that information insufficient to enable him to distinguish among them on the basis of quality.

Courts may also have difficulty identifying appropriate indicia of firm quality. Judge Walls specifically addressed quality considerations in his Cendant opinion, but the quality factor to which he devoted the most attention was trial experience. In light of the fact that the vast majority of securities fraud class actions settle prior to trial and that, in any event, the successful bidder could obtain the services of specialized trial counsel if necessary, it is difficult to understand why trial experience is a substantial indication of firm quality. In Quintus, Judge Walker stressed the importance of malpractice coverage despite conceding that no bidder had substantial coverage relative to its exposure in the case. Similarly, the court in Wenderhold v. Cylink concluded that one bidder was superior.

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196. Although in theory the first-to-file rule could be characterized as quality based in the sense that it rewards investigation efforts by awarding the lead counsel position to the lawyer who originally uncovered the defendant’s misconduct, in practice, the rule merely reaffirms the limited judicial commitment to quality evaluation. Courts applying the rule rarely inquire into the actual degree of investigation; indeed, they apply the rule even in cases that piggyback on prior government proceedings. Moreover, the rule itself discourages thorough investigation in favor of rapid filing.

197. The most extensive quality analysis to date was conducted by Judge Walker in In re Quintus Sec. Litig., 148 F. Supp. 2d 967, 974–82 (N.D. Cal. 2001).

198. See, e.g., id. at 974–79 (relying on information provided by firms to gauge experience and expertise).

199. See In re Oracle Sec. Litig., 132 F.R.D. 538, 542 (N.D. Cal. 1990) (concluding it was “impossible objectively to distinguish among [the bidding] firms in terms of their background, experience and legal abilities”).


201. See also In re Commtouch Software Ltd. Sec. Litig., No. C-01-00719, app.B at 1 (N.D. Cal. June 27, 2001) (listing description of trial experience as first substantive information required from prospective lead counsel). This is not to argue that trial experience is irrelevant. A lawyer’s credible threat to go to trial affects his or her ability to negotiate a settlement.

202. In re Quintus, 148 F. Supp. 2d at 978, 980 (observing that Weiss & Yourman’s lack of malpractice insurance was “a definite strike against it”).
to its competitor, in part, on the basis of quality considerations that included, according to the court, the winning bidder’s smaller size, lack of a west coast office, and absence of litigation experience in the circuit.203 One might as readily have viewed these characteristics as demonstrating the inferior quality of the winning bidder.204

Perhaps most troubling in this regard was Judge Walker’s analysis of Milberg Weiss’s quality in Quintus. Judge Walker purported to determine whether he was sacrificing quality in failing to select Milberg by reviewing empirical evidence on settlements.205 Judge Walker reasoned that “[o]ver a large enough sample of cases, the quality of lawyering by a plaintiff law firm should be shown by its ability to recover a greater proportion of the potential available damages than that obtained by lesser quality firms.”206 Citing evidence that Milberg’s settlements, measured against potential investment losses, did not vary substantially from those of other firms,207 the court concluded that Milberg lacked a qualitative advantage in practice ability that would justify a higher rate of compensation.

Judge Walker’s analysis is flawed for several reasons. First, as previously indicated, potential damages in securities litigation are difficult to measure objectively.208 Second, the range and type of factors likely to influence settlement variation suggest that it is impossible to determine the quality of lawyering by viewing the proportion of losses recovered.209 At minimum, such an endeavor would need to determine whether Milberg’s cases were similar to those handled by other firms with respect to such factors as the size of the defendant, the size of investor losses, the nature of the allegations and the circuit in which the case was filed.210 Third, and most importantly, Judge Walker’s reasoning failed to reflect his previously articulated position about the relevance of market considerations. Milberg’s opportunity costs, which reflect the alternative use of

203. 191 F.R.D. 600, 602–03 (N.D. Cal. 2000).
204. Cf. In re Quintus, 148 F. Supp. 2d at 980 (reasoning that larger firm has greater resources to pursue case).
205. Id. at 981–82.
206. Id. at 981.
208. See supra note 105 and accompanying text; see also In re Comdisco Sec. Litig., 150 F. Supp. 2d 943, 945 (N.D. Ill. 2001) (rejecting institution’s first-in-first-out (FIFO) methodology for computing its losses and determining, instead, that institution had derived a net gain during the class period).
209. See, e.g., Foster et al., supra note 105, at 7–9 (describing factors that explain variation in settlement values).
210. Bajaj’s own statistics on median and average settlement amount raise questions about whether Milberg’s cases are representative. See Bajaj et al., supra note 207, at 33 (showing Milberg as handling cases with substantially lower average but higher median settlement amounts than other firms).
its time litigating other securities cases, may be substantial. The returns in those other cases serve as the market and so form a more appropriate benchmark by which reasonableness should be measured than suppositions about practice ability.

Evaluation of lawyer quality does not appear to pose an insurmountable problem. Courts are experienced at dealing with and evaluating lawyers; indeed, most judges are lawyers. Although information problems may hinder a judge's ability to evaluate counsel's quality based on the results of prior litigation, it is reasonable to assume that judges have sufficient expertise to evaluate lawyers' performance in the same manner as a client, through a review of prior performance, legal writing, legal arguments, demonstrated familiarity with the relevant legal issues, reputation, and so forth.\textsuperscript{211}

Courts might also develop more objective standards for evaluating bidder quality. Government agencies conduct auctions under circumstances in which both price and bidder quality are relevant. The procurement auctions conducted by the Department of Defense (DOD) are a common example.\textsuperscript{212} The DOD addresses the quality dimension through the application of scoring systems which convert the various non-price characteristics of the bids into an objective score. Bidding guidelines in such auctions specify the relevant quality criteria and the scoring system in advance.\textsuperscript{213} The DOD then evaluates the competing bids on the basis of both price and quality scores to select the winning bid.

However, quality scoring is only the first step toward addressing the issue. Even if the court can quantify quality factors, it must then develop a methodology for comparing bids that compete along two dimensions: price and quality. Such multidimensional auctions are complex.\textsuperscript{214} In addition to developing a system for quality scoring, the court must articulate a preference function for price and quality scores, in which both variables are given appropriate weight.\textsuperscript{215} The design of such a preference function is not trivial. For example, although a client will likely be willing

\textsuperscript{211} On the other hand, courts are seemingly unable to evaluate and compare lawyer quality for the purpose of selecting lead counsel under the traditional approach. Indeed, judicial refusal to focus on quality led to the adoption of the first-to-file rule. See Weiss \& Beckerman, supra note 26, at 2062 (describing use of first-to-file rule).

\textsuperscript{212} See, e.g., Yeon-Koo Che, Design Competition Through Multidimensional Auctions, 24 RAND J. Econ. 668, 668-69 (1993) (describing DOD procurement auctions and quality scoring).

\textsuperscript{213} Id. at 668.

\textsuperscript{214} See, e.g., Fernando Branco, The Design of Multidimensional Auctions, 28 RAND J. Econ. 63, 77 (1997) (demonstrating that, under certain conditions, a single stage multidimensional auction cannot provide an optimal result).

\textsuperscript{215} The utility of the court, or more appropriately, of the plaintiff class, can be described as a function of \( p \) and \( q \) (\( U = f(p, q) \)). If the court specifies a utility function, it can then determine which bid, consisting of specifications for \( p \) and \( q \), maximizes it. See Martin Cripps \& Norman Ireland, The Design of Auctions and Tenders with Quality Thresholds: The Symmetric Case, 104 Econ. J. 316, 317 (1994) (describing price/quality preference function).
to pay more for increased lawyer quality up to a point, it is difficult to determine the rate at which the client is willing to substitute between quality and price. Moreover, the marginal utility of increased quality probably varies, although it presumably declines as price increases.

Even assuming that it is possible for the court to specify such a preference function, the limited economic literature suggests that designing an appropriate multidimensional auction is extremely difficult. Existing analysis of multidimensional auctions is incomplete, but it indicates that the standard bidding process is unlikely to produce an optimal result. Yeon-Koo Che has concluded, for example, that traditional auction procedures are likely to over-reward quality in a multidimensional auction. Fernando Branco extends this analysis and concludes that a single bidding process will not function well and that the seller in a multidimensional auction should, instead, use a two step process in which bidding over price is followed by negotiation over quality.

Moving from theory to practice, real world auctions often simplify the analysis by specifying a minimum quality standard instead of allowing bidders to compete freely on the quality dimension. This task, which has the effect of reducing the auction to a single dimension, can be accomplished in several ways. The auctioneer can specify minimum quality criteria and require that bidders pass the quality threshold before being evaluated on the basis of price, thus using quality as a screening device. Bids can be ranked on the basis of price and then bidder quality evaluated in that order, until a bid of acceptable quality is identified. Alternatively, bidders can submit a package of price and quality, which is considered as a unit.

Even assuming that the application of a minimum quality standard is a realistic method for selecting legal services, for any of these methods fairly to address quality considerations, the court must both be capable of articulating its approach at the outset of the auction and committing to the articulated standards. If the court evaluates quality on an ad hoc ba-

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216. See, e.g., id. at 317 (arguing that the variety of preference functions among parties and the difficulty of quality monitoring over time render unlikely an ideal multidimensional auction reflecting price and quality criteria).

217. Che, supra note 212, at 675–76.

218. Branco, supra note 214, at 77.

219. See Cripps & Ireland, supra note 215, at 317–18 (explaining that specifying minimum quality criteria and allowing competitive bidding on price alone offers a more feasible alternative to conducting a multidimensional auction). This approach was used by the United Kingdom in auctioning television franchises. Id. at 318.

220. See id. at 317–18.


222. The Bank One court appeared to use this approach. See In re Bank One Shareholders Class Actions, 96 F. Supp. 2d 780, 788 (N.D. Ill. 2000) ("[T]he Wechsler Firm is entitled to be designated as class counsel—[i]f, of course, it qualifies as a responsible bidder in terms of its credentials and experience.").
sis, without specifying formal standards in advance, it introduces subjectivity that is inconsistent with the auction methodology.

Moreover, as with DOD auctions, it may be very difficult for the court to communicate its quality preferences effectively or to provide sufficient information to third party bidders about the details of its evaluation. Indeed, specification of a minimum quality standard in an area such as legal services may be inherently ambiguous. This both creates uncertainty in the operation of the auction and detracts from bidder ability to make efficient tradeoffs between price and quality in preparing a bid. At a minimum, the ambiguity significantly reduces the objectivity and transparency of the auction process and gives the court increased discretion to mask decisions made for other reasons on the basis of quality factors that are difficult to verify.

2. Agency Issues. — Anytime a court appoints lead counsel, it acts as an agent for the plaintiff class. In attempting to further the best interests of the class, the court is subject to the standard agency problems. Auctions seem to address these agency problems by replacing discretionary government decisions with a more objective procedure. If, however, the court controls the design and implementation of the auction and through that control makes discretionary choices, the agency problems remain.

Deciding the relative priority to be given to price and quality, as described in Subsection 1 above, is an example of a discretionary choice. In making these choices, the court may not be a good agent for the plaintiff class. Judges are not simply surrogate clients. First, judges may act out of self-interest. The legal literature has begun to recognize that judges may be motivated by personal goals, including power, prestige, autonomy, and even maximizing leisure time. It is important to recognize that the court’s goals need not be related to maximizing class recovery. Instead, a managerial judge may want to expedite settlement. A judge with a crowded docket may want to minimize the time expended on the
A court concerned about finality or its reversal record may seek to limit the number of objectors or eliminate possible issues for appeal. A judge with political interests may weigh the public relations implications of the litigation.

These goals create an alternative set of priorities for the court in appointing lead counsel. Should the court prefer a creative lawyer who can generate a novel resolution to the case? Will an assertive judge seek a lawyer who is unlikely to resist the court's efforts to control the course of the litigation? Are overworked judges unduly likely to seek conciliators who will strive for consensus?

Second, by nature, the agency relationship causes a degree of divergence between the agent's actions and the best interests of the principal—the so-called residual costs of the agency relationship. Accordingly, even the best-motivated court will perform tasks such as evaluating firm quality and developing preference functions imperfectly; the imperfections result from the court's inability fully to internalize the preferences of the plaintiff class. These considerations limit the court's ability to perform the complex tasks necessary to address the multidimensional nature of the lead counsel auction. Moreover, the subjectivity inherent in evaluating quality and weighing price versus quality provides a ready vehicle to accommodate judicial policy choices under the guise of procedural objectivity.

More generally, this Article suggests that auction design and administration are complex tasks that require the expenditure of substantial judicial resources. It is not clearly desirable for courts to devote the necessary time to perform these tasks well. Apart from the question of whether courts are well suited to design complex auctions, there is reason to question the willingness of the bench to devote itself to this task. Certainly, the judiciary's history of relying on crude benchmarks such as the first-to-


229. See, e.g., Resnik et al., supra note 31, at 386 (identifying the risk that judges will select counsel based on docket management concerns); Statement of Keith Johnson to the Third Circuit Task Force on Selection of Class Counsel 2 (May 5, 2001) [hereinafter Johnson Statement], available at http://www.ca3.uscourts.gov/classcounsel/witness%20statements/keithjohnson.pdf (on file with the Columbia Law Review) (warning that shareholder goal of maximizing recovery may conflict with court's incentive to avoid a complex and lengthy trial).

230. See, e.g., Komik & Cohen, supra note 40, at 1123 & n.227 (describing Judge Weinstein's receipt of an "enormous amount of attention and prestige" due to his handling of the Agent Orange class action). The public attention currently focused on abusive class actions and excessive legal fees may also lead courts to favor compensation structures that appear to reduce fee awards even when such structures sacrifice class recovery.

231. For a fairly extreme description of a court's efforts to exercise control over the litigation and settlement of a class action see generally Schuck, supra note 46. According to Schuck, judge Weinstein's involvement in the settlement negotiations was so substantial as to make his approval of the settlement a virtual certainty. See id. at 178–79.
file rule in place of carefully investigating and comparing lawyer quality suggests some reluctance, as does the tradition of seeking resolution of lead counsel appointments by consensus rather than competition. The seeming objectivity of the auction procedure is likely to tempt an overburdened judiciary to place undue reliance on price in general and crude elements of price such as fee caps in particular rather than carefully weighing the nuances of auction design.

3. Judicial Neutrality. — In conducting a lead counsel auction, the court may also bias itself with respect to the future course of the litigation. As the discussion in Part III.B demonstrates, for the court to evaluate competing bids, it must predict the future course of the case. Because counsel is appointed at an early stage, the information available to the court for this task is necessarily limited. Some courts have responded by requiring bidders to predict the likely recovery and to support their prediction. This requirement uses the bidding process to force information from the bidders about the merits of the case. Although these submissions may improve the information available to the court, the bidders, too, lack complete information at this early stage. The discovery and legal research that would enable a firm accurately to estimate recovery are expensive, and it is irrational for a firm to make large expenditures prior to securing the lead counsel position. If some or all of the bidding firms do limited research, the information provided to the court is likely to be of poor quality and may not lead to appropriate judicial estimates.232

Moreover, having gone through the process of estimating the likely outcome of the case, the court may subsequently be reluctant to revise its opinion, even though the opinion is based on ex parte information about the merits of the case from the plaintiffs' perspective.233 The court's conclusions for the purpose of the auction may permanently color its judgment about the case, resulting in a loss of judicial neutrality. A court that has erroneously estimated too low a recovery may approve too cheap a settlement. A court that has mistakenly overestimated the likely recovery may resist good faith efforts to settle the case and be unduly hostile to the defendant's position in settlement negotiations. Such results are particularly likely in cases in which the court's prediction differs substantially from that of counsel. At the extreme, a court's predictions about the case

232. Arguably, the Oracle case demonstrates this risk. The winning bidder submitted a fee schedule suggesting that it expected the case to settle for less than $15 million. This prediction was inconsistent with those submitted by the other bidders, whose schedules clearly anticipated a much larger recovery, and with the actual settlement of $25 million.

233. It is obviously inappropriate for defendants to participate in the selection of class counsel. Indeed, most courts have refused to allow defendants input into the selection of the lead plaintiff. See Fisch, Aggregation, supra note 13, at 54 n.5. Moreover, disclosure of bid information to the defendant can induce strategic litigation behavior. A defendant who knows class counsel will receive a bonus for early settlement may attempt to pressure counsel with a low-ball settlement. The knowledge that counsel has agreed to a fee cap may lead the defendant to impose excessive litigation costs through discovery requests, and so forth, in an effort to undercut the economics anticipated by the firm.
may prevent it from subsequently deciding that the litigation is meritless, such as by granting a motion to dismiss.

A court that has selected counsel through an auction may also have difficulty subsequently awarding a fee that fails to provide counsel with reasonable compensation. How would the Auction Houses court have dealt with the realization that a fair settlement was less than $405 million, if the consequence of approving that settlement was the inability of counsel to collect any fee? Although courts that use auctions generally reserve to themselves the right to modify the fee award when appropriate,234 generous use of such an option would undermine the court’s commitment to the auction and distort the bidding process.

4. Alternative Auctioneers. — One possible response to the problems identified in this Section is to substitute a special master or a second judge to perform some or all of the tasks associated with the auction procedure. Andrew Niebl er has suggested that a special master could be used to conduct preliminary discovery and add information to the auction process.235 Similarly, Alon Klement suggests a private monitor who would select class counsel and determine an appropriate fee arrangement.236 Another alternative is to employ a substitute auctioneer rather than using the trial judge.237 This substitution would most clearly address the neutrality concern identified in Subsection 3 above. A substitute auctioneer would be no better suited to address the price/quality tradeoff identified in Subsection 1 or the more general agency concerns addressed in Subsection 2. An independent auctioneer would also introduce an additional layer of agency problems.

Agency theory indicates that even a disinterested agent may not act in the best interests of the principal.238 The problem is that independence may breed apathy; without sufficient incentive to work hard, the agent may disserve the interests of its principal through inattention or lack of effort. Given the difficult problems posed by appropriate auction design and implementation, there is particular reason to be concerned

234. See, e.g., In re Cendant, 182 F.R.D. 144, 152 (D.N.J. 1998) (stating that auction “will not obviate the Court’s final review of fees and costs pursuant to Rule 23(e)” although “the results of the auction will serve as a benchmark of reasonableness”).


about the agent’s incentive to act diligently. Seemingly routine tasks such as bid evaluation may entail considerable work. The trial judge at least remains responsible for the case outcome and must continue to work with appointed counsel. An independent auctioneer, whose role is limited to selection of counsel, lacks even this minimal accountability.

Corporate law typically responds to concerns about agent apathy by creating incentives for the agent to act in the principal’s interests.239 Similarly, the agency problem of the independent auctioneer could, in theory, be solved through a compensation structure that rewarded the auctioneer based on the results of the auction. For the reasons detailed above, however, judging these results is likely to prove difficult.240 At the same time, the use of an independent auctioneer introduces a second selection issue that, in some ways, duplicates the problem of selecting and compensating class counsel.241 Will the courts need to create a competitive market in auctioneers? What selection criteria should courts employ? Finally, auctioneer compensation creates an additional cost. A compensation level high enough to motivate the auctioneer will reduce recovery to the plaintiff class.

An alternate decisionmaker may nonetheless be preferable to the trial judge for selecting and retaining class counsel. Indeed, the empowered lead plaintiff model described in Part IV below entails the use of such an alternative—a member of the plaintiff class. As that discussion explains, the lead plaintiff model largely addresses the problems identified in this Section. Reliance on a lead plaintiff shields the court from issues of bias. At the same time, the lead plaintiff is both a principal and an agent for the rest of the plaintiff class. Accordingly, the lead plaintiff’s preexisting stake in the litigation provides an incentive for diligence that combats the agency problems described here.


240. An independent auctioneer also introduces a risk of collusion, particularly if the auctioneer is a private individual compensated with a percentage of the recovery or the fee award. See Klement, supra note 236, at 53–58 (describing risk of collusion).

241. See id. at 4–5 (describing an auction structure for selecting a private self-interested individual to act as monitor for the class).
D. Price and Allocation Issues

As explained in Part III.A above, the most defensible basis for using lead counsel auctions is their potential to reduce fee awards and improve the quality of representation. This Section uses auction theory to evaluate the capacity of the lead counsel auction to meet these goals.

In an ideal world, this question could be answered through empirical research comparing the results of cases using lead counsel auctions with comparable cases in which alternative selection methods were used. Unfortunately, this type of analysis is not currently possible. First, the sample size is too small; auctions simply have not been used in enough cases to provide reliable information. Second, many of the current cases involve the use of flawed auction designs, limited competition, or both. Accordingly, the results in these cases provide poor insight into the potential value of an appropriately designed and implemented auction. Third, the task of constructing comparable samples to test the effect of auctions is difficult. Litigated cases differ over a large number of variables, many of which are not readily quantifiable. Fourth, as described above, the apparent results of the auction process can be misleading. In the absence of objective criteria for evaluating the merits of the lawsuit and the quality of the recovery—criteria that, if available, would eliminate the need for auctions—empirical analysis cannot identify whether perceived savings in legal fees were obtained at the cost of reduced attorney effort, poor lawyer quality, or both. In other words, empirical analysis cannot readily capture the effect of auctions on recovery to the plaintiff class.

Auction theory offers an alternative method of analysis. The auction theory literature explains the benefits of auctions, the limitations of the auction methodology, and the conditions under which auctions operate well. Accordingly, auction theory offers some insight into whether auctions are likely to be effective in improving the selection and compensation of class counsel.

1. The Economics of Auction Theory. — The operation of an auction is highly context specific. Auction theory demonstrates that the results of the auction process depend on the auction type. Moreover, the success of an auction is critically dependent on the appropriate auction design, and one size does not fit all. Theorists divide auctions into two

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242. See supra Part II.B.

243. See, e.g., Paul R. Milgrom & Robert J. Weber, A Theory of Auctions and Competitive Bidding, 50 Econometrica 1089, 1093 (1982) (demonstrating that, under idealized independent private values model, the Revenue Equivalence Theorem applies, and all four standard auction models produce the same outcome; this result does not hold, however, under the common value model or with the introduction of factors such as affiliated information, risk aversion, or inadequate competition); see also Paul Klemperer, Auction Theory: A Guide to the Literature, 13 J. Econ. Surv. 227, 235 (1999) (explaining that standard auction types produce very different results in auctions with affiliated information).

basic types: the independent private values auction and the common value auction.\textsuperscript{245} In an independent private values auction, the value of the auctioned object is different for each bidder, and each bidder’s valuation is independent of the value of the object to other bidders.\textsuperscript{246} In the common value auction, the auctioned object has the same value to all bidders.\textsuperscript{247} Auction theory demonstrates that the two models operate quite differently.\textsuperscript{248}

Under the classic assumptions, each bidder in an independent private values auction knows his or her own valuation of the object.\textsuperscript{249} Each bidder’s valuation is private information, unknown to the auctioneer and the other bidders. Auction theory demonstrates that, in such an auction, regardless of the auction structure,\textsuperscript{250} the bidder’s dominant strategy is to bid his or her true value, which equals marginal cost.\textsuperscript{251} In other words, if lead counsel auctions are independent values auctions, it is reasonable to expect firms to submit bids based on their opportunity costs.

The auction then allocates the item to the highest bidder. This allocation is presumptively efficient, because the bidder willing to pay the highest price is the one who values the item most highly.\textsuperscript{252} In the lead counsel auction, the winning bidder would be the firm with the lowest

\textsuperscript{245} See Milgrom & Weber, supra note 243, at 1090–95 (describing both auction models). Real world auctions can rarely be classified as pure independent private values auctions or pure common value auctions. Indeed, some commentators use the term correlated or affiliated value auctions to refer to auctions in which the valuations of individual bidders are independent yet related to each other. See, e.g., McAfee & McMillan, supra note 117, at 720 (describing auctions with correlated valuations); see also Rasmusen, supra note 133, at 246 (describing all three models).


\textsuperscript{247} Id.

\textsuperscript{248} See, e.g., Peter Gamson & Alan Schwartz, Using Auction Theory to Inform Takeover Regulation, 7 J. L. Econ. & Org. 27, 28–29 (1991) (arguing that whether takeover regulation should require an auction depends critically on whether the takeover auction environment is properly characterized as an independent private value auction or a common value auction).

\textsuperscript{249} See id. at 28 (describing classic assumptions that cause traditional English auctions to maximize selling price and generate allocational efficiency and arguing that these assumptions do not apply in takeover context).

\textsuperscript{250} The four standard auction structures are the English auction, the Dutch auction, the first-price sealed-bid auction, and the second-price sealed-bid auction. See Milgrom & Weber, supra note 243, at 1089–90.

\textsuperscript{251} Id. at 1091.

\textsuperscript{252} Id.
opportunity cost. Accordingly, by selecting this firm, the auction minimizes the cost of the litigation. The auction method also produces a price which, from the seller's perspective, is optimal in maximizing revenue, because it has induced the bidder to reveal private information—his value—through the submission of the bid. The auction thus eliminates the need for the court to attempt to estimate a firm’s opportunity cost to determine a reasonable fee.

The alternative common value model differs in several important respects. First, in a common value auction, the value of the auctioned object is unknown. Bidders estimate the item's value, based on the information available to them, and bid accordingly. As in the independent private values auction, price formation is based on the information conveyed by the bids. Indeed, an attractive attribute of common value auctions is that they enable price formation in circumstances in which the value of the item is unknown to both buyer and seller, because the auction process causes the selling price to reflect each bidder’s partial information about the item’s value.

In the common value auction, however, this information is necessarily incomplete. Moreover, a second essential difference between common value auctions and independent values auctions is that the common value literature addresses and rejects the traditional assumption that bidders can costlessly acquire information about the auctioned item's value. Although uncertainty about this value makes it rational for bidders to investigate, this investigation is costly and cannot completely eliminate the uncertainty.

This leads to two consequences. First, unlike independent private values auctions, common value auctions may not maximize the seller's revenue. The winning bidder faces a risk of overpayment because it cannot determine the value of the auctioned item with certainty, a phenomenon known as the winner’s curse. Bidders respond to the risk of overpayment by discounting their bids. As French and McCormick have demonstrated, bidders must also incorporate the sunk costs of the auction procedure, such as their investigation and bid preparation costs,

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253. See, e.g., McAfee & McMillan, supra note 117, at 712-14 (describing the “Revelation Principle” whereby auction functions as a tool to produce price optimality).
254. See, e.g., Harrison, supra note 246, at 123.
255. See, e.g., Milgrom & Weber, supra note 243, at 1094 (explaining how price in common value auctions aggregates private information).
257. In addition, small asymmetries between bidders, which create an “almost common value” auction, can dramatically reduce bid prices. See Paul Klemperer, Auctions with Almost Common Values: The ‘Wallet Game’ and Its Applications, 42 Eur. Econ. Rev. 757, 758 (1998) [hereinafter Klemperer, Almost Common Values].
258. See McAfee & McMillan, supra note 117, at 720-21 (describing winner’s curse).
259. Id. at 721; Rasmussen, supra note 133, at 252.
into their bid price, in order to make participation in the auction profitable. This reduces bid price further and causes the seller to bear the industry’s sunk costs. A particularly unsettling implication of this conclusion is that, in the common value auction, high levels of competition, which increase the industry’s estimation costs, can have the effect of reducing rather than increasing selling price.

Second, the auction may not be allocationally efficient. To the extent that the value of the auctioned item does not vary with the identity of the bidder, the concept of the right winner is inapplicable to a common value auction. Nonetheless, because it is not a winning strategy to bid one’s private value in a common value auction, and because bidders cannot ascertain their private values with certainty, even if there are differences among the bidders, the auction need not allocate the item to the bidder who values it most highly. Accordingly, the lead counsel auction need not award the case to the firm that can litigate it most efficiently.

The investigation costs of the common value auction are potentially burdensome not merely for the seller, but for society as well. Because a bidder benefits from superior information only if that information is private, bidders are unlikely to cooperate, leading to the risk that investigation will be duplicative, excessive, or otherwise socially wasteful. Investigation costs increase as the number of participants in an auction increases and as the degree of uncertainty about the value of the auctioned item increases.

2. Application of the Theory. — Should lead counsel auctions be analyzed according to the independent private values model or the common value model? To determine which model offers the better fit, that is, better predictions about the operation of the lead counsel auction, the


261. See French & McCormick, supra note 260, at 423–24 (explaining that each bidder’s expected payoff falls as the number of bidders increases, and that bidders must therefore adjust their bid prices); Macey, Auction Theory, supra note 260, at 90–91 (explaining that if bidders poorly estimate the number of competitors they may underestimate their potential profits, leading them either to reduce their bids or to fail to participate).

262. See Rasmussen, supra note 133, at 251.

263. See, e.g., Steven Matthews, Information Acquisition in Discriminatory Auctions, in Bayesian Models in Economic Theory 181, 197 (Marcel Beyer & Richard E. Kihlstrom eds., 1984) (concluding that bidders are likely to purchase excessive private information in common value auctions, and that such purchases are costly to both the seller and society).

264. Bidders will not, of course, share the information they uncover; to do so would forsake the competitive advantage they obtain by purchasing such information. Indeed, auction theory indicates that firms may have an excessive incentive to investigate, because small informational asymmetries among bidders can heavily influence auction results. See Klemperer, Almost Common Values, supra note 257, at 758.

265. See, e.g., Macey, Auction Theory, supra note 260, at 93–94 (identifying socially wasteful duplication of bidders’ investigation costs in common value auctions).
most important consideration is the extent to which the value of the case to the bidder is a function of firm-specific attributes versus factors common to all bidders. If value is primarily a function of firm specific attributes such as the skills, costs, and expertise of the bidder, the appropriate auction model is the independent private values model. If, on the other hand, most bidders are likely to pursue the same litigation strategy, incur similar costs, and achieve comparable results, and the value of the case will primarily be determined by the resolution of factual and legal uncertainties, then the common value model is applicable.

There are several reasons to believe that the common value model is the more appropriate choice. First, it seems that the overriding uncertainty in class actions concerns the estimated recovery. Among the factors that affect the recovery are the strength of the case, the factual record, the class size, the provable damages, the settlement funds available, including insurance coverage, and characteristics of the defendants that affect their willingness to settle. Although bidders face substantial uncertainty in quantifying these factors, especially at the early point in the case at which the lead counsel auction is conducted, all bidders face these factors jointly. Thus the value of the case is primarily a function of factors that are common to all bidders but unknown.

Second, under a percentage of recovery fee structure, the return to the winning bidder is primarily a function of the recovery in the case. Even to the extent that bidders differ with respect to the litigation costs they face, the factors that affect the recovery in the case will affect all bidders similarly, leading to affiliated or correlated valuations. In other words, a factor that causes one bidder to view the case as valuable will likely cause other bidders to value the case highly as well. A strong case will be more valuable for all bidding firms; a well-heeled defendant increases the potential recovery for all bidders.

Third, firm specific characteristics are unlikely to affect the value of the case to a bidding firm. The most relevant firm specific characteristic in preparing a bid is the firm’s opportunity cost, which is a function of the alternative uses of the firm’s time. Although, in theory, firms might bid on the basis of their opportunity costs, in reality, these costs are likely to be both unknown and unknowable. In part, this is due to the fact that plaintiffs’ firms are likely to be involved in multiple cases, including other class actions, at any given time. The return on each of those cases depends on the expected time involved and likely recovery, which are both

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266. Cf. Cramton & Schwartz, supra note 248, at 47–48 (analyzing which auction environment is prevalent in the takeover context).

267. Some commentators argue that most common fund litigation does not present substantial risks of nonliability; others challenge that argument. Any risk of nonliability can be reflected, however, by appropriately discounting the predicted recovery.

268. See McAfee & McMillan, supra note 117, at 722 (describing valuations as affiliated “if the fact that one bidder perceives the item’s value to be high makes it likely that other bidders also perceive the value to be high”).
uncertain and continually changing. Further uncertainty is added as ongoing cases are concluded and new cases enter the office. Accordingly, the assumptions of the independent private values model, that a bidder knows its subjective valuation of the auctioned item and that this valuation drives the bidder's strategy, do not apply.

The degree to which firm opportunity costs vary is also unclear. Although firms with greater expertise and experience can presumably represent the class more efficiently, the degree of variance among bidding firms may not be substantial. Even if firms vary substantially in quality, market forces are likely to result in a direct correlation between firm quality and billing rate. The more expert firms will have higher opportunity costs because their expertise makes them more attractive in the market for legal services. As a result, even if a high quality firm can litigate a case more efficiently, it will require higher compensation for doing so. Thus, to the extent that bids reflect firm specific differences in opportunity costs, less qualified firms are more likely to submit lower bids.

This results in the classic lemons problem.269 If the court relies heavily on bid price in the selection decision, high quality firms may be unwilling to incur the costs of bidding to participate in an auction they cannot win. If high quality firms do not compete, the court will face a pool with a high percentage of low quality lawyers. Because they have lower opportunity costs, low quality firms will be able to price their services lower, and will continue to participate.

The foregoing analysis suggests that the common value auction model more closely describes the operation of a lead counsel auction. Three important consequences follow from this characterization. First, the auction theory literature suggests significant reasons to question whether lead counsel auctions are capable of producing quality prices or qualified selection decisions. Second, the operation of common value auctions substantially complicates the task of selecting an appropriate auction design. Third, the lemons problem is likely to affect adversely both the quality of representation in a given case and the overall functionality of entrepreneurial litigation.

With respect to the first point, as described above, a common value auction may result in poor quality price production. In part, this is a function of transaction costs—common value auctions are costly because of the substantial investigation and bid preparation costs entailed, and these costs are ultimately borne by the plaintiff class in the form of higher legal fees.270 In part, the auction structure is itself costly—bidders must discount to reflect the risk associated with the winner's curse problem.


270. Unlike traditional class actions, in which the plaintiff class bears only the investigation costs of plaintiffs' counsel, in a lead counsel auction, the class bears the cost of all the bidders. See French & McCormick, supra note 260, at 424–25 (explaining that
and increased competition among bidders requires increased discounting of bid price. Lastly, the nature of the common value auction magnifies the significance of minor differences between bidders, including informational asymmetries, reputational advantages, and so forth.\textsuperscript{271} This can give one bidder a significant advantage in winning the auction and greatly reduce the price paid by that bidder.\textsuperscript{272} In a lead counsel auction, such an advantage may produce a winning bid that substantially exceeds a reasonable fee award.\textsuperscript{273}

In a common value auction, appropriate auction design is also more important. The Revenue Equivalence Theorem does not hold in common value or affiliated value auctions; hence the choice between standard auction types becomes significant.\textsuperscript{274} Auction results may also be greatly affected by a variety of more complex procedures that appear to be beyond the current scope of lead counsel auction design, including limitations on entry, imposition of entry fees, and the use of reserve prices.\textsuperscript{275} As commentators have warned,\textsuperscript{276} insufficient attention to these details may greatly reduce the seller’s revenues or, in the case of a lead counsel auction, increase the cost of representation.\textsuperscript{277}

The lemons problem is significant for several reasons. First, it is obviously likely to result in the selection of lower quality lawyers. Second, to the extent that the lemons problem decreases participation by high quality firms, it may impact the quality of the auction process. As described in Part III.B, above, auctioning courts have used the information provided investigation costs of all bidders are reflected in the bid price and ultimately borne by the seller).

\textsuperscript{271} Klemperer, Almost Common Values, supra note 257, at 767–68.

\textsuperscript{272} See id. at 758 (“An apparently small advantage can greatly increase a bidder’s probability of winning, and greatly reduce the price he pays when he wins.”).

\textsuperscript{273} It may be argued that the Cendant auction structure gave the winning firms such an advantage by giving them the option to match the lowest qualified bid. This might explain why the Cendant auction produced what seems to be a high fee award.

\textsuperscript{274} See McAfee & McMillan, supra note 117, at 722 (explaining differences in expected revenue depending on auction type used).


\textsuperscript{276} See, e.g., Chakravorti et al., supra note 256, at 347 (explaining the importance of appropriate auction design in radio spectrum auctions); Klemperer, Almost Common Values, supra note 257, at 760–64 (describing several cases in which auctions with almost common values produced poor price results); Klemperer, Matters, supra note 244, at 6 (explaining that even bidders with no costs of participation can be driven out of poorly designed common value auction).

by bidding firms to predict recovery and evaluate competing bids. Lower quality firms may provide the court with qualitatively poor information about the case with which to perform these tasks. Finally, anticipating a lemons problem, high quality lawyers may refrain from investigating misconduct at the pre-filing stage, because they would fail to capture the rewards of their efforts if the court, through an auction, awarded representation to a low bidding latecomer. Accordingly, the widespread use of lead counsel auctions may reduce the effectiveness of entrepreneurial litigation in deterring misconduct.

IV. Auctions Versus What? The Lead Plaintiff Alternative

As indicated above, it is difficult to evaluate the lead counsel auction without an appropriate benchmark. Shortcomings in the current regulatory approach and deficiencies in the existing fee jurisprudence foster the temptation to regard any alternative as an improvement. Lead counsel auctions have not developed in a vacuum, however. Over the past five years, as courts have experimented with auctions, Congress has provided an alternative.

A. The PSLRA and the Statutory Lead Plaintiff

In 1995, Congress adopted the PSLRA. As part of its package of statutory reforms, the PSLRA establishes a statutory lead plaintiff, which is presumptively the investor with the largest interest in the case. The statute then vests the lead plaintiff with a degree of control over the litigation process. Significantly, for purposes of this Article, the statute empowers the lead plaintiff to select and retain lead counsel, subject to the approval of the court.

As its legislative history indicates, the statute contemplates the active involvement of large investors, particularly institutional investors. According to its creators, law professors Elliott Weiss and John Beckerman, the lead plaintiff provision was designed to enable large, sophisticated

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279. The court is required to appoint as a lead plaintiff, the “member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members.” 15 U.S.C. § 78u-4(a)(3)(B)(i) (Supp. V 1999). The statute provides a rebuttable presumption that the most adequate plaintiff is the person or group with the largest financial interest in the claim. Id. § 78u-4(a)(3)(B)(iii)(1)(bb).

280. See generally Fisch. Aggregation, supra note 13, at 61 (describing the lead plaintiff provision).


282. See Fisch. Aggregation, supra note 13, at 71 n.131 (describing legislative history regarding involvement of institutional investors).
investors to investigate, negotiate with, and monitor class counsel. As such, the provision was expressly designed as a market-based alternative to the existing regulatory approach. Weiss and Beckerman contemplated that institutions would develop continuing relationships with plaintiffs’ firms and that, as repeat players in securities litigation, large investors would be able to develop case review criteria, procedures to identify and evaluate prospective counsel, standardized retention agreements, and so forth.

Early experience under the PSLRA was mixed. Initially institutional investors appeared reluctant to seek lead plaintiff status. Additionally, courts have varied in their interpretations of the lead plaintiff provision, with some courts adopting views that limit the involvement or the power of institutional investors. Nonetheless, as institutions have obtained greater familiarity with the PSLRA, they have increased their involvement. At the same time, a number of institutions have begun to consider carefully how best to function effectively as lead plaintiffs and to rationalize their approaches to the selection and retention of lead counsel. These developments will be described in the following Section.

B. Institutional Selection Procedures

Institutional participation in securities litigation has clearly increased since the adoption of the PSLRA. Many institutions are developing the types of practices that Weiss and Beckerman envisioned. Institutions are developing sophisticated fee structures and retention agreements. They are forging ongoing relationships with class action counsel. And, in many cases, institutions are negotiating competitive fee agreements that provide for lower fees than those typically awarded by courts.

The quantity of institutional involvement to date is insufficient for formal empirical analysis. Instead, this Article has assembled illustrative and experiential information on developing practices by institutional investors. The information is collected from a variety of sources, including public statements by institutional investors, litigation papers that describe the selection procedures used in particular cases, formal interviews, and informal discussions. The material set forth below does not purport to reflect the full range of institutional experiences to date; rather, it at-


284. See Weiss & Beckerman, supra note 26, at 2106–07.


286. Fisch, Aggregation, supra note 13, at 74, 92–93 (explaining how appointment of lead plaintiff groups or use of lead counsel auctions thwarts institutional involvement).
tempts to demonstrate the methodologies institutions are currently employing.

Although there are several instances of institutional involvement in securities litigation prior to the adoption of the PSLRA, the formalization of the statutory lead plaintiff generated a much greater quantity of participation. Institutions have struggled with a variety of issues as they seek to develop and rationalize their participation in litigation. These issues include when to become involved in securities litigation, how to identify prospective lead counsel, what criteria to use in selecting counsel, methodologies for fee structure and negotiation, and the appropriate degree of participation in the ongoing litigation subsequent to the selection of counsel.

On the question of when to become involved, institutions have identified several relevant criteria, including their perception that the case has merit, the size of their interest in the case, and the potential impact that they can have by becoming involved. Significantly, unlike the court, which typically lacks significant case specific information at the time it is required to appoint lead counsel, institutions evaluate the merits of the case and the size of their losses at the threshold stage, prior to commencing the search for counsel. The State of Wisconsin Investment Board (SWIB), for example, maintains several law firms on retainer for the specific purpose of reviewing filings and determining whether it should get involved. This evaluation provides a benchmark for the institution in evaluating litigation proposals and fee structures by prospective lead counsel. Institutions typically screen cases and decline to become involved unless their losses are substantial. Institutions also seek to add value through their involvement. Often they will decline to seek lead plaintiff status if another capable institutional investor is actively involved.

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287. See Fisch, Reform, supra note 285, at 539-40 (describing institutional involvement in securities litigation over Intel Pentium chip and in In re California Micro Devices Securities Litigation, 169 F.R.D. 257 (N.D. Cal. 1996)).

288. Telephone Interview with Kayla Gillan, General Counsel, California Public Employees' Retirement System (Feb. 14, 2001) [hereinafter Gillan Interview] (explaining that California Public Employees' Retirement System employs its case review policy prior to choosing counsel).

289. Telephone Interview with Keith Johnson, Chief Legal Counsel & Cynthia Richson, Investor Responsibility Program Officer, State of Wisconsin Investment Board (Nov. 20, 2000) [hereinafter Johnson & Richson Interview].

290. See, e.g., Telephone Interview with Horace Schow, II, General Counsel, Florida State Board of Administration (Apr. 10, 2001) [hereinafter Schow Interview] (explaining that Florida fund will typically not get involved unless its losses exceed $2 million or, in some cases, $5 million); Gillan Interview, supra note 288 (accounting that, because of the California Public Employees' Retirement System's investment strategy, it generally does not suffer trading losses sufficient to justify its involvement).

291. See Gillan Interview, supra note 288 (describing key criterion as whether CalPERS can add value and noting that "if there is another active institution that will get involved, we're not necessary"); Johnson & Richson Interview, supra note 289 (explaining
Once institutions decide to proceed, they take different approaches. Some institutions, including SWIB and the New York City Employees' Retirement System (NYCERS), identify and select counsel on a case-by-case basis. Others, including the California Public Employees' Retirement System (CalPERS) and the Florida State Board of Administration (FSBA), have created a pool of prospective lead counsel in advance and choose counsel from that pool when a specific case arises. An institution may also choose a single firm to represent it on a long term basis.

In either case, the institution's first task is to identify prospective firms to serve as lead counsel. Toward this end, institutions have used a variety of procedures. Some institutions rely primarily on contacts initiated by counsel. Catharine LaMarr, General Counsel for the Office of the Treasurer of the State of Connecticut, explains that it is generally unnecessary for Connecticut to seek out prospective lead counsel because it is continually approached with proposals. Several institutions have developed more proactive procedures for identifying prospective counsel, such as preparing and circulating a request for proposals, seeking recommendations, inviting proposals from firms that have performed well in similar cases, and making use of repeat relationships. Some institutions have also made an affirmative effort to solicit proposals from

that institutions can be most effective by spreading their resources and taking turns in order to get involved in as many cases as possible.

292. See Johnson & Richson Interview, supra note 289; Interview with Lorna Bade Goodman, Senior Assistant Corporation Counsel, New York City Law Department (Oct. 13, 2000) [hereinafter Goodman Interview].

293. See Gillan Interview, supra note 288; Schow Interview, supra note 290.


295. Telephone Interview with Catherine LaMarr, General Counsel, Office of the Treasurer of the State of Connecticut (Nov. 14, 2000) [hereinafter LaMarr Interview].

296. See, e.g., Gillan Interview, supra note 288 (describing process of inviting prospective lead counsel to apply for position by sending letters to the universe of potential firms and posting invitation on CalPERS website); Johnson & Richson Interview, supra note 289 (explaining that SWIB solicits proposals from firms that have filed a complaint in the case, firms that have contacted SWIB, and nontraditional plaintiffs' firms); Declaration of Roger Pugh at 2, In Re Candant Corp. Litig., 98 F. Supp. 2d 602 (D.N.J. 2000) (No.98-2819) [hereinafter Pugh Declaration] (describing procedures used by the New York City Pension Funds to identify prospective lead counsel in Candant).

297. The New York State Common Fund, for example, has used formal requests for proposals. Goodman Interview, supra note 292; see also LaMarr Interview, supra note 295 (explaining that Connecticut has not used requests for proposals but is likely to do so in the future); cf. Telephone Interview with George Kim Johnson, General Counsel, Colorado Public Employees Retirement Association (Feb. 2, 2001) [hereinafter Johnson Interview] (questioning whether requests for proposals are appropriate given the difficulty in quantifying professional services).

298. See, e.g., Johnson Interview, supra note 297 (describing use of recommendations and review of other cases to identify prospective lead counsel).
firms that do not traditionally represent plaintiffs in securities fraud class actions in order to increase the level of competition.299

Institutions then use a variety of criteria to select from among the prospective firms either counsel for a specific case or a group of counsel that can be employed on a rotating basis as litigation opportunities arise.300 In either case, the selection process appears highly competitive. Institutions choose from a large number of interested firms,301 focus their efforts on a group at least as large as the group that participates in a typical lead counsel auction,302 and then apply a detailed evaluation process.

The criteria include both price and quality factors. Unlike courts employing the regulatory approach, institutional lead plaintiffs consider price during the selection process. Nonetheless, institutions repeatedly stress that they are unwilling to make their selection decisions on the basis of price alone, emphasizing the importance of quality criteria.303 As Horace Schow explains, "I'm not sure I want to get my brain surgeon as the lowest bidder."304 Institutions describe a more detailed inquiry into quality factors than is reflected in auction decisions.305 Institutions report checking refer-


300. See Gillan Interview, supra note 288 (explaining that advance identification of a qualified pool is necessary due to time constraints in specific cases).

301. See, e.g., id. (stating that approximately thirty firms applied for positions as part of CalPERS's pool).

302. See, e.g., Declaration of Keith L. Johnson in Support of State of Wisconsin's Investment Board's Motion for Approval of Selection of Lead Counsel at 1, Charles Dechter Family Trust v. Anicom, Inc., No. 00-C-4391 (N.D. Ill. Nov. 10, 2000) [hereinafter Johnson Declaration] (describing review of proposals from nine law firms); Pugh Declaration, supra note 296, at 2 (describing personal interviews with seven law firms in Cendant litigation); Affidavit of Hilary B. Klein in Opposition to the Motion of the New York State Pension Fund Group for Appointment as Lead Plaintiff at 2, Aronson v. McKesson HBOC, Inc., No. CV99-02920 (N.D. Cal. Aug. 25, 1999) [hereinafter Klein Affidavit] (describing contact with eight firms and evaluation of six); Gillan Interview, supra note 288 (describing personal interviews with eight to nine firms).

303. See, e.g., Pugh Declaration, supra note 296, at 3 (identifying "high quality legal work and reasonable price" as the "two principal criteria for the selection of lead counsel").

304. Schow Interview, supra note 290. Keith Johnson expressed the sentiment in virtually the same terms: "I don't necessarily want to have surgery performed on me by the cheapest doctor." Johnson & Richson Interview, supra note 289.

305. See Johnson Interview, supra note 297 ("Auctions are pure competition—there's not much evaluation.").
ences, reviewing performance in other comparable cases, and even checking writing samples from prospective counsel. Every institution requires an analysis of the case and a summary of proposed litigation strategy; institutions report that the submissions vary dramatically from one firm to another. Institutions also indicate that they consistently use in-person meetings or beauty contests in addition to reviewing paper submissions. Finally, institutions typically involve several people in the evaluation process rather than relying on a single decisionmaker.

Institutions seem to consider a number of quality criteria that do not play a part in the judicial analysis of firm quality. For example, institutions value firm style and client relationship issues. They place considerable importance on identifying a firm with which they can develop a good working relationship, and cite joint decisionmaking and regular reporting as important priorities. As Kayla Gillan explains, “selection of counsel is pretty personal.” Institutions identify concerns about firm unwillingness to remain accountable to the client and also hardball litigation.

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306. See, e.g., LaMarr Interview, supra note 295 ("We ask for references and check them.").

307. See, e.g., Gillan Interview, supra note 288 (describing review of litigation experience in post PSLRA cases); Johnson Interview, supra note 297 (describing evaluations of prospective lead counsel obtained from other funds).

308. See, e.g., Klein Affidavit, supra note 302, at 2 (describing review of writing samples).

309. See, e.g., Johnson Interview, supra note 297 (reporting that firm outlines of litigation plans vary greatly).

310. See Klein Affidavit, supra note 302, at 2 (describing detailed questioning of law firms about “the facts and the law relating to the McKesson litigation, their views on the probabilities of success and the difficulties likely to be encountered in prosecuting the action on behalf of the class, and the firm’s experience in prosecuting actions of a similar nature”).

311. See, e.g., Johnson Declaration, supra note 302, at 1 (describing use of selection panel); Affidavit of Catherine E. LaMarr in Opposition to the Taft Hartley Pension Group’s, the Waste Management Plaintiffs Group’s and the WMI Institutional Shareholder Group’s Respective Motions for Appointment as Lead Plaintiff and Approval of Their Respective Selections of Counsel and in Opposition to the Appointment of an Option Subclass Lead Plaintiff at 3, In re Waste Mgmt., Inc. Sec. Litig., 128 F. Supp. 2d 401 (S.D. Tex. 2000) [hereinafter LaMarr Affidavit] (recounting joint effort by Connecticut State Treasurer’s office and State Attorney General’s office to select and retain counsel); Gillan Interview, supra note 288 (describing the use of lawyer consultants to assist in selection of counsel).

312. See, e.g., Goodman Interview, supra note 292 (explaining that NYCERS looks for intellect and integrity; trial experience is not significant).

313. See, e.g., Gillan Interview, supra note 288 (explaining the importance of both a firm’s litigation philosophy and how the firm deals with having a real client as opposed to a passive class).

314. See, e.g., LaMarr Affidavit, supra note 311, at 4 (describing reporting requirements and strategic discussions provided in retention agreement).

315. Gillan Interview, supra note 288.
tion tactics as reasons to reject candidates.\textsuperscript{316} Institutions also stress firm preparation. By personally interviewing candidates, institutions are able to gauge each firm's degree of investigation and the appropriateness of the proposed litigation strategy.\textsuperscript{317} Finally, institutions convey a nuanced sense of the importance of firm expertise, describing the selection process in terms of the best firm for a particular case. This description appears to refer to the price/quality tradeoff and conveys the recognition that the necessary level of expertise is likely to be a function of case-specific characteristics.

After identifying qualified candidates, institutions then use the candidates' price proposals as a starting point for negotiating the price and structure of the fee agreement.\textsuperscript{318} Institutions explain this process as identifying a quality firm and then using the negotiation process to minimize price and to obtain a fee structure that minimizes agency costs.\textsuperscript{319} Unlike some courts that have conducted auctions, institutions appear acutely sensitive to agency issues and readily defend their chosen fee structure in terms of minimizing agency costs.\textsuperscript{320} Institutions have experimented with creative fee structures designed to address these concerns.\textsuperscript{321} Moreover, institutions explain that they have enjoyed consider-

\textsuperscript{316} See, e.g., LaMarr Interview, supra note 295 (explaining importance of firm strategy and reputation, as well as compatible style: "The approach must meet our objectives. We don't want slash and burn litigation.").

\textsuperscript{317} See, e.g., Klein Affidavit, supra note 302, at 2 (describing process of interviews conducted); Johnson & Richson Interview, supra note 289 (explaining how personal interviews in \textit{Just for Fees} litigation, Burke v. Ruttenberg, 102 F. Supp. 2d 1280 (N.D. Ala. 2000), enabled SWIB to identify firm that had done detailed investigative work). Importantly, this evaluation allows the lead plaintiff to reward a lawyer who has conducted original investigation and brings misconduct to the attention of the investor. In contrast, the auction reduces or eliminates counsel's ability to profit from such investigation.

\textsuperscript{318} See, e.g., Pugh Declaration, supra note 296, at 3, ex.A (explaining how initial bids were used as bargaining points in fee negotiations and presenting fee grids detailing initial fee proposals).

\textsuperscript{319} See Goodman Interview, supra note 292 (explaining process of using firms' fee proposals to negotiate lower fees); Johnson & Richson Interview, supra note 289 (explaining that one does not always get the lowest fee from the first choice firm, and that SWIB has generally tried to balance price and quality and to negotiate the fee down from the firm's original proposal).

\textsuperscript{320} Institutions relate a high degree of sensitivity to both agency issues and case specific factors. See, e.g., Goodman Interview, supra note 292 (defending preference for declining percentage fees balanced with a lodestar crosscheck); Johnson Interview, supra note 297 (explaining that fees vary considerably in both amount and structure depending on the nature of the case); LaMarr Interview, supra note 295 (arguing that Connecticut's fee structure provides a basis for adjusting to individual case differences); Schow Interview, supra note 290 (explaining that a case involving a smaller potential recovery may require a higher fee percentage to give counsel sufficient incentive to "litigate hard"); see also Keith L. Johnson, Institutional Investor Participation in Class Actions After the Private Securities Litigation Reform Act of 1995, \textit{A.L.A.B.A.}, Nov. 7-8, 1996, at 379, 388-89 (defending fee structure in Cellstar on the basis that it minimized agency costs).

\textsuperscript{321} Kim Johnson, for example, has negotiated an hourly fee rather than a contingency fee in circumstances in which there clearly would be a settlement. Another
able leverage in fee negotiations and cite retainer agreements that provide for considerably lower fees than the traditional class action benchmarks. Even those institutions that place less emphasis on minimizing price report fee structures below the reported benchmarks.

Institutional involvement typically does not end after the selection of counsel. Institutions report ongoing supervision of the litigation process. They review pleadings, sometimes making substantial revisions or edits, discuss litigation strategy, and monitor settlement discussions. In some cases, institutions have participated actively in the settlement negotiations. Some institutions also monitor counsel’s work effort during the course of the litigation, reviewing time records and similar data.

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alternative is to provide a bonus payment to counsel if the recovery level is a sufficiently high percentage of the losses claimed. Johnson Interview, supra note 297. Johnson also explains that the up-front payment of litigation expenses relieves cash flow pressure on a small firm, thereby reducing its incentive to push for a quick settlement. See also Pugh Declaration, supra note 296, at 4–5 (explaining how negotiated fee structure in Conti· and contained safeguards to address uncertainty about the extent of recovery).

322. See, e.g., LaMarr Interview, supra note 295 (explaining that law firms are highly motivated to work with Connecticut in securities litigation, and that this offers a competitive advantage in negotiations).

323. See, e.g., In re Conseco, Inc. Sec. Litig., 120 F. Supp. 2d 729, 732–34 (S.D. Ind. 2000) (describing representation by Anchorage & Louisiana Fire that they had negotiated a percentage fee structure that is substantially below typical fee awards in securities class actions); State of Wisconsin Investment Board’s Motion for Approval of Selection of Lead Counsel at 6–7, Charles Dechter Family Trust v. Anicom, Inc., (N.D. Ill. 2000) (No. 00-CV-4391) (explaining SWIB’s competitive bidding process as resulting in lower fee awards and citing example of 15% fee award in In re Physician Computer Network Sec. Litig., Civ. No. 98-981 (D.N.J.)); Klein Affidavit, supra note 302, at 3 (describing negotiated retainers as providing fees “significantly lower than the original fee structures proposed”); LaMarr Affidavit, supra note 311, at 5 (describing fee schedule as providing lower fees than those typically awarded); Daniel Wise, Big Apple, Empire State Vio to Control Stock Suit, Nat’l L.J., July 19, 1999, at A5 (quoting assistant corporation counsel Hilary Klein as stating that the city’s fee agreement with its counsel in McKesson provides for fees of less than 10% of the recovery).

324. See, e.g., Schow Interview, supra note 290 (acknowledging that Florida has been less aggressive than some institutions in seeking to minimize fees but describing typical fee range as 20%–25%, sometimes less).

325. See Goodman Interview, supra note 292; LaMarr Interview, supra note 295.

326. Johnson Interview, supra note 297 (describing how Colperta monitors ongoing litigation and participates in settlement negotiations).

327. See, e.g., Schow Interview, supra note 290 (describing importance of institutional presence at settlement discussions and recounting attendance at mediation session); Johnson & Richson Interview, supra note 289 (describing Johnson’s “intimate involvement” in Cellstar settlement negotiations).

328. See Johnson Interview, supra note 297 (describing review and approval of hours expended on a monthly basis).
In summary, the selection process employed by institutions closely resembles the process by which corporations select legal counsel. Institutions report using a variety of methods to increase competition and to identify a wide pool of candidates. They are developing selection criteria that are case specific and reflect a combination of price and quality considerations. They are increasing their knowledge of market rate fees and becoming familiar with both traditional and alternative fee structures. This familiarity, coupled with their bargaining power, has enabled them to negotiate reduced fees.

Moreover, institutional investors do not approach selection of counsel in securities litigation as novices. Like corporations, institutional investors are repeat players in the market for legal services. Most institutions are accustomed to hiring outside counsel routinely, using some type of competitive basis and evaluation process that considers price and quality. Finally, because of their careful up-front work assessing their interest in the case, institutions profess an ability to measure the results of counsel’s efforts by comparing the recovery to the claimed losses. As George Kim Johnson has observed, given this experience, it is not clear what value judicial involvement adds to the selection process.

C. Advantages of Institutional Procedures

Both the characteristics and the developing practices of institutional investors are well suited to address inadequate competition and lack of information, the potential causes of market failure. Evaluated against the goal of creating a functioning market for legal services, institutional empowerment appears to be a viable solution. Importantly, negotiation by institutions offers several advantages over both traditional judicial selection of counsel and lead counsel auctions.

Institutional investors can clearly generate a competitive selection process. They have used a range of approaches, each of which effectively pits competing firms against each other. By using a variety of methods to identify prospective firms, and by actively soliciting participation until they have considered a reasonable number of firms, institutions can ensure sufficient levels of participation to generate competitive prices. Significantly, institutions appear to generate greater law firm participation.

329. Indeed, a number of institutions have directly modeled their selection procedures on the market for corporate legal services, some going so far as to hire outside counsel to teach them how to run a beauty contest.

330. The institutional experience can be contrasted with the seeming inability of contingency fee plaintiffs to negotiate deviations from benchmark rates such as 33%.

331. See Johnson Interview, supra note 297. Kayla Gillan explains, “I have been picking outside counsel for fifteen years. I know how to pick; I know how to monitor.” Gillan Interview, supra note 288.

332. See Johnson Interview, supra note 297; Schow Interview, supra note 290. Schow explains that, because institutions are repeat players, they have an advantage over the court in measuring damages. Id.

333. Johnson Interview, supra note 297.
through their selection procedures than the typical lead counsel auction.334

Institutional negotiation enhances competition. In an auction, the court is limited to the bids submitted. The fact that a bid is the lowest need not make it reasonable, particularly given the limitations on the ability of auctions to generate optimal prices.335 In a negotiated process, the lead plaintiff can gauge the market by reviewing various firms’ proposals and then use this information to secure a better price than that initially proposed.

By acting as repeat players, institutions learn the market, enabling them to act, much like corporate clients, as sophisticated purchasers of legal services. Institutions explicitly describe the learning curve that has enabled them to refine their negotiations both through repeated participation and by becoming familiar with likely recovery amounts and the litigation processes necessary to obtain these recoveries. Importantly, as frequent class members, institutions can develop extensive information on the range of legal services available. An institutional investor such as the FSBA, which has participated in dozens of class actions, is likely to have far more extensive knowledge of the marketplace than a judge whose docket includes a handful of securities cases.336

Additionally, institutional investors increase their information base through activities that extend beyond securities litigation. Institutions select and retain counsel for a variety of purposes. Many institutions have developed competitive procedures for evaluating and selecting lawyers prior to becoming involved in securities litigation. Accordingly, institutions can draw upon their other experience in the legal marketplace to evaluate, select, and negotiate most effectively.

Institutional selection offers several advantages over lead counsel auctions. One substantial difference between lead counsel auctions and the more traditional auctions used to sell artwork and oil wells is that the former involves the sale of a service contract. As previously indicated, as auctioneer, the judge acts reactively toward many of the contract terms, such as the structure of the fee arrangement, the specified contingencies, and the treatment of costs. If the judge specifies a particular structure,

334. Institutions also appear willing to consider a broader range of firms, thus increasing competition. See, e.g., LaMarr Statement, supra note 299, at 2 (describing Connecticut’s chosen firms as including “a large, full service law firm,” a local “boutique securities litigation firm,” and a “minority-owned firm”).


336. See, e.g., In re Oracle Sec. Litig., 131 F.R.D. 688, 695–96 (N.D. Cal. 1990) (explaining that judges rarely have necessary market information to permit competent evaluation of reasonableness of proposed fee award).
he or she makes value judgements about various contract terms that may not be appropriate and may thwart innovation.\textsuperscript{337}

Institutional negotiations, in contrast, allow both greater tailoring of contract terms, and the opportunity to make tradeoffs between different aspects of the contract. The contractual detail described by institutional investors demonstrates the richer contracting capacity that can be achieved through a negotiated selection process. Institutions describe contract provisions that set forth anticipated litigation timetables and structure monitoring of lawyer effort and output.\textsuperscript{338}

Enhanced contracting capacity also permits institutions to develop creative fee structures. For example, institutions report negotiating complex contracts that address both incentives and agency costs, such as increasing percentage of recovery fee structures that are limited in size through lodestar or other types of cross-checks or hourly fees coupled with bonuses.\textsuperscript{339} Institutions describe fee structures that permit higher rewards when counsel succeeds in recovering from more culpable defendants.\textsuperscript{340} Institutions explain fee structures that reward counsel for pursuing nonmonetary benefits, such as corporate governance reforms.\textsuperscript{341} Finally, institutional fee structures, unlike those set by auction, typically permit some adjustment, with the institution's consent, in the event of unanticipated litigation developments, thereby reducing the risk that poorly operating fee incentives will induce inappropriate litigation decisions.\textsuperscript{342} The institution's reputation and repeat player role enable the institution to credibly commit to these adjustments, freeing counsel from the need to price the risk of unanticipated litigation developments into the fee structure. At the same time, the fact that the institution bears the cost of such adjustments in the form of a lower recovery limits the risk that institutions will respond too readily to midstream requests for increased fees.

\textsuperscript{337} Significantly, although courts have typically limited fee structures to a choice between the lodestar and percentage of recovery methods, the literature reflects a broader range of options. See, e.g., Painter, supra note 122, at 4-5 (proposing fee structure called "the New American Rule" based on the lower of a lodestar and a percentage of recovery award and reviewing other proposals for contingent fee reform).

\textsuperscript{338} See Goodman Interview, supra note 292; LaMarr Interview, supra note 295.

\textsuperscript{339} See Goodman Interview, supra note 292; Johnson Interview, supra note 297.

\textsuperscript{340} See Johnson & Richson Interview, supra note 289; see also Letter from the Public Pension Funds to the Hon. William H. Walls (Aug. 17, 1998), in Pugh Declaration, supra note 296, ex.C at 2 (identifying concern that auction procedure will not adequately address the importance of recovery from Ernst & Young).

\textsuperscript{341} See, e.g., Schow Interview, supra note 290.

\textsuperscript{342} See, e.g., Letter from The Association of the Bar of the City of New York, Committee on Federal Courts to Third Circuit Task Force on Selection of Class Counsel (May 8, 2001) (identifying potential for mid-case adjustments of fee arrangements in light of unanticipated consequences as an advantage of empowered lead plaintiffs over auctions); Johnson Statement, supra note 229, at 5 (citing retention of flexibility to adjust fee agreement in light of changed circumstances as "a hallmark of client-directed litigation").
Institutional negotiations can also directly counter some of the factors that weaken the ability of lead counsel auctions to produce reasonable fees. The winner’s curse problem, for example, can be reduced through the potential for midstream fee adjustments or more complex contracts. To the extent that institutional participation reduces counsel’s risk of undercompensation, counsel need not compensate for that risk by demanding a higher overall fee. Similarly, although auction theory suggests that firms will seek excessive fees to compensate them for investigation costs, institutions can make a firm’s investigation less expensive through participating in fact development and analysis. By developing case specific information and disclosing it to prospective counsel, an institution can both reduce counsel’s costs and increase efficiency because the information can then be used in the case, unlike information obtained by prospective auction bidders, most of which is ultimately wasted. Institutions can also reduce socially wasteful investigation and bid preparation costs by dividing the selection process into stages and screening prospective counsel prior to requiring them to perform detailed investigations.

Finally, and most importantly, institutional investors are clients. When they select counsel and negotiate a fee agreement, they are acting as principals, not agents.343 As suggested above, clients are not motivated by the same factors as courts in selecting and retaining counsel.344 The difference seems particularly relevant to the price/quality tradeoff; institutional investors do not place the same importance as courts on price minimization. For a court, the easiest factor to evaluate in a proposed fee agreement is price—specifically the percentage of the recovery reflected in the fee award. Price offers the court a seemingly objective standard, and one that facilitates review through the traditional judicial methodology—comparison with other cases. Price dominance also frees a court from the need to develop complex formulas to weigh price relative to lawyer quality. These factors encourage courts to focus primarily on minimization of legal fees.

On the other hand, clients rarely view minimizing counsel’s fee award as the dominant goal; clients typically seek to maximize their recovery.345 Institutions describe their priorities in these terms and explain that price minimization is inconsistent with maximizing recovery. Moreover, institutions seem to take quality quite seriously, evaluating prospective counsel on a far wider range of quality factors than the courts.

343. To the extent that their interests diverge from those of other class members, institutions are also agents and subject to traditional agency cost analysis. This Article takes the position that such divergence is limited in the context of securities litigation. For further discussion of this issue, see infra notes 355–357 and accompanying text.

344. See, e.g., Johnson Statement, supra note 229, at 2 (identifying ways in which interests of institutions and other class members may diverge from those of other players in the litigation).

345. The maximum recovery may of course include nonmonetary factors in addition to money damages. See infra note 346.
By emphasizing quality evaluation, institutional investors can address factors that fall completely outside the auction process, such as the societal impact of the litigation and the value of rewarding original investigations that uncover bases for liability. The interest of institutional investors in pursuing particular types of cases, such as those that enhance overall deterrence or increase market safety, is likely to generate increased investigation efforts by prospective lead counsel. Institutional unwillingness to seek lead plaintiff status in cases viewed as frivolous will discourage lawyers from filing strike suits. At the same time, the interest and involvement of large investors at the prefiling stage may reduce costs and facilitate the success of entrepreneurial lawyers at the preliminary investigation stage.

As the background and legislative history to the lead plaintiff provision explain, institutions are well suited to perform these tasks due to their experience, relative sophistication, and substantial stakes in the litigation. The dollar amount at issue for a large institution provides a tangible incentive for the institution to invest the necessary time and effort to identify qualified counsel, negotiate a reasonable attorney’s fee, and develop a fee structure that minimizes agency costs. Unlike the court, the lead plaintiff with a substantial interest in the case has a financial interest in maximizing the net recovery to the plaintiff class, and inferior fee structures adversely affect its expected return from the lawsuit.

One additional point should be addressed. Even if institutional negotiations are superior to lead counsel auctions in addressing price and quality considerations, auctions have been widely used in government contracting to address concerns about collusion and favoritism. With the growing involvement of public pension funds, which are also political actors, as lead plaintiffs, it is necessary to consider whether auctions are warranted to limit political influence on case selection and counsel selection.

346. One important nonmonetary factor in securities litigation is the potential to obtain corporate governance reforms through the settlement. The extent to which lead plaintiffs should pursue governance reforms in securities litigation is an interesting question. Pursuit of such reforms may make securities litigation more of a positive sum game. Moreover, governance reforms arguably can improve corporate and market performance to the benefit of all investors. Nonetheless, it can be argued that pursuit of nonmonetary forms of recovery creates a conflict between class members who are continuing investors in the defendant corporation and those who are not. This Article will not attempt to resolve the issue except to observe that, for the moment, institutions state that they are not sacrificing damages in favor of governance reforms. See Schoff Interview, supra note 290. As institutions become increasingly involved with monitoring litigation decisionmaking, however, it will become important to determine the extent to which such a sacrifice would be appropriate.

347. See, e.g., Fisch, Aggregation, supra note 13, at 74, 92–93 (describing background and legislative history as detailing advantages of participation by institutional investors).

348. See supra note 138 and accompanying text.

349. See Cohen, supra note 137, at 1352–54 (advocating use of auctions in order to eliminate such political influence).
Two troubling scenarios are possible. The more obvious risk is that a fund will choose a law firm on the basis of political contributions made by that firm to the fund or politicians with political control over the fund. In the Cendant case, for example, a competing lead plaintiff applicant alleged impropriety because two of the firms selected by New York State to represent it in securities fraud litigation had made substantial contributions to the State Comptroller’s campaign for reelection.350 Although the allegation of impropriety was unproven, the court defended its decision to use an auction, in part, as addressing this concern.351 A second and more subtle risk is that public pension funds may face political pressure from politicians as to which law firms to hire and which cases to enter.

Political corruption in the selection of class counsel is a serious concern. As the SEC has warned, selection of a firm after political contributions by the firm to the lead plaintiff’s decisionmaker warrants serious scrutiny.352 More generally, political pressure at any stage of the litigation process can cause an institutional investor’s interests to diverge from those of other members of the plaintiff class. Currently, however, these concerns fail to rise to the level of justifying an auction. Despite widespread allegations of misconduct and mudslinging in recent battles over the selection of lead plaintiff and class counsel,353 and the incentives for competing lead counsel applicants to uncover wrongdoing, there are no reported cases in which improper political influence has been demonstrated.354 Moreover, reports of successful attempts to game government auctions are rampant, and as indicated above, judges too are susceptible to political influence, although it is influence of a different kind. Finally, as the preceding discussion of the price/quality tradeoff demonstrated, attempts to curtail the role of judgment in the selection process are most likely, as is often the case in government contracting, to sacrifice quality.

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350. See Wise, supra note 323 (describing allegations of pay-to-play).
351. See In re Cendant Corp. Litig., 182 F.R.D. 144, 152 (D.N.J. 1998) ("[N]otwithstanding the absence of proof of pay-to-play, the auction is salutary because it removes any speculative doubt about that issue.").
353. See, e.g., Z-Seven Fund, Inc. v. Motorcar Parts & Accessories, 231 F.3d 1215, 1217 (9th Cir. 2000) (describing counsel’s “shriil allegations of unethical conduct” in competing for lead counsel appointment); In re Network Assocs, Sec. Litig., 76 F. Supp. 2d 1017, 1031 (N.D. Cal. 1999) (recounting “inflammatory charges of fraud, incompetence, and solicitation—even allegations of criminal conduct”).
354. Despite Ms. Cohen’s assertions that paying-to-play is widespread, she cites only a single example of pay-to-play in securities fraud litigation, the Cendant case. Cohen, supra note 137, at 1342–43. Although one of the lead counsel firms in Cendant had contributed $40,000 to the campaign fund of the New York State Comptroller, the court did not find any improper influence and, in fact, subsequently appointed the firm as lead counsel despite its knowledge of the contribution. See In re Cendant Corp. Sec. Litig., 264 F.3d 201, 209 (3d Cir. 2001) (describing absence of evidence supporting allegation of pay-to-play).
The risk of political influence, at this point, seems insufficient to justify abandoning a process that has the potential to produce high quality representation in favor of one better suited to producing mediocrity.\textsuperscript{355}

Although attention has focused on political corruption, there is also a risk that conflicts of interest will cause institutional investors to behave inappropriately. Institutions could enter into side agreements to obtain private benefits in exchange for selecting a particular firm or agreeing to terms in a retainer agreement. An institution might, for example, seek to trade a higher legal fee in a class action for representation on better terms in another case. An institution could also seek a resolution of the litigation that disproportionately benefits it at the expense of other class members.\textsuperscript{356} Only further experience with the empowered lead plaintiff model will reveal the magnitude of these risks. Several factors, however, mitigate against these types of self-dealing. First, the decisions of public pension funds are subject to oversight procedures and disclosure requirements that are likely to reveal actual and potential conflicts of interest.\textsuperscript{357} Second, as institutions adopt clearly defined structures for selecting class counsel, they minimize the potential for their other interests to influence the selection. Third, concern about reputational effects may constrain institutional opportunism.\textsuperscript{358}

\section*{D. Interpretive Guidelines for the Judiciary}

The developments described above are precisely what Congress contemplated in adopting the PSLRA.\textsuperscript{359} They are threatened, however, by two types of judicial decisions that undermine lead plaintiff control. First, some courts have aggregated the holdings of multiple investors to appoint lead plaintiff groups rather than a single investor.\textsuperscript{360} Second, some courts have sought to retain affirmative control over the selection and compensation of lead counsel, rather than deferring to the lead plaintiff’s decisions.\textsuperscript{361}

\textsuperscript{355} It should also be noted that a number of institutions have structures or policies designed to limit the potential for political influence. See Gillan Interview, supra note 288 (describing CalPERS’s thirteen member board, of which only three members are appointed by the governor, and which must approve counsel selection decisions, as “not very vulnerable to political influence”); Goodman Interview, supra note 292 (explaining that selection criteria in future cases will exclude firms that have made political donations).

\textsuperscript{356} An argument can be made that institutional efforts to obtain corporate governance reforms as part of the settlement process reflect this type of conflict. See supra note 346.

\textsuperscript{357} See, e.g., Gillan Interview, supra note 288 (describing role of CalPERS board in overseeing litigation decisions).

\textsuperscript{358} See, e.g., Schow Interview, supra note 290 (identifying importance to institution of maintaining the quality of its reputation in order to be effective).

\textsuperscript{359} See Fisch, Aggregation, supra note 13, at 92-93 (describing congressional objectives concerning participation by institutional investors).

\textsuperscript{360} See id. at 65-69.

\textsuperscript{361} In a prior article, I have questioned the propriety of continued judicial efforts to assert control over the counsel selection process in light of the fact that many existing
I have previously identified a number of problems with the appointment of lead plaintiff groups. Among other problems, the use of lead plaintiff groups adds subjectivity and unpredictability to the process of appointing a lead plaintiff. Groups suffer from a variety of functional limitations that reduce the litigation control of group members, generally in favor of greater lawyer control. Even small groups introduce uncertainties about decisionmaking structure and may result in compromise decisions or coordination problems. Finally, judicial acceptance of aggregation may result in the displacement of a large individual or institutional investor by a group with a larger aggregate interest, but whose individual members have relatively small stakes, thereby diminishing the incentive for active client participation.

The power of even a single lead plaintiff is undermined when the court seeks to maintain control over the selection and compensation of class counsel. Judicial efforts to exert control vary in degree. Some courts, such as those that conduct lead counsel auctions, have effectively ignored the PSLRA mandate in favor of selecting counsel themselves and determining an appropriate fee structure. Indeed, in Quintus, Judge Walker went so far as to appoint counsel and then instruct counsel to choose an appropriate lead plaintiff—thereby restoring the type of lawyer control targeted by the PSLRA.

deficiencies in class action procedures are products of judicial creation. See id. at 94–95. Judicial participation in the litigation process may introduce particular biases or perception problems that hinder effective evaluation of the problems. For a more comprehensive treatment of the comparative institutional advantage issues raised, see generally Neil K. Komesar, Imperfect Alternatives (1994).

362. See Fisch, Aggregation, supra note 13, at 71–73. Of course groups also offer some advantages, such as increasing representation, adding expertise or experience, generating a diversity of ideas and perspectives, and assisting in litigation financing.

363. In Cendant, for example, only one member of the lead plaintiff group appeared in opposition to the fee award, which was based on the terms of the auction. Transcript of Proceedings at 98–99, in re Cendant Corp. Sec. Litig. (D.N.J. June 28, 2000) (No. 98–1664). The absence of a formal response from the other members made it difficult for the court to ascertain the official position of the group. Id. In Laborers Local 1298 Pension Fund v. Campbell Soup Co., the court appointed as co-lead plaintiffs two individuals and the Treasurer of the State of Connecticut, and appointed two corresponding sets of lead counsel. No. 00–152, 2000 U.S. Dist. LEXIS 5481, at *11 (D.N.J. Apr. 24, 2000). This forced the institution to work with a law firm that it had not selected and with which it had no personal or formal contractual relationship, thus limiting the institution’s ability to engage in the type of ongoing monitoring and control described in the previous Subsection. See LaMar Statement, supra note 299, at 3 (describing “poor responsiveness and slipshod quality of the work” performed by co-lead counsel).

364. Similar analysis applies when a court simply substitutes its preferred lawyer for the one chosen by the lead plaintiff. See, e.g., Z–Seven Fund, Inc. v. Motorcar Parts & Accessories, 231 F.3d 1215, 1217 (9th Cir. 2000) (describing trial court’s appointment of individual investor Francine Ehrlich as lead plaintiff but selection of the lawyer representing a competing lead plaintiff applicant as lead counsel).

365. After judge Walker used an auction to select Weiss & Youman as lead counsel, the original lead plaintiff refused to work with the firm. See Jason Hoppin, Attorneys Getting the Silent Treatment, Recorder, June 19, 2001 at 4, available at WL. 6/19/2001
Other courts pay lip service to the lead plaintiff role but attempt to exert control indirectly, such as by designating appropriate selection procedures or fee structures and threatening the lead plaintiff with the prospect of removal for failing to defer to the court’s preferences. Thus the court in *Network Associates* unsuccessfully sought to impose its selection of counsel procedure on the institutional lead plaintiff.366

Some judges have explicitly concluded that the failure to select the court’s preferred candidate or negotiate the court’s preferred fee structure rebuts the statutory presumption of adequacy and justifies the court in replacing the lead plaintiff. In *Copper Mountain*, for example, Judge Walker held that “a negotiated deal with the best, competitive terms supports an inference that the negotiating plaintiff is the most adequate plaintiff.”367 Accordingly, the court found that the presumption of adequacy in favor of investors with substantially larger losses was rebutted and selected an individual investor who had suffered a loss of only $59,000 because his negotiated fee agreement was, in the opinion of the court, “significantly better for the class.”368

As indicated above, uncertainty about the most appropriate fees and fee structures, coupled with demonstrated judicial weaknesses in securing and compensating counsel, make it hard to accept judicial superiority over lead plaintiffs. Simply put, lead plaintiff negotiations are a market approach; judicial selection is not. To quote Judge Posner, “[m]arkets know market values better than judges do.”369

Nor do recent judicial opinions demonstrate greater procedural protections or more sophisticated evaluation of agency issues. The *Copper Mountain* decision, for example, rejected without discussion the possibility that the higher fee structure for CMI’s chosen counsel could be justified based on quality differences.370 Similarly, the court viewed the fee caps and declining percentage structure of the Barton’s proposed fee agreement as advantages despite the agency problems they create. More troubling is the court’s rejection of selection decisions made through a competitive process by investors with substantial stakes.371

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366. See supra note 111 and accompanying text.
368. Id. at *34.
369. In re *Cont’l Ill. Sec. Litig.*, 962 F.2d 566, 570 (7th Cir. 1992).
370. See In re *Copper Mountain*, 2001 U.S. Dist. LEXIS 16560, at *37 (“The significant differences in potential attorney fees cannot be rationally explained by intangible factors such as the well-recognized brand name in securities litigation of CMI’s counsel.”); cf. supra text accompanying notes 205–207 (describing court’s analysis of this factor in *Quintus*).
371. See, e.g., In re *Copper Mountain*, 2001 U.S. Dist. LEXIS 16560, at *32 (finding CMI to have demonstrated a willingness to negotiate with counsel); Transcript of Hearing dated Mar. 8, 2001, at 89, In re *Copper Mountain Networks Sec. Litig.*, (N.D. Cal. Apr. 12, 2001) (No. C-00-3894 (VRW)) (testimony of plaintiff Hannum describing his consideration of...
tain is not an isolated example; the court’s decision to conduct an auction in Cendant after institutional plaintiffs had negotiated a competitive fee agreement is analogous. Such decisions either reflect a rejection of the lead plaintiff’s ability to perform its role or an effort to try to whip-saw counsel into accepting a lower price. The former position is inconsistent with the PSLRA; the latter undercuts the lead plaintiff’s ability to negotiate effectively with prospective counsel.

It is difficult to reconcile this judicial oversight with the objective of client control. Potential judicial interference with the lead plaintiff’s decision also discourages large investors, particularly institutions, from active participation. A lead plaintiff must expend its own resources to investigate the case, develop information on the market for legal services, identify qualified counsel, and negotiate a fee agreement. Although an investor can justify these expenditures if they ultimately enhance the recovery, they are wasted if the investor’s decisions are supplanted by the court.

approximately eleven firms before deciding on Milberg Weiss); id. at 35–43 (detailing each CMI member’s negotiation experience, familiarity at dealing with lawyers and counsel selection procedures in this case).

372. See, e.g., Brief of New York City Pension Funds for Appellants at 30, In re Cendant Corp. Litig. (3d Cir. Dec. 13, 2000) (Nos. 00-2769, 00-3653) [hereinafter Cendant NYC Brief] (arguing that lead plaintiffs had fulfilled exactly their role under the statute, including negotiating the “hardest bargain . . . ever negotiated in advance in a securities class action”).

373. Judically determined fee structures also reduce counsel’s accountability, both directly, by eliminating negotiated provisions providing for ongoing reporting and client oversight, and indirectly, by removing the lead plaintiff’s control over counsel’s compensation, which reduces the incentive to monitor and limits the effectiveness of attempts to exercise control. By reducing counsel’s accountability to the lead plaintiff, these structures place a greater burden on the court to determine, on an ex post basis, if counsel’s efforts were reasonable. See In re Cendant Corp. Prides Litig., 213 F.3d 722, 732 (3d Cir. 2001) (concluding that fee resulting from auction must nonetheless be evaluated for reasonableness).

374. See, e.g., Cendant NYC Brief, supra note 372, at 32 (arguing that district court decision “will surely impact the willingness of institutional investors to step forward as Lead Plaintiffs”); LaMarr Statement, supra note 299, at 4 (warning that “imposition of class counsel through an auction . . . may well be a deterrent to participation of the type of institutional investor plaintiffs we believe Congress sought to attract to this process”). Alternatively, institutions may opt out of class actions in favor of individual suits in state or federal court. See Remarks of Horace Schow II Before Third Circuit Task Force on Selection of Class Counsel, June 1, 2001, at 5 (explaining that FSBA may opt out and institute its own action to avoid risk of auction or the possibility of having to share control as part of an unaffiliated group). For an example in which an institution chose an independent state suit in favor of class participation in federal court see Louisiana State Employees’ Retirement Sys. v. Citrix Sys., Inc., No. 18298, 2001 Del. Ch. LEXIS 2 (Del. Ch. Jan. 5, 2001).

375. See, e.g., Pugh Declaration, supra note 296, at 6 (identifying costs associated with lead plaintiff position and warning that by “taking away the lead plaintiffs’ right to choose its own counsel as well as their ability to negotiate attorneys’ fees to maximize recovery for the class, the [Cendant] auction procedure virtually nullified the City pension Funds’ incentive to serve as lead plaintiff”).
How should this analysis affect judicial implementation of the lead plaintiff provision? First, as I have argued elsewhere,376 and as the statute directs, the appointment decision should rely on an objective criterion, the size of the investor's interest.377 Both the text of the statute and strong policy arguments militate against judicial attempts to review counsel selection procedures or the terms of fee agreements in the guise of determining the adequacy of the lead plaintiff.378 Simply put, the court should not inject its preferences regarding selection of counsel into the process of appointing the lead plaintiff.379

Second, although the court retains approval power over the selection of lead counsel, that power should be exercised narrowly. To ensure that the lead plaintiff mechanism is used to effect client control rather than to shield lawyer driven litigation, the court may reasonably require the lead plaintiff to demonstrate 1) that the selection of counsel was the result of a competitive process, and 2) that the lead plaintiff actively negotiated a fee agreement with counsel.380 These criteria, however, should be satisfied by minimal showings—the court should not withhold approval on the rationale that an alternative selection process is preferable or that a lower fee agreement is possible. Only by allowing lead plaintiffs a degree of discretion is it possible to promote a variety of competitive selection methods and creative fee structures that include quality and other intangible factors, in addition to price.381 Finally, a failure by the lead plaintiff to make the necessary showing should not result in his or her disqualification as lead plaintiff, or entitle the court to select counsel itself.382 The

376. See Fisch, Aggregation, supra note 13, at 76.

377. The presumption of adequacy, which extends to the investor with the largest stake in the case, should only be rebutted by factors that interfere with the lead plaintiff's ability fairly to represent the class, such as conflicting ownership interests or unique and ongoing contractual relationships with a defendant.

378. Indeed, in many cases it will be inappropriate for the court even to consider appointment of lead counsel at the time that it appoints the lead plaintiff. In cases in which there are competing applicants for the lead plaintiff position, it may not be reasonable for potential lead plaintiffs to incur the time and expense of negotiations with counsel prior to the court's ruling. Moreover, an investor will be able to negotiate more effectively with plaintiffs' firms after securing the appointment as lead plaintiff.

379. E.g., In re Cell Pathways, Inc., Sec. Litig. II, 203 F.R.D. 189, 192 (E.D. Pa. 2001) (concluding that appointment of lead plaintiff and approval of lead counsel are "two separate issues").


381. For the same reason, the court should accord the fee arrangement negotiated by an institutional investor a "presumption of reasonableness" and should award fees in accordance with such an agreement absent changed circumstances or clear excessiveness. Id. at 282–83.

382. Disqualification of the lead plaintiff should be reserved for extraordinary circumstances, such as demonstrated client unwillingness actively to participate, bribery, or the selection of patently unqualified counsel.
court should merely defer its approval of the lead counsel appointment pending the necessary showing.\textsuperscript{383}

Despite recent increases in the involvement of institutional investors, not every case will involve an institutional lead plaintiff. In some cases, no institutional investor will seek the appointment; in others, an individual investor may have a larger stake.\textsuperscript{384} It is important to note that the PSLRA does not limit its presumption of adequacy to institutional investors.\textsuperscript{385} Moreover, although institutions may offer some advantages, individual investors are fully capable of performing the duties of the lead plaintiff.\textsuperscript{386} In securities litigation, the size of the investor's loss serves as a reasonable proxy, both for the investor's incentive to participate actively and for his or her ability to do so. Wealthy individuals who suffer large losses have similar motives to participate actively as clients in traditional litigation, and they are likely to be experienced in negotiations, in dealing with lawyers, and in monitoring agents. Accordingly, the absence of an institutional lead plaintiff does not entitle the court to ignore the statute and assert control over the selection and retention of counsel.\textsuperscript{387}

V. Extending the Empowered Plaintiff Model

Although the PSLRA is the only statute formally to endorse the empowered lead plaintiff, the model can be extended to other substantive areas. Courts have the power to select a lead plaintiff in other class actions and to vest the lead plaintiff with the authority to select and retain

\textsuperscript{383} Cf. In re Quintus Sec. Litig., 201 F.R.D. 475, 490 (N.D. Cal. 2001) (order concluding that plaintiff could not meet adequacy requirement of FRCP 23(a)(4) without demonstrating that “he is able effectively to select and negotiate with a prospective lead counsel”); In re Lucent Techs., Inc. Sec. Litig., 194 F.R.D. 137, 156-58 (D.N.J. 2000) (order refusing to appoint lead plaintiff’s choice of counsel and instead ordering an auction because court found no evidence that plaintiff considered other counsel or actively negotiated a fee agreement).

\textsuperscript{384} See, e.g., Z-Seven Fund, Inc. v. Motorcar Parts & Accessories, 231 F.3d 1215, 1216 (9th Cir. 2000) (describing alleged losses of appointed individual investor as exceeding those suffered by Louisiana State Employees’ Retirement System); In re Telxon Corp. Sec. Litig., 67 F. Supp. 2d 803, 823 (N.D. Ohio 1999) (finding that the loss of $1,087,967 asserted by the two Hayman brothers “is clearly larger than the $428,000 loss of the [FBSA]”).

\textsuperscript{385} See, e.g., Telxon, 67 F. Supp. 2d at 821-22 (“The institutional investor is not presumptively the most adequate plaintiff solely by virtue of its status as an institutional investor, however. If that were the case, Congress would have simply provided that institutional investors are presumptively the most adequate plaintiffs, regardless of the size of financial loss . . . .”)

\textsuperscript{386} Cf. Quintus, 201 F.R.D. at 487 (reasoning that “Congress found, and most courts would agree, that institutional plaintiffs are better equipped than individuals to serve as lead plaintiffs”).

\textsuperscript{387} Cf. Armour v. Network Associates, Inc., 171 F. Supp. 2d 1044, 1056 (N.D. Cal. 2001) (suggesting that deference may not be warranted if lead plaintiff is an individual investor); Wenderhold v. Cylink Corp., 188 F.R.D. 377, 387 (N.D. Cal. 1999) (reasoning that, because the lead plaintiff was an individual rather than an institutional investor, his ability to select and monitor class counsel was less than ideal, and, therefore, conducting auction).
lead counsel, subject to the approval of the court, on the terms described in this Article.\textsuperscript{388} This Part considers the potential scope of such an expansion.

Class actions differ. Arguably mass tort cases, securities fraud litigation, and consumer fraud lawsuits have little in common beyond the procedural vehicle that establishes a collective litigation structure.\textsuperscript{389} These differences frequently condemn efforts to develop universal solutions to problems in class litigation. Accordingly, this Article does not purport to propose a solution to all class action deficiencies, or to offer a mechanism for addressing counsel selection and compensation issues in all contexts. Rather, the Article explicitly recognizes that the empowered lead plaintiff model is not suitable for all class actions and will work effectively only if certain criteria are met.

This Article proposes three criteria for determining when it is appropriate to delegate selection of counsel, fee negotiation, and case supervision to an empowered lead plaintiff. First, the class must include members with a sufficient financial stake in the litigation. Only if the empowered lead plaintiff has a sufficient interest in the case will it incur the costs of identifying, negotiating with, and monitoring class counsel.\textsuperscript{390} Second, the potential lead plaintiffs must be sufficiently representative of the interests of other class members. The interests of all class members need not be identical, but large class members should not have interests that are qualitatively different from those of smaller members. If they do, agency problems will hinder the lead plaintiff’s ability to make decisions on behalf of the plaintiff class. Third, the size of a class member’s interest should be correlated with its sophistication and ability to handle the selection, negotiation, and monitoring processes.\textsuperscript{391} This correlation permits the court to use the size of the plaintiff’s interest as an objective selection criterion.

These criteria are satisfied in the typical securities fraud class action. Plaintiff classes generally include members who have suffered substantial losses, institutional investors and wealthy individuals, who are competent

\textsuperscript{388} Courts need not await explicit statutory authorization. Courts have developed the roles of lead plaintiff and lead counsel under their general power to supervise class litigation. The model described here is consistent with the courts’ broad judicial authority although it entails a less proactive judicial role than that reflected under the traditional approach.

\textsuperscript{389} See Joseph A. Grundfest & Michael A. Perino, The Pentium Papers: A Case Study of Collective Institutional Investor Activism in Litigation, 38 Ariz. L. Rev. 559, 574–76 (1996) (describing class actions as a continuum ranging from cases in which class members have small stakes, and, therefore, no incentive to monitor, to cases in which members with large interests are likely to opt out).

\textsuperscript{390} In some cases, plaintiffs who are repeat players can spread these costs over multiple lawsuits, in which case the stakes in any single case need not be as high.

\textsuperscript{391} This correlation is likely, for example, when loss size is related to the plaintiff’s wealth, as is typically the case in securities litigation.
to perform the responsibilities of the lead plaintiff.\textsuperscript{392} By comparing the stakes of would-be lead plaintiffs, the court can use a simple benchmark to select a class member who is both interested and capable of functioning as lead plaintiff. Finally, the interests of institutions and large investors in securities fraud litigation are not qualitatively different from the interests of other class members. Because all class members have a common interest in maximizing the total recovery, and because recovery is allocated on a per share basis among all shareholders, large investors are capable of representing the interests of the entire class.

Because the empowered lead plaintiff model is well designed for securities litigation, it is difficult to understand the propensity to use auctions in this context.\textsuperscript{393} As the New York City Pension Funds argued to the Third Circuit, "there [is] no need to 'simulate' the market in the presence of actual market negotiations."\textsuperscript{394} The same criteria can be used to identify other suitable candidates for the lead plaintiff model. For example, antitrust class actions and some intellectual property cases include class members with large stakes, a commonality of interests among large and small class members, and a correlation between the size of a plaintiff's interest and the predicted ability of that plaintiff to perform the role of lead plaintiff. In the Auction Houses litigation, the losses of all class members due to the alleged price-fixing were similar regardless of the amount of the claimed loss.\textsuperscript{395} In addition, the class included wealthy and sophisticated members who had suffered substantial losses.\textsuperscript{396}

The empowered lead plaintiff model can be extended to some state court litigation. Shareholder derivative suits are a particularly good example of litigation that would be amenable to the empowered lead plaintiff model.\textsuperscript{397} In many relevant ways, shareholder derivative litigation,
based on state corporate law,398 is analogous to securities fraud class litigation.399 Commentators have characterized derivative suits as representative litigation and raised similar concerns about the potential for excess lawyer control, suits that do not further shareholder interests, collective action problems that limit shareholder attempts to monitor counsel and the inability of courts to address the potential abuse through review of proposed settlements.400

The empowered lead plaintiff model has the same potential to address these problems in shareholder derivative suits. The shareholder class is the real party in interest in derivative litigation. The shareholders are fundamentally a class of investors, and similar to the plaintiff class in a securities suit, the class includes institutions and other large investors, who have both sufficient stakes to benefit from active participation and the ability to select and monitor counsel effectively. The interests of large investors in derivative litigation are likely to reflect the interests of the entire shareholder class, perhaps even to a greater degree than in securities fraud litigation because there is a greater degree of commonality among the interests of current shareholders.401

Moreover, there is reason to believe that large investors, including institutions, would be willing to take on the role of empowered lead plaintiff in derivative litigation. Even in the absence of statutory or case law providing them with the powers of a statutory lead plaintiff, institutions have attempted to participate actively in some derivative suits,402 although their efforts, to date, have met with limited success.403 Indeed,

398. The same analysis applies to shareholder derivative suits brought in federal court on the basis of diversity of citizenship.

399. Much of the leading scholarship on representative litigation is addressed to both class actions and derivative suits. See generally Macey & Miller, Plaintiffs' Attorney's Role, supra note 12; Goffin, Understanding, supra note 19.


401. The interests of institutional investors may also parallel more general social interests regarding the desirability of litigation. See Falk, supra note 400, at 242.

402. Twelve institutions, including CalPERS and the NY State Common Retirement Fund, recently joined together to pursue a derivative suit on behalf of Columbia/HCA Healthcare Corporation. See McCall v. Scott, 239 F.3d 808, 816–17 (6th Cir. 2001) (finding sufficient allegations of demand futility to reverse dismissal).

403. See, e.g., Kahn v. Sullivan, 539 A.2d 48, 48–49 (Del. 1991) (describing participation by CalPERS in opposition to proposed settlement); Falk, supra note 400, at 283 (describing objection by CalPERS and FSBA to proposed settlement in Felzen v. Andrews, No. 95-2279, 1997 U.S. Dist. LEXIS 23646 (C.D. Ill. July 7, 1997), and subsequent attempt to appeal from district court's approval of the settlement); Grundfest & Perino, supra note 389, at 582–90 (describing successful participation by institutional investors in Pendium chip derivative and class action suits); Keith L. Johnson, Deterrence of Corporate
to a significant extent, courts have resisted institutional involvement. Formal recognition by courts of the empowered lead plaintiff position would create a model that structured the role of the institutional investor. This would enable institutions to participate actively from the outset of the litigation, minimize disruption of ongoing procedures and assure institutions that their expenditures of time and effort will not be wasted.

The empowered lead plaintiff model is not suitable for all class actions. In particular, it is unlikely to work well in cases that fall toward either end of the spectrum of class actions—small claimant cases, on the one hand, and mass tort cases on the other. In small claimant class actions, such as consumer fraud cases or nonpersonal injury products liability cases, no class member is likely to have a sufficient stake in the case to make active participation viable. Thus collective action problems will dominate, and lead plaintiff oversight is unlikely to overcome excessive lawyer control.

The lead counsel auction is likely, however, to exacerbate the risk of opportunistic behavior by counsel. As this Article has demonstrated, lead counsel auctions are unlikely to produce well structured legal services contracts that align the interests of counsel and the plaintiff class. Because the lead counsel auction sacrifices extensive ex post review by the


406. In the absence of a formal mechanism for structuring institutional involvement, institutional efforts to participate may be viewed as interfering with ongoing litigation decisions by other parties. For example, the parties objected to CalPERS’ efforts in Felzen as obstructionist. See Falk, supra note 400, at 236.

407. Collective action problems currently create frequent opportunities for opportunism by plaintiffs’ counsel in small claimant class actions. Among other things, these cases furnish many of the most egregious examples of settlements in which the plaintiff class receives little if any value, but counsel receives a substantial fee award. A recent example is the proposed settlement of Rinaldi v. Ionmega Corp., a lawsuit alleging the sale of defective zip disc drives to some 28 million consumers. 1999 Del. Super. LEXIS 563 (Del. Super. Ct. 1999). The settlement provides class members with rebates ranging from $5 to $40 applicable to future purchases of Ionmega products. See Gary Hind, Ionmega Settles Class-Action Lawsuit, Standard-Examiner, Apr. 14, 2001, at C1 (describing settlement terms). The proposed fee award to plaintiffs’ counsel is up to $1.7 million. Notice of Pendency of Class Action and Hearing on Proposed Settlement, at 4, Rinaldi v. Ionmega Corp. (Del. Super. Mar. 23, 2001) (No. 98C-08-465-PRC).
court in favor of an ex ante fee determination, it also reduces counsel's accountability to the court in precisely the cases in which judicial oversight is important and client oversight is unlikely. In particular, small claimant class actions are the most likely to suffer from the auction model's excessive reliance on price. Accordingly, if auctions are used in these cases, they are likely to produce lowball bids that subsequently lead to quick, cheap settlements. If anything, auctions may induce judicial complacency over the litigation outcome and the fee award, thereby reducing the court's review of both the proposed settlement and the legal fees.

Furthermore, the use of auctions eliminates the court's ability to tailor litigation incentives through its fee awards. Small claimant class actions provide the most common examples of lawsuits that may not be socially desirable. At the same time, small claimant class actions are often the only possible mechanism for deterring certain types of widespread misconduct that cause a limited degree of harm. Because entrepreneurial litigation is highly influenced by the potential financial rewards, and because counsel's financial interest in these cases will dominate the interests of the class, it is particularly important for legal fees in these cases to reflect, to the maximum extent possible, the private and social value of the litigation. Under the traditional ex post approach, courts can, in setting legal fees, consider such factors as the social value of the suit, the extent to which the litigation reflected original investigation or pathbreaking legal theories, and the deterrence value of the litigation.

The lead plaintiff model is problematic in mass tort cases for different reasons. Although mass tort cases generally include class members with substantial stakes, the interests of class members may diverge substantially. In particular, the interests of those class members with the largest stakes, often the most seriously injured, are likely to conflict with other class members, such as those with more modest injuries or exposure only plaintiffs. As a result, although the severely injured plaintiffs may have sufficient motivation to participate actively, they may not be

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408. See, e.g., Fisch, Reform, supra note 285, at 552–53 (describing proposal to amend Fed. R. Civ. P. 23 to reduce the incidence of litigation that will produce only trivial benefits to class members).

409. For citations to the literature examining the extent to which social and private litigation costs and benefits are aligned, see Fisch, Qui Tam, supra note 10, at 171 n.22; see also Dunbar et al., supra note 152, at 8 (challenging standard efficiency critique of fee awards for failure to address "that what is optimal for the plaintiff may not be optimal for society").

410. But see Resnik, supra note 46, at 2129 (arguing that, because judges "are the market" in mass tort cases, they should structure the market for legal services by shaping the supply and demand for litigation through their allocation of legal fees in accordance with social goals).
capable of representing the plaintiff class fairly.\textsuperscript{411} Additionally, because the process that generates differing class stakes is likely to be fortuitous or random, there is little reason to believe that those with larger interests in the case are likely to be particularly well qualified to serve as lead plaintiff.

The conflicting interests in mass tort litigation pose a similar obstacle for the use of lead counsel auctions, however. The appointment of lead counsel in mass tort litigation through any mechanism, thereby delegating class control to a limited subset of plaintiff’s lawyers, many of whom have preexisting relationships with individual class members, raises problems. These problems include the limited ability of lead counsel to represent class members with disparate interests, the potential for the appointment of lead counsel to interfere with existing lawyer-client relationships,\textsuperscript{412} the risk that the use of lead counsel will undermine prior litigation efforts by individual plaintiff’s lawyers, and the appropriate division of fee awards between lead counsel and other participating lawyers. By focusing the court on the method of appointment, the lead counsel auction masks these issues.

In sum, although the empowered lead plaintiff will not work in every class action, current experience suggests that it can readily be extended beyond securities litigation to other substantive areas and that, where appropriate, it is likely to be more effective than the lead counsel auction at providing a market-based solution to counsel selection and compensation problems. In other cases, deficiencies in the lead counsel auction are likely to create greater problems than the traditional regulatory approach. In particular, a lead counsel auction cannot substitute for active judicial review of intraclass conflicts, adequacy of representation, and the fairness of any proposed settlement.

**Conclusion**

This article has evaluated the use of lead counsel auctions in the selection of class action counsel. As an increasing number of courts experiment with the auction model, it becomes critically important to evaluate whether lead counsels can effectively address selection of counsel problems such as the absence of a market mechanism and the resulting information problems, absence of competition, and problematic fee awards. The article demonstrates that the auction approach is ill-conceived and that, for a variety of reasons, judicially conducted lead counsel auctions are unlikely to improve the existing regulatory approach. In particular, the article describes structural problems in the design of lead


\textsuperscript{412} See, e.g., In re Dalkon Shield, 693 F.2d 847, 851 (9th Cir. 1982) (“[T]he right of litigants to choose their own counsel is a right not lightly to be brushed aside.”).
counsel auctions, explains that the price dominance of the auction approach may compromise selection of quality counsel, and reveals important limitations on the ability of an auction to produce reasonable legal fees.

The Article proposes an alternative market-based approach to counsel selection—the empowered lead plaintiff. It explains the impact of the lead plaintiff provision of the Private Securities Litigation Reform Act and describes recent developments in the involvement of institutional investors as lead plaintiffs. The Article argues that these developments are having the effect of increasing the role of market forces in the selection and compensation of class counsel and proposes an extension of this approach, carefully implemented, as the most promising solution to selection of counsel issues in class litigation. Accordingly, it sets forth criteria to determine circumstances under which the empowered lead plaintiff model will be effective and argues that the model should be extended in particular to antitrust and derivative litigation.