Auctioning for Loyalty: Selection and Monitoring of Class Counsel

Alon Harel† and Alex Stein††

This Article takes a fresh look at the misalignment of interests between class attorneys and their clients. Specifically, it examines the class attorneys' opportunity for shirking and for striking collusive settlements with corporate defendants. Both case law and scholarly writings offer numerous solutions to this misalignment of interests; yet, those solutions suffer from serious flaws. Professors Harel and Stein examine the reasons for that failure and propose a new solution that overcomes the class action agency problem. They argue that the law should resolve this problem by choosing between two basic paradigms of class action lawyering: Attorney-as-Owner *and* Attorney-as-Servant *(Ownership and Servantship). The Ownership paradigm seeks to align the attorney's and the claimants' interests by giving the attorney a proprietary right in the action (usually, through a contingent-fee arrangement). The Servantship paradigm attains this alignment through the attorney's supervision and monitoring, coupled with penalties for inadequate performance. Professors Harel and Stein analyze these paradigms by rigorously identifying the attorney's "conflict-of-interests differential" and by juxtaposing the two paradigmatic attempts to bring this differential down to zero. Subsequently, they develop a new competition-based mechanism that operates under the Servantship paradigm and aligns the interests of class attorneys and their clients.*

† Faculty Fellow, Harvard University Center for Ethics and the Professions. Associate Professor of Law, Faculty of Law, Hebrew University of Jerusalem. LL.B. (1983), LL.M. (1985), Hebrew University of Jerusalem; LL.M. (1989), Yale; D.Phil. (1989), Oxford.

†† Visiting Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. Sylvan M. Cohen Professor of Law, Faculty of Law, Hebrew University of Jerusalem. LL.B. (1983), LL.M. (1987), Hebrew University of Jerusalem; Ph.D. (1990), University of London.

We thank Lisa Bernstein, Steve Goldstein, Jill Fisch, Jesse Fried, Guy Halfteck, Sam Issacharoff, Gideon Parchomovsky, Ed Rock and Charles Yablon for helpful comments and conversations.

CONTENTS

I. PREFACE

Attorneys must represent their clients loyally. This duty is fundamental to the attorney-client relationship. In class actions, however, this duty is notoriously difficult to enforce because members of the suing class—the clients—are unable to select and monitor their attorney. This inability creates a serious agency problem. The class attorney's egoistic incentive is to maximize his or her fees—awarded by the court if the action succeeds—with a minimized time-and-effort investment. This objective does not align with a both zealous and time-consuming prosecution of the class action, aimed at maximizing the amount of recovery for the class members. The attorney may attain this egoistic objective through shirking, by not investing enough effort into representing his or her clients. He or she may also attain this objective in a more malicious way, by striking a collusive settlement with the corporate defendant. This misalignment of interests between the class attorney and the class members is both manifestly unjust and inefficient. It is unjust because it does not provide adequate remedy to the victims of wrongs; it is inefficient because it dilutes the deterrence of corporate wrongdoers.

This handicap can only be remedied by setting the appropriate incentives under which representing the clients loyally would be in the attorney's best interest. In both positive law and academic literature, these incentives largely fall into the *Attorney-as-Owner* (or *Ownership*) paradigm. They seek to align the attorney's self-interest with that of the class members by turning the attorney—in exchange for her or his services—into a co-owner of the action (usually, through a contingent-fee mechanism).

The Ownership paradigm, however, is both logically and operationally unnecessary. Any incentive that a legal system can create by positive payoffs can also be set through negative payoffs: a stick and a carrot are two equally functional sides of the same economic coin. If a $10 remuneration induces a rational person to act in a socially desirable way, an imposition of a $10 fine upon those who fail to act in that way would produce equally good results. The Ownership paradigm is also flawed in its substance. There is only one, highly unrealistic, scenario in which this approach fully eliminates the class action agency problem. In this scenario, a prospective class counsel purchases the action from the members of the suing class at the highest market price and subsequently prosecutes it as his or her own lawsuit.

Based on these simple insights, this Article advocates a shift to an economically new—but ideologically old—paradigm of class action advocacy: that of *Attorney-as-Servant* (or *Servantship*). Under the Servantship paradigm, attorneys seeking to represent class members must credibly commit themselves to loyalty. The Servantship paradigm elicits this credible commitment by offering a compulsory auction mechanism that features a set of rules. Under these rules, prospective class attorneys participate in a compulsory auction in which they file bids specifying the minimum recovery amount for the class members and the requested fee (the "auction rule"). The competing attorneys also commit themselves to a rigorous penalty system that determines which shortfalls between the actual and the promised recovery amounts would manifest an *inadequate representation* of the suing class—a case in which the attorney would normally be denied her or his fee (the "fee-forfeiture rule"). Under these and some supplementing conditions—featuring an absolute ban on economically inadequate settlements—the attorney promising the class members the highest recovery amount for the lowest fee would win the auction.

Specifically, our auction would create competition among prospective class attorneys by granting control over the action to the highest bidder, namely, to the attorney willing to sue the defendant for the largest amount of money. This stated amount would bind the attorney only: the court would be free to award the class members any amount it deems adequate. Under the fee-forfeiture rule, an attorney who sued for an unreasonably exaggerated amount would be denied his or her fee. We provide a rigorous definition for an unreasonably exaggerated amount. This definition is based upon comparison between the recovery amount actually awarded by the court and the auction offers filed by other attorneys. For example, in a case in which the auction-winning attorney sued the defendant for $50,000,000, but ultimately recovered only $40,000,000, the attorney would be denied his or her fee if the runner-up offered to sue the defendant for any amount above $30,000,000. Finally, under yet another binding rule, the court would have to strike down any settlement under which the class members' total recovery amount is below the stated amount. The synergetic operation of these rules would eliminate the attorneys' opportunity both for shirking and for striking collusive settlements with corporate defendants. Consequently, these rules would turn the class counsel into a faithful servant of the suing class.

II. OVERVIEW

This Article was inspired by a recent far-reaching development in the law of class actions. Several federal courts have conducted auctions for appointing lead class counsel,[1] a development culminating in the deployment of a

1. *In re* Oracle Sec. Litig., 131 F.R.D. 688 (N.D. Cal. 1990), 132 F.R.D. 538 (N.D. Cal. 1990), 136 F.R.D. 639 (N.D. Cal. 1991); *In re* Wells Fargo Sec. Litig., 157 F.R.D. 467 (N.D. Cal. 1995); *In re* Amino Acid Lysine Antitrust Litig., 918 F. Supp. 1190 (N.D. Ill. 1996); *In re* California Micro Devices, 168 F.R.D. 257 (N.D. Cal. 1996); *In re* Cendant Corp. Litig., 182 F.R.D. 144 (D.N.J. 1998), *rev'd*, 264 F.3d 201 (3d. Cir. 2001); *In re* Network Assoc. Inc., 76 F. Supp. 2d 1017 (N.D. Cal. 1999); Sherleigh Assocs. LLC v. Windmere-Durable Holdings, Inc., 184 F.R.D. 688 (S.D. Fla. 1999), 186 F.R.D. 669 (S.D. Fla. 1999); Wenderhold v. Cylink Corp., 188 F.R.D. 577 (N.D. Cal. 1999), 191 F.R.D. 600 (N.D. Cal. 2000); *In re* Lucent Techs., Inc. Sec. Litig., 194 F.R.D. 137 (D.N.J. 2000); *In re* Bank One

sophisticated bidding mechanism in the multimillion *In re Auction Houses Antitrust Litigation.*[2] This mechanism emulates a free-market environment in which attorneys compete with each other for an opportunity to represent a rational and self-seeking client by promising the client the highest amount of recovery for the lowest possible fee.[3] Subsequently, the best promise wins (but a serious enough indication that the attorney who made that promise would be unable to deliver on it might still disqualify the promise).[4] As the court in *Auction Houses* explains, this emulation of a free market is necessary in the field of class actions because the client is composed of a large group of dispersed and mostly unidentified claimants that cannot consolidate into a single owner.[5]

Together with its precursors[6] and progeny,[7] *Auction Houses* introduces a remarkable shift both in the doctrine regulating class action lawyering and in that doctrine's underlying motivation.[8] In deciding the preliminary issue of appointing an attorney to represent the class, courts effectively broke with the fiduciary tradition that deems an attorney's trust obligations towards her clients[9] to sufficiently inhibit the attorney's self-seeking temptations. The courts have abandoned this idealized (if not naïve) moralistic perception in favor of a cold-blooded analysis of the class attorney's egoistic incentives. They have conducted this analysis by explicitly resorting to economic theory. In *Auction Houses*, the court's resort to that theory was particularly impressive in its sweep and professionalism.[10] On the doctrinal level, these courts uniformly held that an auction-based appointment of class counsel lies within

---

S'holders Class Actions, 96 F. Supp. 2d 780 (N.D. Ill. 2000). *See also In re* Synthroid Mktg. Litig., 201 F. Supp. 2d 861, 871-78 (2002) (using auction cases as a benchmark for determining class attorney fees).

2. *In re* Auction Houses Antitrust Litig., 197 F.R.D. 71 (S.D.N.Y. 2000) (Kaplan, J.).

3. *Id.* at 82.

4. *Id.* at 72-73, 84-85.

5. *Id.* at 78.

6. *See* cases cited *supra* note 1.

7. *See, e.g.*, *In re* Quintus Sec. Litig., 148 F. Supp. 2d 967 (N.D. Cal. 2001); *In re* Comdisco Sec. Litig., 141 F. Supp. 2d 951 (N.D. Ill. 2001).

8. *See also* William B. Rubenstein, *A Transactional Model of Adjudication*, 89 GEO. L.J. 371, 426-38 (2001) (underscoring the importance of lead class counsel auctions as part of the general shift towards a transactional model of adjudication).

9. At their core, these obligations include diligence, loyalty and competence. *See* MODEL RULES OF PROF'L CONDUCT R. 1.3 cmt. 1 ("A lawyer must . . . act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf."); *id.* R. 1.7 cmt. 1 ("Loyalty [is an] essential element[] in the lawyer's relationship to a client."); *id.* R. 1.1 ("Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."). *See also* Nancy J. Moore, *Who Should Regulate Class Action Lawyers?*, U. ILL. L. REV. (forthcoming 2003) (arguing for adjustments in the professional ethics standards that would accommodate the peculiarities of class action litigation).

10. In devising the auction, Judge Kaplan commissioned amicus curiae briefs from academic experts and conducted an explicit economic analysis of class attorneys' incentives. *See Auction Houses*, 197 F.R.D. at 74, 75-85.

their discretionary powers under both Federal Rule of Civil Procedure 23—which controls class actions in general—and the Private Securities Litigation Reform Act of 1995 (PSLRA)[11] that introduced some special arrangements for class actions filed in connection with securities. Under these rulings, the court's discretion to appoint the class attorney by an auction that best serves the interests of the suing class overrides the traditional "first-to-file" principle[12] and may even trump the PSLRA's "largest investor" approach.[13] Underlying this shift is the courts' aspiration to place class attorneys under egoistic incentives that align with the interests of the attorneys' clients. Attorneys operating under such incentives would ardently maximize their private profits by zealously promoting their clients' interests. They would no longer be willing to enter into collusive settlements with corporate defendants or otherwise misuse their control over class actions by making profits at their clients' expense. If such incentives could be devised, the well-being of individuals would become better protected from abuses by corporate power.[14]

This shift has not gone unchallenged. Academic writers have generally

---

11. *See* Securities Exchange Act of 1934 § 21D, 15 U.S.C. § 78u-4 (2003); Securities Act of 1933 § 27, 15 U.S.C. § 77z-1 (2003). These amendments were introduced by the Private Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67, § 1(a), 109 Stat. 737 (1995). The courts' holdings to which we refer in the text appear in cases cited, *see supra* notes 1-2. In particular, see *In re* Lucent Techs., Inc., Sec. Litig., 194 F.R.D. 137, 155-57 (D.N.J. 2000) (holding, in a class action governed by PSLRA, that determination of lead counsel through a competitive bid process is necessary for protecting the interests of the suing class); *Auction Houses*, 197 F.R.D. at 78-82 (holding the same under Rule 23 of the Federal Rules of Civil Procedure). *But see In re* Cendant Corp. Litig., 264 F.3d 201, 220 (3d Cir. 2001) (holding that, although there are situations under which PSLRA would permit a court to employ the auction technique, generally, a court's decision to hold an auction to select lead counsel would be inconsistent with PSLRA, a piece of legislation designed "to infuse lead plaintiffs with the responsibility (and motivation) to drive a hard bargain with prospective lead counsel and to give deference to their stewardship"); STEPHEN A. SALTZBURG ET AL., THIRD CIRCUIT TASK FORCE REPORT ON SELECTION OF CLASS COUNSEL (2001), *reprinted in* 74 TEMP. L. REV. 689 (2001) [hereinafter TASK FORCE REPORT]. The Task Force found that auctions are inconsistent with the goal of the PSLRA, which is to assure that the "most adequate" plaintiff will choose counsel and negotiate a reasonable fee. The PSLRA mandates that class actions are to be client-driven, not court-driven. The Task Force further stated:

> To the extent that an auction is even permissible under the PSLRA, it should only be conducted if the lead plaintiff's choice of counsel, or process in choosing counsel . . . is so infirm as to rebut the presumption that the plaintiff is "most adequate" under the statute, and then only if the alternative candidates for the "most adequate plaintiff" do not appear willing or able to engage in a meaningful search for and negotiation with counsel.

Id. at 768.

12. *See Auction Houses*, 197 F.R.D. at 81-82 (acknowledging the benefit of the "first-to-file" principle as "an incentive for attorneys to ferret out wrongs that may be difficult or impossible for individual plaintiffs ever to identify," but holding that the class-member advantages that attorneys' auctions produce outweigh that benefit).

13. *See In re* Lucent Techs., Inc., Sec. Litig., 194 F.R.D. 137, 155 (D.N.J. 2000) (holding that the approval of lead counsel is not governed by the "largest investor" principle and by other guidelines that control the lead plaintiff determination, and that the judgement of a lead plaintiff is not dispositive in the appointment of lead counsel); *In re* Cendant Corp. Litig., 264 F.3d 201, 220 (3d Cir. 2001) (holding that in an action governed by PSLRA, the court may conduct an auction for selecting class counsel only on exceptional grounds).

14. We refer to well-being in its broadest possible sense, accommodating not only compensation for the actual victims of corporate abuses, but also the deterrence benefits for the potential victims.

commended its motivation but have voiced opposition to the selection of class counsel through auctions.[15] A special Third Circuit Task Force, convened by former Chief Judge Edward R. Becker,[16] has reached similar conclusions after conducting a thorough investigation of the subject.[17] Specifically, it concluded that auction is a risky and complicated procedure for selecting class counsel,[18] and recommended its use only in a very restricted spectrum of cases.[19] Both the Task Force and academic critics of the auctions have, however, focused on the particular type of auctions that have so far been conducted by courts. This type of auction turns the selected class counsel and her clients into co-owners of the action in order to align the interests of the two. After examining a variety of such auctions, both the Task Force and academic critics have concluded that such auctions are unlikely to attain the desired alignment of interests.[20]

The *Attorney-as-Owner* (or *Ownership*) paradigm, however, does not stand alone as an ideological tool for designing class counsel auctions. This Article offers a competitor: the *Attorney-as-Servant* (or *Servantship*) paradigm. Under the Servantship paradigm, auctions for class counsel services need not facilitate the optimal purchase of the attorney's loyalty to her clients by inviting prospective class counsel to trade their services for a share in the clients' action. Placing the attorney in the same boat with her clients is neither necessary nor sufficient for securing the attorney's loyalty. The latter can be secured by directly auctioning for loyalty. Under the Servantship paradigm, *prospective class counsel bid for a services-supply contract, not for property*, and the contract for which they bid structures their incentives in a way that turns faithful representation of the suing class into the only profitable course of

15. *See* Lucian A. Bebchuk, *The Questionable Case for Using Auctions to Select Lead Counsel*, 80 WASH. U. L.Q. 889 (2002) (arguing that auction-based selection of class counsel will both underrate and under-motivate high quality attorneys); Jill E. Fisch, *Aggregation Complex Litigation at the Millenium: Auctions and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53 (2001) (expressing skepticism with regard to lead counsel auctions as a means for eliminating the agency problem); Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction*, 102 COLUM. L. REV. 650 (2002) (arguing that auctions are poor tools for identifying the best class counsel and for setting reasonable fee awards); TASK FORCE REPORT, *supra* note 11, at 723 (certifying that both scholarship and academic witnesses who testified before the Task Force "concluded that the asserted benefits of an auction are . . . unproven and that whatever benefits might exist are either outweighed by the risks and costs of an auction or are available in only a limited range of cases").

16. TASK FORCE REPORT, *supra* note 11, at 689.

17. *Id.* at 704-705, 723.

18. *Id.* at 704.

19. The task force noted:

> The paradigmatic case in which an auction might be considered is one in which the defendants' liability appears clear; the damages appear to be both very large and collectible; and the lead plaintiff is not a sophisticated litigant that has already retained counsel of its choice through a reasonable arm's-length process.

Id; *see also id.* at 741-45 (substantiating the recommendation above).

20. *E.g.*, *id.* at 723-41.

action. This new mechanism of class counsel selection is developed in the pages ahead.

Corporate power poses a serious threat to the well-being of individuals. In many instances, this power does not originate from the absence of substantive rights protecting individuals, but rather from the lack of an efficient procedural mechanism by which individuals can realize their rights. This observation was one of the key factors that triggered the adoption of a sophisticated procedural mechanism—class action—that facilitates compensation for wrongs committed against large groups of individuals when each individual wrong is too small to justify the costs of rectification through legal process. This mechanism is justified in part by the need to prevent the injustice that would be caused by denying a remedy to the victims of such wrongs. Efficiency concerns also justify this mechanism as an incentive against wrongful conduct. If corporations could escape from liability for such conduct, their incentives for avoiding it would be substantially reduced. Consequently, corporations would commit wrongs that yield them a profit and would not take the precautions necessary for preventing the wrongs, even when those precautions were efficient. Therefore, class action is a mechanism that promotes both individual justice and efficiency.

The efficacious conduct of class actions, however, requires a major concession on the part of the individuals wronged by corporate power. The class action mechanism grants the power of prosecuting class actions to self-appointed attorneys, and this deprives the victims of their power to control the legal process, but the law does not reallocate this power for the benefit of attorneys alone. Individual victims give up control over the legal process in exchange for a realistic prospect that the wrongs that they suffered will be remedied. The class counsel must secure this prospect in exchange for seizing control over the lawsuit and for the corresponding fee-earning opportunity. Indeed, this exchange is the very essence of the legally imposed transaction between the victims and their self-appointed attorney.

However, as numerous commentators point out, this transaction suffers from an inherent agency problem. As such, it does not promise the victims that their damages will be properly rectified. The agency problem that arises in the class action context is twofold. It involves both shirking and collusive behavior on the part of class attorneys. An attorney controlling the action may decide to earn her fee without investing the appropriate effort in securing the victims' rights. Such an attorney may also explicitly or implicitly conspire with the corporate wrongdoer to deprive the victims of their full remedy and to share the proceeds among themselves. Such deprivation and sharing of the proceeds can be effected through a collusive settlement between the wrongdoer and the class attorney. As a consequence, the designated beneficiary of the class action—the individual victim—would be deprived not merely of her procedural rights, but also of her right to receive adequate compensation. A collusion between the wrongdoer and the class attorney would also generate inefficiency. In exchange for paying the class attorney a generous fee, the wrongdoer would reduce his liability, if not effectively eliminate it. The resulting reduction of liability would leave corporate wrongdoers under-deterred.

Academic literature offers a number of law reform proposals striving to overcome the shirking problem and to break the unholy alliance between class attorneys and corporate defendants. One of these proposals has even been adopted by Congress.[21] Yet, as many commentators note, these proposals have failed to resolve the problem. Individual victims of wrongs perpetrated by large corporate wrongdoers can still be deprived of their rights by unscrupulous attorneys who nominate themselves as class counsel. The Orwellian vision in *Animal Farm*[22] has not been fully realized in reality, but class actions are one of the areas where this vision is not far from being realized.[23]

This Article pursues two central objectives. First, it aims at improving the understanding of the class action agency problem. The Article attempts to attain this objective by rigorously identifying the sources of that problem and by categorizing the available solutions. Second, the Article aims at improving the class action mechanism by offering its own solution to the problem. We dedicate Parts III and IV of this Article to the former objective and Part V to the latter. Part III divides the available solutions to the problem into two general types: *Ownership* and *Servantship*.[24] The Ownership solutions aim at aligning the class attorney's interests with those of the purported class by granting the attorney an appropriate proprietary interest in the action. The solutions surveyed in Part IV largely follow this path. These solutions, however, suffer from serious drawbacks that we also discuss in Part IV. In that Part of the Article, we pay special attention to the auctioning solutions that federal courts increasingly adopt.

---

21. *See* Private Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. §§ 77a to 78u-5.). The statute was guided by Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995) (suggesting abolishment of the "first come, first serve" determination of lead plaintiffs in securities class litigation and conferral of this status on institutional investors, who would appoint class counsel and effectively monitor them).

22. *See* GEORGE ORWELL, ANIMAL FARM 111-18 (1945) (providing a vivid literary depiction of the social harm inflicted by self-appointed promoters of collective welfare).

23. Bentham labeled such phenomena "Judge & Co." in his critique of the fee-gathering system, in which judges and attorneys form an exclusive alliance to pursue their own interests at the expense of others. *See, e.g.*, WILLIAM TWINING, THEORIES OF EVIDENCE: BENTHAM & WIGMORE 76-82 (1985).

24. Our invocation of these two paradigms resonates with Professor Steven Shavell's general treatment of the principal-agent relationship. *Cf.* Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979) (arguing that optimal allocation of enterprise risks between the principal and the agent would provide the agent with both proprietary interest and effort-based fee).

The Servantship solutions attempt to resolve the class action agency problem by limiting the power of class attorneys and by monitoring their performance. The prevalent legal doctrine provides one such solution: it attempts to limit the class attorneys' power and to monitor their performance through judicial control over class action settlements and class-attorney fees. However, this solution is generally perceived as inadequate, and Part IV lends further support to this evaluation.[25]

Part V presents our solution to the problem at hand. Similar to the still prevalent doctrinal solution of that problem, our solution falls under the Servantship paradigm. However, unlike the prevalent doctrine, we do not base our solution on judicial monitoring of settlements and fees.[26] Our solution offers to create a competitive environment in which the class attorney's litigation plan and performance will be closely monitored by other attorneys eager to gain control over the class action, as well as by the defendant. We offer to create this environment by adopting a fairly simple system of rewards and punishments. This system consists of three rigorously defined principles: *auction*, *fee forfeiture*, and a *ban on inadequate settlements*. The auction principle creates competition among prospective class attorneys by granting control over the action to the highest bidder, namely, the attorney willing to sue the defendant for the largest amount of money.[27] This stated amount would bind the attorney only, so the court would be free to award the class members any amount it deems adequate. The action's stated amount would thus function as a settlement floor for class attorneys and defendants, not as a verdict-ceiling for judges and juries; and, whenever appropriate, jurors should be instructed

25. Professor John Coffee offered yet another solution that follows the Servantship paradigm. *See* John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370 (2000). This solution facilitates the class members' "voice" and "exit" in order to secure their loyal representation by the class attorney. We discuss this solution in Part IV. Another solution, which we do not discuss, belongs to Alon Klement, *Who Should Guard the Guardians? A New Approach for Monitoring Class Action Lawyers*, 21 REV. LITIG. 25 (2002), who offers a system of private monitoring conducted by individuals and organizations—not necessarily class members—who would compete and pay for obtaining the monitoring position and would receive a share of the class recovery in return. This solution should be assessed by its costs, for it introduces an additional intermediary between the class members and their dues. Engaging a faithful and effective watchdog in monitoring the class counsel performance would require the suing class to pay the watchdog substantial remuneration.

26. Nor do we ground it on the hostile takeover possibility, for which see Coffee, *supra* note 25, at 422. Similar to Professor Coffee, we favor the creation of competitive environment for class attorneys. Unlike him, however, we believe that competition among prospective class attorneys should take place only before filing of the action. Attorneys participating in that competition must receive an assurance that there will be no second round; subject to extreme cases, such as death or disbarment, an attorney who prevails in that competition ought to be immune from further attempts to replace her by another attorney. *See infra* notes 113-121 and accompanying text.

27. We are generally skeptical with respect to non-monetary remedies in class actions. Many such remedies are easily convertible into the conjurer's decoy that functions as a cover for a sleight of two collusive hands: that of the class counsel and that of the corporate defendant. Yet, there are cases in which such remedies are appropriate, and our model would apply to such cases by translating the non-monetary relief into money.

about it in explicit terms. In order to guarantee that auction bidders do not artificially inflate their bids, we design two supplementary principles. The first principle is *fee forfeiture*: an attorney who sues for an unreasonably exaggerated amount will be denied her fee. Our model provides a rigorous definition for an unreasonably exaggerated amount. This definition is based upon comparison between the actual compensation awarded by the court and the auction offers filed by other attorneys. The second principle *bans inadequate settlements*: the court will not approve a settlement under which the plaintiffs' total recovery amount is below the stated amount. Hence, defendants sued for exaggerated sums would have no incentives to settle. Nor would they be able to seduce class attorneys by offering them "sweetheart" settlement deals. Attorneys eager to save their time, efforts and expenses would not sue for exaggerated amounts, knowing that they would lose their settlement opportunities and thus inevitably expend the full amount of their opportunity costs. The combined operation of these principles would eliminate the attorneys' opportunity for both shirking and collusive settlements. Consequently, these principles would turn the class counsel into a faithful servant of the suing class.

Our model also guarantees that class attorneys have an incentive to file a class action for a sum that reflects the attorneys' genuine evaluation of the action's expected value.[28] This sum equals the compensation that the court would award if the case were to be resolved in a trial, multiplied by the claimants' probability of winning the case. Furthermore, our proposal guarantees that, if the attorney is right in her evaluation of the action's expected value, the defendant would rationally settle the case for this amount in order to avoid the costs of a lengthy and cumbersome trial. Our proposal also offers a solution for exceptional cases in which the class attorney discovers that her evaluation of the action's expected value was too high.

By operating in this way, our model guarantees both a loyal and professionally adequate representation of class members. The model attains this objective through the elimination of false signaling on the part of prospective class counsel, which is yet another important feature of the model. The model precludes such false signaling by screening out the bids tendered by potentially disloyal and incompetent attorneys. Indeed, there is only one type of attorney capable of winning our auction: an attorney who conscientiously estimates the class members' expected recovery, offers them a competitive fee and pledges her earnings from the case as a security for her undertaking to provide the class members both a loyal and competent representation. All other attorneys would

28. The attorneys' determination of this sum would also involve an estimate of the size of the pool (net of opt-outs) of similarly-situated classable claims.

either be defeated in the auction or forfeit their earnings from the case. To operate properly, this model needs to be supplemented by an appropriate mechanism for pre-auction discovery. Without such a mechanism, prospective class counsel would hardly be able to estimate the expected return of the action. Many attorneys would consequently decline to search for and prosecute violations, and those who would still be willing to do so would base their auction offers on a fair amount of guesswork. Due to this informational handicap, the bidding attorneys would also account for the "winner's curse" problem, that is, for a possibility that the winning bid overestimates the fee-earning potential of the action. To offset the unknown risk, the attorneys would consequently tend to reduce the stated value of the action and to increase their fee percentage.

A more general operation of the attorney services market would exacerbate this tendency. Absence of an appropriate pre-auction discovery mechanism would dissuade some able attorneys from placing a bid. The number of bidders would consequently decrease, thereby weakening the forces of the envisioned competitive environment. The remaining bidders would therefore be able to win the auction by placing lower bids, which would work to the detriment of both the class (as far as the compensatory objective of the law is concerned) and society at large (to the extent that the law aims at deterring corporate wrongdoers).[29] Part VI therefore offers the required discovery mechanism, a procedure that would be conducted by a special master for a secured fee. The appointment of a special master for activating that mechanism is possible under Rule 53 of the Federal Rules of Civil Procedure.[30]

In Part VII, we address a special variant of the class action agency problem: intraclass conflicts. We do so by describing the intraclass conflict problem and by identifying its possible solution under our model. Part VIII summarizes this

---

29. The proposed mechanism for pre-auction discovery would be socially beneficial for an additional reason: it would eliminate duplicate efforts and costs that discovery undertaken by individual bidders would otherwise incur.

30. *See* FED. R. CIV. P. 53(a) ("The court in which any action is pending may appoint a special master therein. As used in these rules, the word 'master' includes a referee, an auditor, an examiner, and an assessor. The compensation to be allowed to a master shall be fixed by the court, and shall be charged upon such of the parties or paid out of any fund or subject matter of the action, which is in the custody and control of the court as the court may direct"); FED. R. CIV. P. 53(c) ("The order of reference to the master may specify or limit the master's powers and may direct the master to report only upon particular issues or to do or perform particular acts or to receive and report evidence only and may fix the time and place for beginning and closing the hearings and for the filing of the master's report. Subject to the specifications and limitations stated in the order, the master has and shall exercise the power to regulate all proceedings in every hearing before the master and to do all acts and take all measures necessary or proper for the efficient performance of the master's duties under the order. The master may require the production before the master of evidence upon all matters embraced in the reference, including the production of all books, papers, vouchers, documents, and writings applicable thereto. The master may rule upon the admissibility of evidence unless otherwise directed by the order of reference and has the authority to put witnesses on oath and may examine them and may call the parties to the action and examine them upon oath.").

Article's principal conclusions.

III. THE CLASS ACTION AGENCY PROBLEM

A. *The Nature of the Problem*

Class action is a mechanism that turns a dispersion of non-assets into an asset by consolidating a large number of economically senseless lawsuits into a single lawsuit that makes economic sense.[31] When a lawsuit owner complains that his telephone company overcharged him by one dollar, he is well-advised not to seek legal remedies: *de minimis non curat lex*. Even when a lawsuit is not de minimis, a rational claimant would not initiate it if its expected return is exceeded by litigation expenses. From an economic viewpoint, such lawsuits also ought not to be initiated because their benefits (compensation and deterrence) are outweighed by costs. However, when such lawsuits are numerous, and when they complain that some wrong was recurrently perpetrated by a single defendant or by a group of defendants, they ought to be prosecuted. If such numerous lawsuits are not carried out, the deterrence and the compensation objectives of the law would be undermined quite severely. Ideally, owners of such lawsuits should unite them into one and then prosecute it with full vigor and with optimized litigation expenses. In reality, however, such a unification is unfeasible: ordinarily, the well-known transaction cost and collective action problems foil the required unification. The law therefore allows an attorney (via a nominal client) to take such lawsuits into her hands, to consolidate them into a single lawsuit (a common fund), and to prosecute it on behalf of the silent dispersion of plaintiffs. Generally, any of the plaintiffs taken aboard as a class member may disembark at will by opting his lawsuit out.[32] To make sure that class members actually decide whether to remain in the class or opt out, the court will require the class attorney to properly publicize the proceedings.[33] Average class members, however, would scarcely, if ever, opt out: because their individual lawsuits are economically untenable, there is no downside for them in sticking to the class (unless a more attractive class action becomes available).[34]

The class attorney consequently appropriates full (although judicially monitored) control over the multitude of dispersed lawsuits. In exchange, she

31. Aggregation and consolidation of similar claims have additional benefits that are recognized by the Federal Rules of Civil Procedure. Among those benefits are prevention of inconsistent adjudications, elimination of an adverse impact of individual verdicts upon non-parties and a simple expediency. *See* FED. R. CIV. P. 23(b)(1), (b)(3).

32. FED. R. CIV. P. 23(b)(3), (c)(2)-(3).

33. FED. R. CIV. P. 23(c)(2).

34. *See* Coffee, *supra* note 25, at 423-4.

affords the lawsuit owners the probability of generating gain through court victory, indexed here as probability *P*. The class attorney appropriates control over the lawsuits not for its own sake: she intends to earn a fee contingent upon the amount of money (or its equivalent) recovered for the class (either through court victory or by a settlement). Determination of that fee lies within the discretion of the court. The attorney's fee would often be a fixed percentage (f) of the recovered amount (R), so it would equal fR. Alternatively (and still more commonly, as far as American class litigation is concerned), the attorney would recover her usual hourly fee and expenditures—that is, the attorney's opportunity costs—to which the court will add an appropriate risk-increment.[35] The court will determine this increment by accounting for the risk of losing the case that the attorney assumed.[36] The court thus will use, explicitly or implicitly, an appropriate risk-multiplier.[37] Under this system, widely known as the "lodestar" formula,[38] the attorney will obtain this increased compensation because she used her opportunity costs as a venture capital investment in her clients' asset. For the sake of convenience, this Article assumes that the percentage system is being used, so f and $(1 - f)$ will respectively represent the attorney's and the clients' fractional shares in the action. The validity of our model, however, does not depend on this simplifying assumption.

To complete the picture, let the class attorney's opportunity costs (including all litigation expenses)[39] be indexed by C; for the sake of simplicity, let C also denote the defendant's attorney fees and other litigation expenses, even though in practice, defending against a class action is typically more expensive than prosecuting it;[40] and let the attorney's and the defendant's settlement costs be ignored (in class actions, settlement costs are much lower than the costs of litigation; in any event, C may represent any positive difference between litigation and settlement costs).[41]

Accordingly, the expected gain for the class members equals $PR(1 - f)$; the expected gain for the class attorney amounts to $fPR - C$; and the expected loss for the defendant is $PR + C$. If we assume that these actors are risk-neutral and

35. *See* TASK FORCE REPORT, *supra* note 11, at 706-7.

36. *Id.* at 706.

37. *Id.*

38. *See In re* Auction Houses Antitrust Litig., 197 F.R.D. 71, 76-77 (S.D.N.Y. 2000) (describing the "lodestar" formula and analyzing its virtues and vices).

39. We make here a both customary and realistic assumption that courts do not reimburse class attorneys for their expenses. *See, e.g.*, *Auction Houses*, 197 F.R.D. at 74 (ruling that "the attorney's fee would be inclusive of all costs, disbursements and other charges incurred in connection with the litigation").

40. *See Developments in the Law—The Paths of Civil Litigation*, 113 HARV. L. REV. 1827, 1833 (2000) (observing that defendants generally spend more than plaintiffs on mass litigation and explaining this phenomenon by the across-the-board implications of defendants' individual defeats and victories).

41. This Article adopts as its baseline the American no-fee rule, under which each party bears its own litigation costs. *See* Alyeska Pipeline Co. v. Wilderness Soc'y, 421 U.S. 240 (1975) (holding that a court may not award attorneys' fees to a prevailing party unless expressly authorized by statute).

equally informed about the case, then each of those sums would represent, respectively, the settlement position of the class members, the class attorney and the defendant. The difference between the defendant's and the class members' settlement positions would determine the settlement range, that is, the surplus that these parties will divide among themselves in the event of a settlement. As far as the class members and the defendant are concerned, if this difference yields a positive amount, the case would rationally be settled out of court; if not, then the case would go to trial. The difference between the defendant's and the class attorney's settlement positions would, respectively, determine the settlement range from these actors' point of view. As far as the interests of the class attorney and the defendant are concerned, if the difference between *their* settlement positions yields a positive amount, they would rationally settle the case out of court; if not, then the case would go to trial. Consequently, two settlement ranges, rather than one, ought to be considered in analyzing the class action agency problem.[42] The first is the settlement range as between the class members and the defendant, which equals $PR + C - PR(1 - f)$. The second is the settlement range as between the class attorney and the defendant, which equals $PR + C - (fPR - C)$, that is, $PR(1 - f) + 2C$.

Here lies the class action agency problem. The action is controlled by the class attorney, so its controlling settlement range—which can be divided by the class attorney and the defendant, assuming that the two are both legally and morally unconstrained—amounts to $PR(1 - f) + 2C$. In other words, the controlling settlement range in a class action encompasses the expected gain for the class members and the sum of the class attorney's and the defendant's litigation costs. This range is very large, which makes settlement very likely. The settlement range is made large by the asymmetry of the stakes: the amount expected to be lost by the defendant is much greater than the amount that the class attorney expects to gain. If the attorney prosecuted her own action, its settlement value for her would be $PR - C$ (the expected gain minus costs). This value would be similar to that of a class action for the members of the suing class, if *they* were to control the prosecution of their action (with C being equal to their legal representation costs and other expenses). The defendant's settlement value would accordingly be $PR + C$. In such an action, the settlement range would therefore equal $PR + C - (PR - C)$, that is, $2C$, which is known to be the normal settlement condition.[43] The difference between the

42. This analysis draws on Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUD. 189 (1987) (identifying and analyzing agency costs in attorney-controlled lawsuits).

43. *See* Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LIT. 1067, 1075 (1989) (identifying the normal conditions for efficient settlements, the cooperative value of such settlements, and the factors impeding settlements).

settlement ranges in attorney-controlled and client-controlled lawsuits would thus equal $PR(1-f)+2C-2C$, that is, $PR(1-f)$. This difference is embedded in the class members' expected gain. The class attorney may therefore sacrifice a fraction of the class members' expected gain—thereby reducing both her litigation effort and the defendant's liability—in order to strike a settlement bargain favorable to herself. The outcome of such a bargain would be low recovery for the class members and high fee for the class attorney. The availability of such bargains means that class attorneys have an ample opportunity for shirking and for collusive behavior.

For obvious reasons, the defendant would only be pleased to strike a collusive bargain with the class attorney: such a bargain would eliminate the immediate threat of the lawsuit; in appropriate cases, it would also provide the defendant with the desired res judicata protection from future lawsuits. Such a bargain is likely to be initiated at one of the earlier stages of the proceeding, so that both the defendant and the class attorney could save a greater fraction of their litigation expenditures. In other words, the defendant and the class attorney may generate and divide between themselves a settlement surplus at the class members' expense. Theoretically—if the court certifying the settlement is willfully blind—the defendant may gain the whole settlement range after paying the attorney her expected fee amount. Realistically, the defendant may "only" gain a large portion of the settlement range by supplementing the attorney's high fee with flowers, an apology and a bundle of coupons for the class members. When a coupon settlement appears suspicious,[44] the defendant may still settle the action by paying the class members a low amount of compensation. The low amount of class-member compensation can be convoluted in a variety of ways. Typically, this can be done by devising complex (or highly refined) settlement criteria for individual recoveries. For example, in cases where proof of causation is either unavailable or prohibitively expensive, a settlement agreement may provide that a liquidated low amount of compensation will be paid to each individual member of the class who failed to establish by a preponderance of the evidence that his actual damage resulted from the defendant's wrongdoing. The defendant's wrongdoing, if admitted in the settlement agreement, may also be defined in a way that would frustrate the possibility of establishing the required causation. Such settlement schemes would be praised by experts and other witnesses, who would testify in meticulously orchestrated settlement hearings when they are virtually unopposed. Any opposition to a proposed settlement is likely to be

44. *See generally* Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, LAW & CONTEMP. PROBS., Autumn 1997, at 97 (analyzing class action settlements involving coupons, securities, outside monitoring, reverter funds and fluid recoveries); Note, *In-Kind Class Action Settlements*, 109 HARV. L. REV. 810 (1996) (analyzing the vices and the virtues of coupon settlements of class actions).

muted by the settlement's proponents, who would utilize for that purpose their superior knowledge of the facts.[45] The judicial incentive to clear dockets would also (perhaps crucially) contribute to the approval of the proposed settlement.[46] Consequently, courts may be persuaded to approve class action settlements that benefit the defendants and the class attorneys at the expense of the individual members of the suing class.

There is, therefore, a serious risk of collusion between the class attorney and the defendant. The class attorney can extract her expected gain, and often even more than that sum, without zealously prosecuting the case. The defendant, in turn, can cheaply get rid of the lawsuit and buy himself the desired res judicata protection. This anticipated collusion would almost always be implicit rather than explicit: consonantly with the positive law, we assume throughout this Article that explicitly collusive settlements between class attorneys and defendants are punishable both criminally and by disbarment, and are also actionable in contract and tort. At some risk of being unrealistic, we also assume that these sanctions effectively deter class attorneys and defendants from entering into such settlements.[47]

A simple analysis of the incentives that parties to such settlements would develop makes our assumption even more reliable. An *explicitly* collusive settlement is generally unstable. To avoid the punishment and other sanctions that the law imposes in connection with such a settlement, its insider information must be kept secret by the contracting parties. This dependence on secrecy generates the prospect of holdouts and extortion: each party to an explicitly collusive settlement—the class attorney, on the one side, and the defendant, on the other side—would anticipate mutual extortions. Each of those

45. Another tactic that the defendant and the class attorney may utilize to make their settlement look appealing is to artificially inflate the size of the class (which would often be sufficiently uncertain) together with the parallel amount of class member recovery. This part of the settlement would guarantee a high fee for the class attorney. Supplementing it with complex criteria for individual recoveries would also practically exempt the defendant from making the actual payments to most of the claimants.

46. *See* DEBORAH R. HENSLER ET AL., RAND INSTITUTE FOR CIVIL JUSTICE, EXECUTIVE SUMMARY, CLASS ACTION DILEMMAS: PURSUING PUBLIC GOALS FOR PRIVATE GAIN 10 (1999) (demonstrating by data analysis that judges "may not have the resources or inclination to scrutinize settlements for self-dealing and collusion among attorneys"). *See also* John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343, 1363-64 (1995) (pointing to judges' motivation to clear dockets by approving mass tort settlements).

47. Defendants entering into such settlements will also risk removal of the res judicata protection. *See* United States v. Throckmorton, 98 U.S. 61, 65-66 (1878) (holding that extrinsic fraud that denies a party an opportunity to present his case invalidates res judicata); Long v. Shorebank Dev. Corp. 182 F.3d 548, 561 (7th Cir. 1999) (invalidating res judicata upon finding an extrinsic fraud, a situation "where 'the unsuccessful party was prevented from fully exhibiting his case . . . as by keeping him away from court'" (citing Falcon v. Falkner, 567 N.E.2d 686, 694-95 (Ill. App. Ct. 1991) (internal quotation marks omitted))); E. & J. Gallo Winery v. Gallo Cattle Company, 955 F.2d 1327, 1335 (9th Cir. 1992) (noting that extrinsic fraud invalidating *res judicata* "essentially entails preventing a party 'from presenting all of his case to the court,' as opposed to defrauding the party with respect to the substantive rights being adjudicated at a proceeding" (citing Sanders v. Sutton, 710 P.2d 252, 235 (Cal. 1985))).

parties would have an ample opportunity to extort additional benefits from the other party in return for not disclosing the settlement. Because losses expected from such holdouts would usually be asymmetric (the defendant would risk a large amount of money; the attorney would risk disbarment; with both parties facing criminal sanctions that are roughly identical), and because society would usually remunerate such holdouts by a reduction (or a complete removal) of the exiting conspirator's liability—the incentive to hold out from an explicitly collusive settlement would be rather substantial. This incentive significantly dilutes the prospect of generating any profit from such a collusion. Both corporate defendants and class counsel would therefore predominantly choose an *implicitly* collusive settlement.[48]

B. *The Conflict-of-Interests Differential*

From the class attorney's perspective, there are, therefore, two principal ways of implicitly colluding with the defendant. One way of doing so is to strike an early settlement that yields the attorney her expected fee and saves a large fraction of her work and other undertaken investments in the case. The attorney would thus cash her share in the action without paying for it with the opportunity costs, in exchange for which she acquired that share. The other way of doing so is to strike a settlement that would leave the attorney an even higher fee. The attorney would thus enlarge her share in the action by reducing her clients' share, which, of course, would be done without her clients' knowledge and consent. From the attorney's viewpoint, the second type of collusion would usually be more profitable, but it would also be riskier than the first, as it could not easily go undetected at the settlement hearing.[49]

---

48. We thank Guy Halfteck for bringing this point to our attention.

49. The class action agency problem is instructively comparable with a similar problem that arises in corporate settings due to the separation between the stockholders, who own a corporation, and the directors who exercise control over its affairs. First, corporate directors are appointed by the corporation's principal stockholders. The directors' selection process is consequently influenced by their reputation for integrity and professional skills. This is not the case with self-appointed class attorneys, who seize control over class actions without being subjected to a selection process by their clients. Courts are also unlikely to conduct aggressive screening procedures for selecting class attorneys. Any such initiative would goad undesirable clashes between the bench and the bar. Besides, judges would rarely have an objective reason for disqualifying an attorney as a class representative. They could do so only in highly exceptional cases. Self-interested defendants would not file motions to dismiss class attorneys on the grounds of inadequacy: the defendant can only benefit from poor representation of the suing class. *See* Geoffrey P. Miller, *Class Actions*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 257, 257-60 (Peter Newman ed., 1998).

Second, corporate directors are subjected to fiduciary and due diligence duties that are generally more demanding than those that apply to litigation attorneys. Litigation is a risky venture and attorneys who conduct it are not underwriters of its successful resolution. A class attorney who strikes a settlement subsequently approved by the court would be practically immune from being successfully sued by her clients. Her chances of being found liable in a malpractice lawsuit would depend on the existence of evidence that establishes her collusion with the defendant. For obvious reasons, such evidence would scarcely be available. Class attorneys therefore act without being subjected to serious constraints. Indeed, those who believe that corporate directors are insufficiently constrained in dealing

Both types of collusion exploit the *conflict-of-interests differential*. In our analysis, this notion represents the difference between the action's expected value for the suing class and the amount of recovery that the class counsel would deliver to her clients after settling the case with the defendant. The class attorney and the defendant accomplish their exploitation of the conflict-of-interests differential by a settlement agreement that divides this differential between the two. The two types of collusion that we have identified above differ from each other by the size of the differential: the first type exploits the minimum differential amount that can be found in every class action; in the second type, the degree of opportunism is contingent upon circumstances, so the sky is the limit. As Part V demonstrates, our model eliminates both types of collusion. At the present stage, however, we focus only on the first type, which exploits the conflict-of-interests differential at its minimum. We now examine cases in which the class attorney's "only" wrong is her failure to deliver the goods which she undertook to deliver in exchange for her share in the action. Unlike blatant embezzlement from the client, such wrongs are more likely to go undetected. They are therefore more tempting from both the class counsel's and the defendant's perspectives.

Professor Geoffrey Miller demonstrated that if a plaintiff's attorney works on a contingent-fee basis, and her agreement with the plaintiff grants her a unilateral power to strike a settlement with the defendant, the attorney would be able to elicit gains at the client's expense.[50] Such an attorney would settle the case (that is, sell it to the defendant) for any amount (S) that would leave her with a fee equal to (or greater than) $fPR - C$ (as previously in this Article, C denotes the attorney's opportunity costs). When $fS \geq fPR - C$, the attorney would settle the case for any S equal to (or greater than) $PR - C/f$. The client's share in that amount would equal $(1 - f)(PR - C/f)$, which is less than the case's expected value for the client, already indexed as $PR(1 - f)$. The difference between the client's expected value of the case and the amount that the client would recover through a settlement procured by her self-seeking attorney would thus equal $C(1 - f)/f$. This difference represents the minimum conflict-of-interests differential.[51]

with corporate assets would find the class attorneys' position truly alarming. *Cf.* 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. 669 (1986) (demonstrating that class attorneys are poorly monitored and suggesting ways of tightening their monitoring); Coffee, *supra* note 25 (arguing that analogizing the mechanisms for class attorneys' monitoring to those that apply to corporate directors would motivate class attorneys to serve their clients with greater loyalty).

50. *See* Miller, *supra* note 42, at 198-202.

51. Throughout this Article, we assume, for the sake of convenience, that the relevant actors are risk-neutral. Other assumptions with respect to the possible attitudes toward risk would introduce unnecessary complications without affecting the substance of our arguments. *See also infra* note 139 and accompanying text (arguing that possible risk-aversion among prospective class attorneys is *not* a

To have a concrete example and visualize the injustice to the client, consider a lawsuit that has an expected value of \$1,000,000 (say, a lawsuit that has a 60% chance of winning approximately \$1,700,000). Further assume that the contingent fee of the claimant's attorney is 30% and that the attorney's anticipated investment in litigating the case (the opportunity cost) equals \$150,000. Under these conditions, the client can rightfully expect to recover from the case \$700,000 (70% of \$1,000,000). The attorney's rightful gain is \$150,000 (30% of \$1,000,000, minus the attorney's \$150,000 litigation investment). Yet, since it is the attorney—not the client—who makes settlement decisions, the attorney would readily accept a \$500,000 settlement offer coming from the defendant, without litigating the case. The defendant would extend this offer to the attorney on the basis of the $PR - C/f$ formula (\$1,000,000 – \$150,000/30% = \$500,000). Following the acceptance of this offer, the client would recover \$350,000 (70% of \$500,000), while the attorney would gain the amount originally craved (\$150,000—a sum amounting to 30% of \$500,000) without making the promised investment into the case. If made as promised, this investment could have generated an additional amount of \$350,000 that would go to the client (70% of the \$500,000 shortfall between the lawsuit's expected value—\$1,000,000—and the settlement amount of \$500,000). The minimum conflict-of-interests differential ($C(1 - f)/f$) identifies this deprivation (\$150,000 × 70% ÷ 30% = \$350,000).

In the present example, the claimant's attorney and the defendant split this differential among themselves in the following way. The attorney embezzles the client's \$700,000 asset (a 70% share in a \$1,000,000 case) by acquiring his or her 30% share in the case for free. Instead of expending a \$150,000 effort on prosecuting the case zealously—and thereby rightfully gaining a \$300,000 fee—the attorney undersells the \$1,000,000 asset for \$500,000. The attorney's share in the embezzlement of the client's asset therefore equals \$150,000, with \$200,000 being the defendant's embezzlement gain. If the client were not defrauded, the defendant would have had to purchase the client's 70% share in the asset for \$700,000, in addition to purchasing the attorney's 30% share for \$300,000 (the defendant's total gain from the collusive settlement thus amounts to \$500,000, plus the saving of its own litigation expenses). The attorney undersells the claimant's case for a sum that also reduces his or her share from \$300,000 to \$150,000. However, this reduction has no impact on the attorney's welfare because the attorney would only have been able to sell his or her share for \$300,000 if he or she had expended a litigation effort worth \$150,000. To reiterate: instead of purchasing a \$300,000 share in a \$1,000,000 asset for \$150,000, the attorney takes over for free a \$150,000 share in the same asset by seizing the asset and by underselling it to the defendant for \$500,000. This

factor that should affect formulation of class action rules).

collusive transaction leaves the client, who owns the asset, with a \$350,000, rather than \$500,000, loss because the asset can only be sold through consumption of legal services that downsize it by 30% (from \$1,000,000 to \$700,000). Consequently, the \$500,000 discount that the claimant's attorney and the defendant collusively put on the asset's actual price takes away from the claimant \$350,000 (\$500,000 × 70%).

The minimum conflict-of-interests differential equals the attorney's promised investment in the litigation (that is, her opportunity costs denoted by C) multiplied by the ratio of the client's and the attorney's fractional shares in the action (denoted, respectively, as $1 - f$ and f). Ideally, the conflict-of-interests differential must be brought down to zero, which would mean that there is no conflict of interests. This, indeed, is one of the primary objectives of the various rules that regulate the delivery of legal services. In reality, however, and especially in class actions, this objective is notoriously difficult to attain. In a class action controlled by the plaintiffs' attorney, the minimum conflict-of-interests differential—$C(1 - f)/f$—is always a positive amount. This amount provides an obvious incentive for the class attorney to embezzle from her clients with the help of the defendant, who would benefit from the embezzlement as its major beneficiary. The two become able to strike a collusive settlement to their mutual benefit at the class members' expense. The attorney's minimum gain from such a settlement would equal her clients' deprivation of the attorney's promised investment in the case, in exchange for which the attorney had acquired her share in the action. The defendant's gain from the settlement would equal the sum of his saved litigation costs and the difference between the expected and the actual settlement amounts. The class members' minimum loss would equal the minimum conflict-of-interests differential, as defined above. If the attorney alone owned the action, then f would equal 1, so the conflict-of-interests differential would equal zero. This restates the simple truth that if the attorney represented her interest alone, she would not agree to settle the case for less than its full expected value (net of litigation costs). In the same vein, *when the attorney's opportunity costs (C) are zero, the conflict-of-interests differential would also amount to zero.*

This point is crucial for understanding our model, and we return to it later. At the present stage, this point merits preliminary clarification. The existing solutions to the class action agency problem attempt to align the class attorney's incentives with her clients' interests. They consequently offer different incentive adjustments that induce the attorney to manage the case as she would manage it if she herself owned the action. Almost invariably, courts and commentators seek to attain this alignment through emulation of the $f = 1$ condition, which represents the Ownership paradigm. Fulfillment of this condition through purchase of the entire class action by the class attorney realizes this approach to its full extent.[52]

Our approach is different: it offers a similarly oriented incentive adjustment by forcing the class attorney to remove her opportunity costs as a factor that influences her decisions concerning the initiation and management of the action. Under our model, *by assuming the class counsel's role, an attorney irrevocably commits her professional efforts and expenses (denoted by* C*) to the promotion of her clients benefit.* Formally, the $C = 0$ condition helps to attain the required alignment between the interests of the class attorney and those of her clients. This crucial condition represents the Servantship paradigm. Indeed, this condition is one of the key features of our model.

This condition, however, is only one component of that model: when it stands alone, it does not guarantee adequate representation of the suing class. Specifically, this condition can only eliminate the minimum conflict-of-interests differential: large-scale embezzlements of the suing class call for additional protective measures. The $C = 0$ condition also holds no assurance that the class attorney will properly assess the settlement value of the action. The $f = 1$ condition, which the Ownership models attempt to emulate, also fails to provide such an assurance. Apart from being a rather unrealistic scenario, fulfillment of this condition only guarantees faithful representation of the suing class. It does not guarantee the proper assessment of the lawsuit's settlement value by the class attorney. The $C = 0$ condition does not, however, represent our entire model. This condition can provide all the assurances that class members require only by combining with other conditions of the model. Part V expounds the model's conditions together with the technique by which they can be created.

IV. The Existing Solutions to the Problem

The prevalent doctrine and the various reform proposals have tackled the class action agency problem in numerous ways. The existing solutions to the problem attempt to align the class attorney's self-interest with that of her clients. Unfortunately, none of these solutions is satisfactory. In this part of the Article, we outline these solutions along with their shortcomings.

A. *Judicial Review of Settlements and Fees*

In law, any settlement of a class action, and the fees to be received by the class attorney under the settlement agreement, are subject to the court's approval.[53] In deciding whether to approve a settlement, the court must act as a

52. *See* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 105-16 (1991).

53. *See* FED. R. CIV. P. 23(e); Forbush v. J.C. Penney Co., 98 F.3d 817, 822 (5th Cir. 1996)

protector of the class members' interests. It must conduct a hearing that will allow every class member to voice opposition to the proposed settlement.[54] This is the law's principal solution to the class action agency problem. Due to the intrinsically private information structure of the court proceedings and to the consequent inability of the courts to uncover hidden information,[55] this solution leaves the problem basically unresolved.[56]

B. *Auctioning the Action*

Under this proposal, the action would be auctioned between attorneys as an economic asset. The attorney who outbids others would purchase the full proprietary right in the action from the class members.[57] The defendant would also be allowed to participate in the auction, but not through purportedly class attorneys implanted as Trojan horses.[58] The class members would consequently receive the highest price for their joint asset, and the agency problem would be eliminated along with the principal-agent relationship.

This proposal is problematic for a number of reasons, well expounded by the existing literature. The "winner's curse" problem is one such reason. Because the action's actual value is unknown, the winning bid—one that estimates the action's value at its highest—would entail the risk of overpayment on the part of the bidder. Facing this risk, attorneys participating in the auction would factor it into their bids. This process would reduce the purchase price of the action to the detriment of the class members.[59]

(holding that class counsel's fee award needs court approval irrespective of the parties' agreements); Piambino v. Bailey, 610 F.2d 1306, 1328 (5th Cir. 1980) (same). *See generally* HERBERT B. NEWBERG & ALBA CONTE, NEWBERG ON CLASS ACTIONS §§ 14.01-.03 (3d ed. 1992) (citing caselaw both acknowledging and structuring the courts' discretion to award class attorneys their fees).

54. *See* FED. R. CIV. P. 23(d)(2), (e)(1)(C).

55. As demonstrated by a recent experimental study, adversarial proceedings are generally unsuitable for revealing hidden facts under a private information structure. *See* Michael K. Block et al., *An Experimental Comparison of Adversarial Versus Inquisitorial Procedural Regimes*, 2 AM. L. & ECON. REV. 170 (2000).

56. As already indicated, an opposition to a class action settlement would face severe informational difficulties: typically, its members are considerably less informed about the case and its merits than the settlement union, formed by the class attorney and the defendant, is. In order to be effective, an opposition to a settlement must overcome those difficulties, which would happen only on very rare occasions. Building an adequate opposition to a skillfully designed class action settlement might also be prohibitively expensive. The familiar collective action problems, and especially that of free-riding, would usually prevent the class members from making the necessary investment. The courts' supervisory role would thus scarcely create the desired panacea. Once the adversarial clash between the class attorney and the defendant is replaced by a masterfully documented *consensus ad idem*, to which a cohort of reputable experts have attached their blessings and praise, the settlement hearing would practically be turned into an ex parte proceeding. Consequently, even when the court overcomes its docket-clearing temptation, a facially reasonable settlement would pass muster.

57. This proposal belongs to Macey & Miller, *supra* note 52.

58. As stated earlier, *see supra* notes 47-48 and accompanying text, we assume that the existing criminal, disciplinary and tort sanctions sufficiently deter such explicit collusions.

59. *See* Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits:*

Another problem—that of liquidity—is this proposal's major deficiency.[60] The liquidity problem is two-fold: it substantially reduces the competition in the class attorney market, and it imposes substantial costs on the auction participants, which would adversely affect their bids. Inability to raise the capital necessary for purchasing the class action would disqualify a large number of both able and well-motivated class counsel, thus leaving the arena to those few who are able to raise the capital. This monopolizing effect promises a lower amount of recovery for individual victims and a lower level of deterrence for corporate wrongdoers. Raising the capital necessary for purchasing the class action would also incur substantial costs. These costs would be deducted from the bids made by the auction participants, which would reduce the amount of compensation recovered by the class members.[61]

C. *Franchising Law Enforcement*

This proposal is a variation of the auction proposal. Under this proposal, the highest bidder amongst participating attorneys would receive a franchise to monitor a given geographical area and prosecute for specified types of violations. Money received from that attorney (and from the winners of the parallel auctions) in exchange for the franchise right would be allocated amongst the violations' victims.[62]

In addition to the liquidity problem that has already been mentioned,

---

A Critical Analysis, 87 NW. U. L. REV. 423, 447 (1993) (explaining the "winner's curse" problem). Arguably, because the defendant has an informational advantage over other bidders, the law should prohibit him from participating in the auction. The defendant's participation in the auction, as a factor intensifying the "winner's curse", would bring the competing bids further down. Acting under asymmetric information as against the defendant, the bidding attorneys would rationally fear that outbidding the defendant would involve paying too much for the action. *Id.* at 448-49 (favoring the defendant's exclusion from the auction on the above grounds). Professors Thomas and Hansen also point to the problematics of pre-auction discovery as yet another reason for rejecting the action-selling auction proposal. *See id.* at 450-56. This problem, however, is rectifiable: one of the ways of rectifying it is to adopt our model of pre-auction discovery. *See infra* Part VI.

60. *See* Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions*, 1999 SUP. CT. REV. 337, 375 n.134 (2000) (noting that the auction proposal would be impracticable in the mass tort context, where "the sheer size of the claims at stake would exceed the resources of even the most well-heeled plaintiffs' firms"). *See also Developments in the Law*, *supra* note 40, at 1848-49 (acknowledging that "[t]he purchase of class actions would require considerable financial resources" and suggesting attenuating this problem by allowing attorneys to effect such purchases with the help of commercial debt instruments).

61. Guy Halfteck brought to our attention a different scenario in which the liquidity constraint disqualifies less capable bidders because more capable bidders are able to extract higher returns from the auctioned claims at relatively lower costs. This prospect enables the more capable bidders to acquire capital more cheaply. The shrinking pool of bidders would weaken competition among attorneys and reduce the prices for which class actions would be sold, but the quality of the bidding attorneys would become higher on average. To spread the cost of capital, some of the bidding attorneys would also form alliances with others, which would further reduce competition, but would improve the quality of the bidding attorneys. The resulting trade-off between the reduced competition and the improved quality of class attorneys is unclear.

62. *See* Coffee, *supra* note 49, at 692.

implementation of this proposal would produce two difficult problems which are probably insurmountable. The bidding mechanism that would have to be employed under this proposal would tend to unduly reduce the amount of compensation that would be recovered by the victims.[63]

Apart from that, the franchise owners would monopolize the relevant law-enforcement powers. For obvious reasons, this monopoly would be liable to abuse. Once isolated from the competitive market, the franchise-owner would tend to magnify her earnings through monopoly rather than by productive efforts. Her case-selection decisions would be oriented towards producing a lesser amount of goods that are priced more expensively; in using her scarce resources, the franchise-owner would prefer prosecuting only those cases where her earnings—as determined by the difference between her expected return from the case and her investment in it—are at their highest. No condition set by the franchise agreement is capable of resolving this problem (the possibility that the franchise-owner will be explicitly bribed by defendants is once again ignored). The aggregate enforcement output would consequently be reduced, thus undercutting the deterrence and compensation objectives of the law.[64]

D. *Auctions for Class Attorney Services*

Federal District Judge Vaughan Walker was the first to appoint class attorneys by conducting auctions for their services.[65] In these auctions, the competing attorneys had to submit sealed bids indicating their proposed fees as percentages from recovery, flat or sliding. The bids could also propose early-settlement discounts,[66] as well as caps on the attorney's expenses.[67] Each bid had to be submitted independently, and the bidder had to certify that she did not cooperate with her competitors in preparing and submitting the bid.[68] The bidder also had to specify her qualifications for the class counsel position.[69] Finally, the court would select the bidding package that promises to generate the largest recovery amount for the suing class by undertaking to charge the

63. Because franchise rights would have to be sold prior to violations and their discovery, auction participants would have to base their bids on the average rate of violations and on the average damage inflicted by each type of violation. *See id.*. This factor and the corresponding conservative assessments would reduce the amount of victims' compensation.

64. *See id.* at 692-93.

65. *See In re* Oracle Securities Litig., 136 F.R.D. 639 (N.D. Cal. 1991); 132 F.R.D. 538 (N.D. Cal. 1990); 131 F.R.D. 688 (N.D. Cal. 1990).

66. *See Oracle*, 132 F.R.D. at 545.

67. *Id.* at 539, 542-43.

68. *See Oracle*, 131 F.R.D. at 697.

69. *Id.*

lowest amount of fees and expenses.[70]

Flat percentage arrangements induce the attorney to strike an early settlement with the defendant at the class members' expense. For that reason, an attorney proposing a flat percentage fee will reduce her chances of winning the auction. Under sliding percentage arrangements, the attorney's fee was to either increase or decrease as the amount of recovery increased. Each type of the sliding percentage fee-arrangement has both advantages and disadvantages. The decreasing percentage-of-recovery fee prevents the attorney from obtaining a windfall fee award. Under such arrangements, the class members would share the attorney's economies of effort.[71] However, such an arrangement creates a decline in the attorney's marginal returns for efforts. There is, therefore, a point at which the attorney's opportunity costs will begin to exceed her expected fee. At that point, the attorney will accept a cheap settlement offer to the detriment of the suing class.[72] A fee discount for an early settlement will rectify this problem only partially because it merely induces the attorney to extend the duration of the litigation, instead of maximizing the amount of recovery for her clients.[73]

The increasing percentage-of-recovery fee induces the class attorney "to avoid premature settlement and push for a higher plaintiffs' recovery."[74] However, as Judge Kaplan observes in *Auction Houses*,

> This fee structure might have the effect of encouraging plaintiffs' lawyers to eschew settlement in search of a very high recovery, even if this strategy is overly risky from plaintiffs' perspective. Further, it is not clear *a priori* how to demarcate the increments of plaintiffs' recovery according to which counsel's fee correspondingly will increase. Setting the increments too low might eliminate the positive effect of the increasing percentage-of-recovery method on counsel's incentives because the opposing parties, after some discovery, will come to value the case in the highest range, eliminating some of the upside benefit to lead counsel of a higher settlement. Conversely, if the increments are set too high, it might become apparent after some discovery that the case will be valued only in the lowest range. This in turn can make the litigation too costly for lead counsel, thereby encouraging premature cheap settlement in order to extricate counsel quickly from the case.[75]

More fundamentally, the cheapest representation of class members—an objective that Judge Walker's auction approach aims to attain—is not

70. *See Oracle*, 132 F.R.D. at 541-47. In subsequent cases, Judge Walker conducted similar auctions featuring various improvements. *See* Wenderhold v. Cylink, 191 F.R.D. 600 (N.D. Cal. 2000); 188 F.R.D. 577 (N.D. Cal. 1999); *In re* California Micro Devices Sec. Litig., 168 F.R.D. 257 (N.D. Cal. 1996); *In re* Wells Fargo Sec. Litig., 157 F.R.D. 467 (N.D. Cal. 1994).

71. *See Oracle*, 132 F.R.D. at 543-44.

72. *See In re* Auction Houses Antitrust Litig., 197 F.R.D. 71, 80 (S.D.N.Y. 2000).

73. *Id.*

74. *Id.* at 80. *See generally* Bruce L. Hay, *The Theory of Fee Regulation in Class Action Settlements*, 46 AM. U. L. REV. 1429 (1997) (offering an economic analysis of fee-caps for class attorneys).

75. *See Auction Houses*, 197 F.R.D. at 81.

necessarily the best-quality representation.[76] Professor Samuel Issacharoff astutely remarked about this method that, "As with dentistry, there may be some pain associated with delivering yourself to professionals whose chief attribute is their willingness to work you over cheaply."[77] Therefore, although numerous courts have adopted Judge Walker's approach,[78] both with and without variations,[79] the *Auction Houses* court declined to follow it.[80]

This court has devised a different auction, which holds a promise of better representation for class members. Initially, the *Auction Houses* court ordered that the competing attorneys submit sealed bids that state two figures, *X* and *Y*. The *X* figure was to represent the recovery amount that would go entirely to the class members, free of the attorney's fees and other expenses.[81] The *Y* figure was to represent "any gross recovery in excess of *X*" that would go entirely to the class attorney.[82] The court further provided that it will keep all the bids secret "prior to the earlier of (a) final adjudication of the action, or (b) notice to the class of a proposed settlement";[83] and it ordered in this connection that the selected class attorney "not disclose the terms of its bid to defendants or

---

76. *Id. See also* John C. Coffee Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW AND CONTEMP. PROBS., Summer 1985, at 77.

77. Issacharoff, *supra* note 60, at 375 n.134. *See also* FED. R. CIV. P. 23(g)(1)(C) (proposed amendments) (stating that when appointing an attorney class counsel, the court must consider, amongst other factors, counsel's experience in handling class actions and other complex litigation and the resources counsel will commit to representing the class, and allowing the court to consider any other matter pertinent to counsel's ability to fairly and adequately represent the interests of the class).

Furthermore, scarcity of information at the auction stage would prevent informed bidding by participating attorneys. These attorneys would consequently tend to undervalue the expected recovery, thus offering higher fees for lower recovery amounts. *See* Issacharoff, *supra* note 60, at 375 n.134. This problem emanates from the "winner's curse." *See* Thomas & Hansen, *supra* note 59, at 446-48 (arguing that the "winner's curse" problem prevents efficient auctioning of class actions). We believe, however, that this deficiency can be rectified by adopting our mechanism for pre-auction discovery. *See infra* Part VI.

78. *See In re* Bank One S'holders Class Actions, 96 F. Supp. 2d 780 (N.D. Ill. 2000); *In re* Lucent Techs. Inc. Sec. Litig., 194 F.R.D. 137 (D.N.J. 2000); Sherleigh Assocs. v. Windmere-Durable Holdings, Inc., 186 F.R.D. 669 (S.D. Fla. 1999); 184 F.R.D. 688 (S.D. Fla. 1999); *In re* Network Assocs. Inc., 76 F. Supp. 2d 1017 (N.D. Cal. 1999); *In re* Cendant Corp. Litig., 182 F.R.D. 144 (D.N.J. 1998); *In re* Amino Acid Lysine Antitrust Litig., 918 F. Supp. 1190 (N.D. Ill. 1996).

79. The most important of these variations was the right of first refusal that some courts gave to the lead plaintiff's attorney. This right allowed that attorney to match the terms of the winning bid. Underlying this right was the court's unwillingness to abolish the "first-to-file" principle that "creates an incentive for attorneys to ferret out wrongs that may be difficult or impossible for individual plaintiffs ever to identify." *Auction Houses*, 197 F.R.D. at 81. *See, e.g.*, *Cendant*, 182 F.R.D. 144. As further indicated in *Auction Houses*, 197 F.R.D. at 81-82: "Granting counsel to the lead plaintiff a right of first refusal conceivably might address this concern by promising the attorney that incurred the search costs, if willing to offer his or her services at a competitive price, a reward for this action. However, a right of first refusal takes control over the selection of lead counsel out of the court's hands and thereby undermines the court's ability to ensure that the class receives the highest quality representation."

80. *Auction Houses*, 197 F.R.D. at 80-85.

81. *Id.* at 73.

82. *Id.*

83. *Id.* at 74.

anyone else without approval of the Court."[84] The court also laid down a number of supplementary provisions for its auction,[85] and explicitly stated that, "if the Court decided to use the bids in selecting lead counsel, lead counsel would be selected on the basis of both the economic terms of the bids and the qualifications of the bidder."[86] The court thus retained its discretion in selecting the bidder, although it explicitly stated the auction's ultimate purpose: maximizing the plaintiffs' recovery (the *X* figure).[87]

This auctioning method has a number of advantages. First, it induces the bidders to compete over the guaranteed recovery amount for the suing class (*X*). Second, it requires the bidders to underwrite the possible non-fulfillment of this guarantee with their fees. The resulting attorneys' incentives thus seem to provide the suing class with the best prospect to receive the feasibly highest amount of compensation. Under this method, the selected class attorney would still be able to accept the defendant's early settlement offer, but any such offer would equal $X + Y$. Therefore, the attorney's acceptance of such an offer would not be detrimental to the class.[88]

This method, however, also has several disadvantages. First, as already indicated in relation to Judge Walker's auction method, lack of discovery would ordinarily foil the bidders' attempts at evaluating the action's prospects.[89] We believe that the pre-auction discovery problem is rectifiable and offer its rectification in our subsequent discussion.[90] However, the *Auction Houses* court did not supplement its auction with an appropriate mechanism for discovery, which clearly reduces the attractiveness of such auctions both for

84. *Id.*

85. The court ruled that one-fourth "of any recovery in excess of Y would be paid to lead counsel as additional compensation and three fourths to the class." The court further ruled that each bidder was to "submit a brief memorandum setting forth the basis for and supporting the bid. The briefs were to explain the bidders' respective evaluations of the case, including their assumptions as to possible and likely recoveries in the event liability were established, and the bases therefor." *Auction Houses*, 197 F.R.D. at 73. The court also required that each bidder submit

> a sworn certification that the bidder had not, directly or indirectly, communicated with (1) any other bidder concerning the terms of the bid or its position with respect to whether the Court should adopt this method, (2) any defendant or prospective defendant following the issuance of the order concerning settlement or possible settlement of any or all of the actions, or (3) any other attorney or firm concerning its possible performance of legal or other services for the bidder in connection with this litigation in the event the bidder were selected as lead counsel.

Id. at 73 n.9. The court clarified that "any compensation awarded to the successful bidder was to be inclusive of all costs, disbursements and other charges incurred in connection with the litigation"; and it reserved its discretion "to compensate lead counsel on a different basis in the event the litigation were resolved in a manner that did not permit determination of a gross recovery by the class or if justice otherwise required." *Id.*

86. *Auction Houses*, 197 F.R.D. at 73.

87. *Id.* at 83-84.

88. *Id.* at 83.

89. *See supra* note 59 and sources cited therein.

90. *See infra* Part VI.

prospective bidders and for their future clients.[91]

Second, the *Auction Houses* decision provides no guidance for evaluating the bids. Indeed, this evaluation is bound to be complex because it involves two variables, *X* and *Y*, rather than merely one variable. Take, for example, Bidder 1, who sets a $100 million value on *X* and $30 million on *Y*, and compare her with Bidder 2 whose *X* and *Y* figures are, respectively, $105 million and $45 million. The court examines the professional and the ethical credentials of these bidders and finds them both adequate and indistinguishable from each other. Which of these two bidders is likely to represent the class members more faithfully, more diligently and more professionally than the other? Can the court adequately answer the same question in relation to two other bids, one of which set slightly lower values on both *X* and *Y* than did the other? These problems appear unresolvable. Indeed, due to these operational problems, and in light of a more fundamental difficulty, to which we now turn, the *Auction Houses* court decided to modify its original auction order.[92]

Third, the original auction formula set by the *Auction Houses* court induces bidders to magnify their *Y* figures. This formula therefore creates a serious conflict of interests between the class members and the selected class attorney. Take, for example, a winning bid that placed both *X* and *Y* at $20 million. The attorney who submitted this bid estimated that she has a 50% chance of obtaining compensatory damages for her future clients to the amount of $50 million. She further estimated that there is a 5% chance that her clients will also receive punitive damages to the amount of $300 million. From the attorney's viewpoint, the expected value of the action thus equals $40 million ($50m × 50% + $300m × 5%). This estimation determined the attorney's sum of *X* and *Y*, and it won the auction because other attorneys set considerably lower values on *X*. Now assume that the defendant's lawyers managed to dispel his concerns about punitive damages. Consequently, the defendant offers the attorney to settle the case for $25 million. This settlement would yield the class members $20 million, which is their maximal recovery, and it would remunerate the attorney with a $5 million fee. In these circumstances, the attorney may well reject the defendant's offer and go to trial, even though it would not be in her clients' interests. By going to trial, this attorney would risk her clients' recovery in order to augment her profit from the action.[93]

---

91. Arguably, the court did not supplement its auction with a discovery mechanism because the latter was unnecessary: the principal item of information upon which the competing attorneys relied in placing their bids—the Interim Committee's Expert Analysis that conducted a study of potential damages—was public information released by the court. *See Auction Houses*, 197 F.R.D. at 74. *See also* TASK FORCE REPORT, *supra* note 11, at 716 (referring to this factor as justifying the auction conducted in *Auction Houses*).

92. *See Auction Houses*, 197 F.R.D. at 83-84.

93. *See Auction Houses*, 197 F.R.D. at 83 (identifying this conflict of interests and exemplifying it

Fourth, an overoptimistic attorney might commit herself to an unreasonably high *X* figure. Subsequently, she might discover her mistake and its no-fee consequence. After that upsetting discovery, the attorney would hardly be willing to invest further resources in a zealous prosecution of her clients' action.

Facing those difficulties, the *Auction Houses* court issued a new order that modified one of the conditions of its original auction. The new order imposed a limit on the *Y* figure. Under this order, the bidding attorneys had to commit themselves only to the value of *X*. The court set the selected attorney's fee at 25% of any amount that the plaintiffs would receive in excess of *X*.[94] The court explained this ruling as follows:

> As counsel will receive no fee if plaintiffs' recovery falls below X, counsel clearly is discouraged from settling prematurely and has an incentive to pursue a recovery higher than X. This effort will accrue to the benefit of both counsel and the class. As the value of the case surpasses X, counsel's marginal returns to effort will increase steadily, as they will receive twenty-five percent of any amount in excess of X. Again, this creates an incentive for counsel to litigate the case aggressively. Insofar as the Y variable has been eliminated, so too has the conflict of interest.[95]

This modified auction formula proved beneficial for the *Auction Houses* class members, who sued two renowned auction houses, Christie's and Sotheby's, for price-fixing. The auction winner, Boies, Schiller & Flexner LLP, set *X* at $405 million, and within six months reached a $512 million settlement with the defendants. This settlement yielded the class members $485.25 million in money damages, and the class attorneys recovered fees and expenses to the amount of $26.75 million.[96]

The *Auction Houses* modified formula is, however, still inadequate. Take an attorney who estimates the action's expected value at $50 million, an estimation based on her 50% chance of winning $100 million for her prospective clients. The attorney is willing to take up the case for no less than $5 million, so her bid sets *X* at $30 million and wins the auction. The defendant is unaware of the attorney's bid, but is informed—as we are—of the auction's formula. After discovery, the defendant's assessment of the action's expected value becomes roughly similar to that of the class attorney, so he offers her to settle the case for $40 million. The defendant makes this offer precisely

---

with a different hypothetical); John C. Coffee, Jr., *'Auction Houses': Legal Ethics and the Class Action*, N.Y. L.J., May 18, 2000, at 5. (same).

By conventional standards, our attorney's behavior is plainly unethical. *See Auction Houses*, 197 F.R.D. at 83. Yet, the attorney might argue that the 5% chance of winning the $300 million punitive-damage award is part of her compensation for attorney services. Furthermore, the attorney might argue that she acquired a partnership share in the action in the amount of $20 million, which she is not willing to give up for $5 million. These arguments are legally unacceptable, but they do highlight the problematics of the Ownership paradigm that informed the *Auction Houses* decision.

94. *See Auction Houses*, 197 F.R.D. at 84.

95. *Id.*

96. *See* Mark Hamblett, *Debate Over Sotheby's Fee-Auction Plan Persists*, N.Y. L.J., Nov. 22, 2000, at 1 (reporting and discussing the above settlement).

because he is aware of the auction's formula: he knows that, under this formula, the *X* figure must have been set far below the action's expected value. If the attorney accepts that offer, she will receive $2.5 million in fees and expenses, which is half of her expected earning from the action. The attorney therefore decides to litigate the case. For reasons already provided,[97] this decision is manifestly detrimental to the plaintiffs' interests.[98] Hence, the formula that the *Auction Houses* court finally adopted still leaves room for a conflict of interests between the class attorney and her clients. Moreover, by allowing corporate defendants to create such a conflict by making a unilateral settlement offer, this formula equips defendants with a damaging tactical opportunity. Aware of that opportunity, attorneys competing in the auction may decide to adjust their bids by lowering the *X* sums. For obvious reasons, such downward adjustments would be detrimental to the suing class.

The foregoing discussion allows us to identify two fundamental drawbacks in each variant of the *Auction Houses* bidding formula. First, the court's stated objective in *Auction Houses* was to optimize the lawyering service that the class attorney was to offer to the plaintiffs.[99] The Servantship paradigm of class litigation is therefore this objective's natural domain. The court, however, chose the Ownership paradigm as a platform for promoting this objective. Unsurprisingly, the fundamental discrepancy between the two paradigms holds unhappy prospects for the suing class. By granting the class attorney a share in the action, the court effectively created a joint-asset partnership between the attorney and the plaintiffs. The partnership's goal is to sell the joint asset to the defendant—by a settlement or through a court judgment—and to divide the profits in accordance with the partners' shares. Under the partnership's conditions, the plaintiffs cash their share first, and the attorney's share cashes second. The value of this partnership's asset and, correspondingly, the value of each partner's share depend on the way in which the attorney represents the plaintiffs. Under this framework, conflict of interests between the attorney and her clients is inevitable. Selling the joint asset for any price that allows the plaintiffs to cash their share would clearly be in the plaintiffs' interest. The attorney, however, would be unwilling to sell the asset for a price that does not allow her to cash her share profitably, and it is she—not the plaintiffs—who decides whether to sell the asset through a settlement agreement. Furthermore, this conflict of interests may be unilaterally effected by the defendant. The defendant may create such a conflict by offering the attorney to settle the case

97. Coffee, *supra* note 93 and accompanying text.

98. *Cf.* John C. Coffee, Jr., *Untangling the 'Auction Houses' Aftermath*, N.Y. L.J., November 30, 2000, at 1 (criticizing the *Auction Houses* modified formula by using a different conflict-of-interest example).

99. *Auction Houses*, 197 F.R.D. at 75.

for an amount that pays enough for the plaintiffs' first-to-cash share in the action, but not enough for the attorney's second-to-cash share.

An ownership-transfer mechanism can attain the adequate-service objective only by inducing the provider of the required service (the selected class attorney) to purchase *full* ownership in the serviced asset (the class action).[100] The class action doctrine must therefore either adopt the Ownership paradigm in its entirety or discard it completely in favor of the Servantship paradigm. Halfway solutions, such as that of the *Auction Houses* court, will not do. Indeed, the unbridgeable gap between the two paradigms is the origin of the class attorney's anomalous position under the *Auction Houses* approach. This approach attempts to align the attorney's private incentives with those of her clients at a totally arbitrary point in time: the pre-filing stage. Subsequently, it leaves the attorney on her own, so the attorney becomes free of virtually any market or legal mechanisms that could monitor her performance and direct it towards her clients' benefit.

Second, none of the *Auction Houses* bidding formulae induces the competing attorneys to explicitly base their bids on the class action's expected value. In fact, each of these formulae motivates the attorneys to bid for amounts that exceed this value and subsequently to attempt to recover those amounts. The X-and-Y formula, originally endorsed by the court, tells the bidders: "The one who will place the highest value on the X figure is most likely to win the auction. As for the Y figure, you can set it as high as you wish: as long as the plaintiffs recover the highest possible X amount, no one would care how much you earned." Consequently, an attorney correctly estimating the action's expected value as \$100 million would do better by setting \$90 million on X and \$60 million on Y than by placing X at \$75 million and Y at \$25 million. The former bid increases the attorney's chances of winning the auction. Subsequently, it would allow her to utilize her clients' share in the action as a gambling chip in her long-shot pursuit of high recovery. At several points in time, the attorney may also decide to abandon this gambling strategy by opting for a solid $Y =$ \$10m fallback. This fallback option would be open to her as long as the defendant is willing to settle the case for its expected value.

The 25% × $(Y - X)$ formula for the attorney's fee is no better. Take attorney A who correctly estimates the action's expected value as \$100 million and is willing to take it up for a modest flat fee of 5%. This attorney would have to visualize \$100 million as representing her formally unstated Y and to place X at \$80 million. However, the attorney's \$80 million bid would say nothing about the action's expected value and the attorney's proposed fee amount. Thus, a different attorney (B) could place the same bid after incorrectly estimating the

100. This full-purchase-of-the-action approach was recommended by Macey & Miller, *supra* note 52.

expected value of the action as $160 million and after setting her fee at a flat 12.5% rate. The 25% × $(Y - X)$ formula is indifferent as between these two attorneys, which hardly replicates the rationally hypothesized attitude of the class members. From the class members' perspective, attorney A is preferable to attorney B because A would rightly accept the defendant's $100 million settlement offer, while B would reject it.

The failure of both *Auction Houses* formulae to elicit the expected value of the action from the bidding attorneys creates serious informational deficiency that is bound to produce anomalies. This informational deficiency impairs the formulae: the expected value of the action is a factor necessary for securing the adequacy of legal representation that the class attorney provides to the suing class. For the *Auction Houses* court, this factor was immaterial since the court grounded its decision on the belief that, by acquiring a second-to-cash share in the action, the attorney will align her private interests with those of the suing class. As demonstrated above, that belief is ill-founded. The court acted on that belief because it adopted the Ownership paradigm as its baseline. Indeed, this baseline is the ultimate source of the problems that accompany the court's auctions, both original and amended.

To these problems we now add an additional difficulty: under both auctions, even the most skillful of the bidding attorneys may find herself uncompensated. Take an attorney who wins the auction and subsequently delivers to her clients the amount X (or a lesser amount). Under the auction's conditions, this attorney would earn no fee. Yet, the delivered amount is much larger than the X-sums offered by other attorneys who took part in the auction. In such circumstances, denying the attorney her fee would be both inefficient and unfair. Absence of rewards for the best assessment of the action's value weakens the bidders' incentive to base their bids on that assessment. Weakening of that incentive is bound to produce distortions in the selection of class attorneys. As far as fairness is concerned, because the attorney in our example acted as the plaintiffs' best available representative, the plaintiffs must pay her for her services.[101]

For these reasons, this Article proposes an altogether different auction that abandons the Ownership paradigm in favor of the Servantship approach. Based on the Servantship approach, our solution avoids all the problems that the *Auction Houses* court failed to avoid. We unfold and justify this solution in Part V.

---

101. *See* Savoie v. Merchants Bank, 166 F.3d 456, 460 (2d Cir. 1999) ("A party whose initiative confers a benefit upon a class of people is entitled to recover its costs—including attorneys' fees—from the common fund.").

E. *Multiplying the Damages*

This proposal seeks to align the class attorney's and the class members' litigation objectives. Under this proposal, the class members' compensation would increase most dramatically. Specifically, the plaintiffs' actual damages would be multiplied by $1/f$, when f, we recall, denotes the attorney's shareholding in the lawsuit.[102] The fee to be recovered by the attorney in the event of victory would consequently amount to the class members' actual damages. The lawsuit's settlement value for the class members would equal $PR(1/f - 1)$. For the class attorney, it would amount to $PR - C$, and for the defendant to $(1/f)PR + C$. Between the class attorney and the defendant, the settlement range would still remain large: it would equal $PR(1/f - 1) + 2C$. The action's settlement range would thus still encompass the expected gain for the class members (together with the class attorney's and the defendant's litigation costs). However, the ensuing settlement would not take away from the suing class any part of the compensation for its actual, as opposed to multiplied, damage (net of the class attorney's fee). The expected aggregate recovery of the class would never go below $PR(1 - f)$: in reality, it would almost certainly be far above that amount. This would be so because the class attorney would not agree to a settlement that would leave her with a fee below $PR - C$. Under this condition, the minimum settlement amount would be $(PR - C)/f$.

This corrective mechanism, however, would be purchased too expensively. First, it would produce a profound ethical anomaly: class attorneys would be awarded a multiplied fee in order not to be bribed by defendants; class members would be grossly overcompensated in order not to be betrayed by their attorneys; and defendants would be forced to grossly overcompensate class members and overpay class attorneys as part of an economic therapy that would help them overcome their temptation to bribe the attorneys. Apart from producing this anomaly, adoption of the multiplied damage proposal would generate over-deterrence, which blemishes the proposal beyond repair. From the deterrence perspective, multiplied or other punitive damages can be justified only as an award-correcting tool in a system that suffers from drawbacks in law-enforcement. Thus, if such drawbacks reduce the rightful imposition of liability to one-third in the average, and if that reduction is reasonably known to potential violators, then those defendants who were found liable should be forced to pay treble damages to the plaintiffs.[103] There is,

102. Coffee, *supra* note 49, at 693-95 (arguing that "multiple damages can be defended as a crude approximation of the [problem's] optimal solution").

103. *See* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 870, 887-900 (1998) (demonstrating that imposition of punitive damages can offset drawbacks in law-enforcement); A. Mitchell Polinsky & Steven Shavell, *Punitive Damages*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 192, 193-94 (Peter Newman ed., 1998)

however, no connection (let alone overlap) between such damage multipliers and the award multiplier $1/f$, whose sole function is to align the class attorney's and the class members' litigation objectives.

F. *Restoring Client Control*

Theoretically, if one could remove the class members' collective-action and transaction-cost problems, so that the suing class could pursue its interests as a single owner, the class action agency problem could be reduced to a tolerable minimum. The class members would then appoint an attorney of their own choice and subsequently negotiate the attorney's fee and monitor her actions. In 1995, to attain this objective in private securities litigation, Congress enacted the PSLRA.[104] This piece of legislation requires courts to determine whether a lead plaintiff can oversee the conduct of the class action litigation and monitor the effectiveness of counsel.[105] It also lays down a presumption in favor of appointing to the lead-plaintiff position an investor, or a group of investors, with the largest financial interest among the named plaintiffs[106] in the class action.[107] Because such investors arguably have the strongest incentive to succeed in the action, and because the court must be satisfied—prior to their appointment—that their interests align with those of the class as a whole,[108] their appointment as lead plaintiffs would minimize the extent of the agency problem that arises in class actions. Furthermore, selection of counsel by the lead plaintiff must be the product of deliberate and in-depth evaluation, as well as of independent, arms-length negotiations.[109] Indeed, the lead plaintiff owes the suing class a fiduciary duty to obtain the highest quality representation at the lowest price.[110] In deciding whether to approve the selected counsel, the court must ensure the performance of that duty.[111]

This client-control model seeks to single out the best plaintiff—that is, the class member whose interests most align with those of the class as a whole—in order to entrust the action to that plaintiff's hands. Under this model, the best plaintiff is the class member with the largest stake in the action. Arguably, this

(same).

104. Private Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. §§ 77a to 78 u-5.). As already mentioned, this piece of legislation drew on Weiss & Beckerman, *supra* note 21.

105. *See, e.g.*, *In re* Lucent Techs., Inc., Sec. Litig. 194 F.R.D. 137, 145-46, 152-55 (D.N.J. 2000) (stating and applying this requirement).

106. Including claimants who "made a motion in response to a notice." *See* 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(aa), (a)(3)(A)(i)(II).

107. 15 U.S.C. § 78u- 4(a)(3)(B)(iii)(I)(bb).

108. *In re* Lucent Techs., Inc., Sec. Litig., 194 F.R.D. 137, 144-45, 150-51 (D.N.J. 2000).

109. *Id.* at 155.

110. *Id.* at 156 (citing *In re* Network Assocs., Inc., 76 F. Supp. 2d 1017, 1033 (N.D.Cal. 1999)).

111. *Id.* at 155-57.

member of the class would suffer from the attorney's agency problem more than any of his fellows and would consequently have the greatest interest in tackling this problem. If the action yields recovery for the class members, then, together with the class attorney, this plaintiff would be awarded for his monitoring efforts and other investments in the action. This member of the suing class consequently becomes more than just a nominal plaintiff, picked up by the purported class attorney when she hunted for a class action opportunity. Arguably, this plaintiff would adequately control the class attorney's actions and thus curb the attorney's self-seeking temptations.

Unfortunately, this model has a manifestly limited scope for application: it is suitable only for securities class actions, in which one can plausibly identify the largest stockholder amongst the suing class.[112] Apart from that, this model would hardly provide a panacea for the suing class: contrary to its inventors' intentions, it merely replaces one agency problem with another.[113]

G. *"Voice," "Exit," and "Loyalty"*

In a recent article, Professor John Coffee presented a framework that enhances the class members' "voice" and "exit" in order to secure their attorney's loyalty.[114] Analogous to that of corporate governance,[115] this framework aims at reducing the extent of the agency problem that arises in class actions.[116] Under this framework, "voice" means sufficient ability of the class members to elect and remove their attorney and to make meaningful collective decisions concerning their lawsuit; "exit" means sufficient ability of the class members to opt out from the lawsuit; and "loyalty" means adequate representation of the class members by their attorney.[117] Development of an efficient market for "exit" is Professor Coffee's innovative proposal for sustaining this framework. To develop such a market, Coffee advances the idea

---

112. Weiss & Beckerman, *supra* note 21 (limiting this model to securities class actions).

113. Under this model, instead of entering into a collusive settlement with the class attorney, the defendant would attempt to strike such a settlement with the class representative (either directly or through the class attorney, both appointed and controlled by that representative). In the securities area, opportunities for such collusion are ample. Institutional investors seek profitable investments, better access to corporate information, and greater influence over corporate governance decisions. They might therefore purchase those benefits from defendant corporations by sacrificing the interests of the other members of the class. Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 548-49 (1997). Apart from that, institutional investors can extract private gains from attorneys appointed by them as lead class action counsel. For example, they may obtain substantial fee discounts from the appointed attorney for services unrelated to the class action. In exchange, they might offer the attorney unfettered control over the action. *Id.* at 550.

114. *See* Coffee, *supra* note 25.

115. *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970) (originally developing the "voice," "exit," and "loyalty" vocabulary).

116. In a separate article, Professor Samuel Issacharoff recommended a similar enhancement of "voice," "exit," and "loyalty". *See* Issacharoff, *supra* note 60, at 366-80.

117. *See* Coffee, *supra* note 25, at 399-422; Issacharoff, *supra* note 60.

of exposing the dispersed mass of claimants to rival solicitations by attorneys.[118] As in the corporate governance context, a regime that allows such counter-solicitation would expose the class action—more precisely, the class counsel's power to control the action—to hostile takeovers by competing attorneys. Such a solicitation, in Coffee's words, "is the equivalent of a hostile tender offer because it asks class members to 'vote with their feet' and leave one class action to join another."[119] Arguably, class attorneys operating in this competitive environment would have a sufficient incentive to avoid conflicts of interests and to promote their clients' interests both loyally and professionally.[120]

This mechanism has obvious merits.[121] At the same time, it suffers from a serious limitation originating from its wholesale rejection of the Ownership paradigm. The mechanism's refusal to grant the class attorney any proprietary right in the action dilutes her incentive to invest resources in the action. Before making any such investment, the attorney would consider the probability of takeover as reducing her expected fee-earning. This dilution of the attorney's incentive to invest in the action is detrimental to the interests of the suing class. Seemingly, raising the attorney's fee would offset this dilution. This, however, is only seemingly so: fee-raising would increase the rate of counter-solicitations and the corresponding risk of takeover. This increased risk would further erode the attorney's incentive to invest in the action (her possible reimbursement for efforts and expenses would mitigate the problem only partially). To maintain the requisite incentive, the law must protect the attorney's control over the action as a payoff for her investment.

We therefore support the idea of contest between prospective class attorneys, but argue that such contests must be conducted in a way that does not jeopardize the class attorney's investment in the action. Before assuming the role of a class attorney, an attorney expends resources on investigating violations and on preparing the class action. Made by many attorneys at their own risk, such preliminary investments do not require special protection. If an attorney makes an insufficient preliminary investment in the class action, the class members might still remain unaffected because the position of the class counsel may ultimately go to another attorney. However, if an attorney under-investing in the class action already represents the suing class, her

118. Coffee, *supra* note 25, at 422-28.

119. *Id.* at 423.

120. *Id.* at 428.

121. As Professor Coffee acknowledges, this mechanism is not devoid of problems. *Id.* at 428-36. Thus, it may produce "Balkanization": through internal divisions and holdouts, rival claimant forces may make the litigation unmanageable. Professor Coffee believes that this problem is not insurmountable. *Id.* For a more skeptical view of "exit," see Issacharoff, *supra* note 60, at 369-70, who argues that dispersed class members cannot meaningfully exercise their "exit" right.

underinvestment would be detrimental to her clients' interests. Therefore, an attorney's appointment as a class counsel should end the attorneys' contest. For the same reason, this appointment must also precede the attorney's investment in discovery and other expensive proceedings.

This Article therefore offers a different model that accommodates these conditions.[122] Similar to Professor Coffee's approach, this model adopts the Servantship paradigm. However, the level of remuneration anxiety experienced by our class servant is much lower than that of Professor Coffee's class servant. We claim that our class servant would provide adequate services to his masters and substantiate this claim in Part V.

H. Parens Patriae: *Deprivatizing Class Action*

This proposal tackles the class action agency problem by entrusting the power to file and prosecute class actions in the hands of appropriate state agencies. As demonstrated by Kenneth Dam in a seminal article on the economics of class action, this *parens patriae* approach "has a worthy lineage."[123] In areas where state agencies are unable to enforce the law efficiently, a residual franchising of the power to file and prosecute lawsuits on behalf of the state (as opposed to the individual victims of violations) can also be bestowed upon private plaintiffs.[124] Fines collected from violators (or other compulsory payments) would create a fund that can be used by the relevant state agency for compensating the victims.[125] In the eyes of this proposal's proponents, the class action agency problem originates in the state's decision to confer upon private legal entrepreneurs the license to sue on behalf of others. Privatization of this law-enforcement power should therefore take the blame for creating the problem. Arguably, states should de-privatize the power to initiate and prosecute class actions.[126]

This proposal replaces the problem at hand with a host of other well-known problems, most of which are associated with expansive bureaucracy.[127] These problems include the reduced capacity of state agencies to detect low-scale and medium-scale violations; the agencies' ingrained preference of deterrence over

---

122. *See infra* Part V.

123. Kenneth W. Dam, *Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest*, 4 J. LEG. STUD. 47, 64 (1975).

124. *Cf.* Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 LAW AND CONTEMP. PROBS. 167, 184-202 (1997) (offering a shared private-public model of law enforcement).

125. *See* Dam, *supra* note 123, at 64-65. Victim compensation may also be replaced with fines, which would create a deterrence-oriented regime akin to criminal law. *Id.* at 65-66.

126. For a recent discussion of the *parens patriae* doctrine, see Richard P. Ieyoub & Theodore Eisenberg, *State Attorney General Actions, the Tobacco Litigation, and the Doctrine of* Parens Patriae, 74 TUL. L. REV. 1859 (2000) (furnishing a comprehensive analysis of the doctrine's merits and limits).

127. *See generally* GEORGE J. STIGLER, THE CITIZEN AND THE STATE: ESSAYS ON REGULATION 114 (1975) (arguing that since bureaucracies and their functioning depend on self-serving politicians, they would be unable to properly protect citizens from abuses).

compensatory objectives; their dependence upon biased politicians; budgetary constraints; a potential for distorted incentives that might produce selective law-enforcement, including predatory prosecutorial tactics, and so forth.[128] In theory, and perhaps also in reality, these problems can be rectified.[129] Their rectification, however, would be rather costly.

V. THE PROPOSED SOLUTION: AUCTION, FEE FORFEITURE, AND A BAN ON INADEQUATE SETTLEMENTS

This part of the Article offers a simple mechanism that resolves the class action agency problem and virtually guarantees adequate compensation to class members. We base this mechanism on the Servantship paradigm. In our model, the normal settlement standard determines the adequate amount of compensation. This amount is represented by the lawsuit's expected value.[130] If class members recovered compensation below this amount, their compensation would be inadequate, and the same goes for deterrence of corporate wrongdoers. Prevention of such outcomes is our mechanism's primary objective. We therefore propose a set of rules that modify the class attorney's and the defendant's payoffs so that the two would no longer be able to settle the action below its expected value amount. Class attorneys and defendants consequently become unable to benefit themselves at the class members' expense. Our model achieves this outcome by eliminating the conflict-of-interests differential and by ensuring that the class attorney files the action for the optimal amount. This operation of the model eliminates the class action agency problem.

Promotion of settlements is another worthy objective that our mechanism helps to attain. If that objective were unworthy—namely, if we were to treat a settlement as a denial of justice—the extent of the class action agency problem could then be reduced by prohibiting any settlement. In accordance with the currently dominant view, our model prefers settlement to litigation.[131] As

128. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW 658-70 (5th ed., 1998) (pointing to these problems and concluding that "the average agency is almost certain to be less well managed than the average business firm"). *See also* Ieyoub & Eisenberg, *supra* note 126, at 1879-82 (acknowledging some of these problems, but claiming that the *parens patriae* doctrine can still yield social benefits, and substantiating this claim by the socially beneficial settlement of the lawsuits that forty-six states brought against the tobacco industry).

129. For various proposals in that area see Dam, *supra* note 123, at 66-70; Gary S. Becker & George J. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. 1 (1974); William L. Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1 (1975); and A. Mitchell Polinsky, *Private Versus Public Enforcement of Fines*, 9 J. LEGAL STUD. 105 (1980).

130. *See* Cooter & Rubinfeld, *supra* note 43 (depicting a lawsuit's expected value as a basis for settling it out of court); Geoffrey P. Miller, *Settlement of Litigation: A Critical Perspective*, *in* REFORMING THE CIVIL JUSTICE SYSTEM 13-19 (Larry Kramer ed., 1996) (same).

131. *See* Miller, *id.* at 21-25 (arguing that settlement is generally preferable to litigation). For

already indicated, however, our model does not prefer settlement to litigation at any price. This model prefers a settlement to litigation only when its amount reflects the expected value of the lawsuit, so the plaintiffs are not under-compensated and the defendants are not under-deterred. We therefore also reject the well-known practitioner saying that "a bad settlement is better than a good trial."[132]

These objectives must be promoted without weakening the attorneys' incentives to search for violations and file class actions against violators. A system that excessively raises the attorneys' opportunity costs or makes their removal from the class-attorney position too easy undercuts those incentives to the class members' detriment.

A. *Auctioning for Loyalty*

We propose to establish the following set of rules that has three interrelated components: auction, fee forfeiture and a ban on inadequate settlements.

1. *Auction*

Under this provision, the class action would be taken over and prosecuted by an attorney (or a group of attorneys) willing to sue the defendant for the highest amount of money. This would require the attorneys participating in the auction to state the total amount of money to be sued for on behalf of the class members. *This stated amount would bind the class attorney only.* This amount would not bind the class members or the court, so the court would be authorized to award in its verdict any recovery it deems fit.[133] To prevent free-riding on the part of competing attorneys, the auction conditions would require that all offers be submitted at the same time in sealed envelopes.

2. *Fee Forfeiture*

Under this provision, the class attorney would be denied her fee if her auction offer is ultimately found unreasonably exaggerated. An unreasonably exaggerated offer would be identified by the shortfall between the sued-for and the recovered amounts and by the existence of a more realistic offer that came

---

critique of settlements, see Owen Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984) (arguing against institutionalization of settlements and reproaching them for generating inequities and perpetuating injustice); and Jules Coleman & Charles Silver, *Justice in Settlements*, SOC. PHIL. & POL'Y, Autumn 1986, at 103 (arguing that settlements erode the quality of justice).

132. *See, e.g., In re* Warner Communications Sec. Litig., 618 F. Supp. 735, 740 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986) (approvingly quoting the saying "A bad settlement is almost always better than a good trial").

133. As explained at the outset, the class action's stated amount would function as a settlement-floor for class attorneys, not as a verdict-ceiling for judges and juries. Whenever appropriate, judges should also instruct jurors about it.

from another participant in the auction. The test for unreasonableness would be rigorous: the court would compare the attorney's initially sued-for amount with those offered by other attorneys in the auction. If one of those attorneys offered an amount closer to the plaintiffs' award, the class attorney would then be denied her fee.

3. *Banning Inadequate Settlements*[134]

Under this provision, the court will categorically decline to approve a settlement that does not yield the class members the sued-for (or a greater) amount of recovery.[135]

Our following discussion expounds the operation of this mechanism as eliminating the class action agency problem. Throughout this discussion, we assume that the attorney's fee (including reimbursement for expenses) is fixed as a flat percentage from the plaintiffs' recovery. The court will determine this percentage prior to conducting the auction. Alternatively, each participant in the auction may state her proposed fee in the offer, and the court will deduct it from the stated amount of the action. Consequently, the attorney promising the class members the highest recovery amount will win the auction.[136]

B. *The Defendant's Incentives*

Under the proposed model, the defendant's settlement-related incentives are straightforward. The defendant would settle the lawsuit only if its stated amount equals his estimation of his expected liability. He would thus be willing to pay this basic amount to the class members and their attorney. The defendant may add to this basic amount an additional sum that derives from his saving of litigation costs. He would, of course, prefer to save those costs in their entirety, but may also be satisfied by saving a fraction of those costs.

---

134. Professor Jesse Fried suggested to us that we replace this provision by a fully secret auction arrangement, under which the auction bids would remain secret until the end of the litigation. Arguably, this would induce the selected class attorney to zealously promote the class members' interests. This proposal is more elegant, but is also less tight than the settlement-ban component of our model. We discuss it below in the text. *See also* TASK FORCE REPORT, *supra* note 11, at 745-56 ("sealed bids would seem to be a prerequisite for the integrity of any auction"; in those cases in which "class members have a legitimate interest in seeing the winning bid . . . there is no reason . . . why they should not be afforded access to it, under an appropriate protective order and without disclosure to the defendant").

135. *See* Mars Steel Corp. v. Continental Ill. Nat'l Bank & Trust Co., 834 F.2d 677, 682 (7th Cir. 1987) (holding that "a settlement is fair to the plaintiffs in a substantive sense ... if it gives them the expected value of their claim if it went to trial, net of the costs of trial"). This holding evidences a judicial presumption against settlements not satisfying the expected value standard. We propose to make this presumption irrebuttable.

136. If a policy-maker prefers deterrence of wrongdoers over compensation of victims, she may provide that the attorney undertaking to sue the defendant for the highest possible amount will win the auction. The fee proposed by that attorney would then be irrelevant.

There would be no settlement, however, if the lawsuit was filed for an exaggerated amount. For obvious reasons, the defendant would not be prepared to pay the lawsuit's stated amount. The only amount the defendant would be prepared to pay is the sum that reflects his estimation of his expected liability. The defendant, however, would be unable to settle for this amount even when the class attorney agrees to that settlement: the court would not approve any settlement below the stated amount.

This foreclosure serves an important function. In its absence, the defendant would still have a strong incentive to strike a collusive settlement with the class attorney. Take, for example, an attorney who won the auction by offering to sue the defendant for $10 million with a runner-up attorney offering to file the class action for just $5 million. Let it also be assumed that the winning offer and the ensuing class action for $10 million are based on a realistic assessment of the expected return. In this case, the class attorney and the defendant may collusively settle the action for $8 million. If they do so, the class attorney would gain a large fee that would not be subject to forfeiture (because the runner-up offer was more distant than her offer from the amount actually recovered by the class members). The settlement ban would therefore be necessary for preventing such a settlement.

C. *The Class Attorney's Incentives*

Under the proposed model, an attorney would win the auction and obtain control over the class action by offering to sue the defendant for the highest amount of damages. No attorney, however, would offer to file a lawsuit for an unrealistically high amount in order to win the auction (a possibility that could be particularly attractive for attorneys with low opportunity costs, as well as for those who seek to gain publicity through participation in a high-profile litigation). Such opportunistic offers would not be submitted for two reasons: the inevitability of the final judgment and the fee forfeiture. Under the auction provision, the sued amount is fixed by the winning offer and cannot be changed during the trial. In conjunction with the settlement-ban provision, this commitment eliminates the possibility that the class attorney and the defendant will strike a collusive settlement *after* the auction. Because the settlement possibility has been translucently ruled out, an attorney who contemplates submission of an opportunistically high offer knows that the ensuing lawsuit would always go to trial, with the judgment on the merits being inevitable. The attorney also knows that the judgment would award the class members much less than the filed amount, so she would lose her proximity-of-recovery contest with the runner-up bidder. Consequently, the attorney would be denied her fee under the fee-forfeiture provision. This prospect would be discouraging even for those attorneys who have relatively low opportunity costs and who are therefore willing to take up a class action without being able to settle it out of court.

This analysis may suggest a possible replacement for our settlement-ban provision. This provision can seemingly be replaced by a fully secret auction arrangement, under which the auction bids would remain secret until the end of the litigation.[137] Arguably, this would induce the selected class attorney to zealously pursue the class members' interests. Unaware of the bids made by her former competitors in the auction, the class attorney would be unable to eliminate the rational fear of losing her fee under the fee-forfeiture provision. Consequently, she would make every effort to secure the highest amount of recovery for the class members by bringing this amount—by litigation or through a settlement—as close as possible to her filed amount.

In our opinion, the settlement-ban provision would still provide a tighter solution to the problem. Under the fully secret auction arrangement, an attorney who prevailed in the auction might still bribe other attorneys by promising them a fraction of her fee in exchange for the information about their bids. This bribing possibility may be counteracted by appropriate ethical or even criminal prohibitions, as well as by the prospect of holdout and extortion.[138] Yet the chances of detecting a violation of such prohibitions are remarkably small. For this reason, we prefer the settlement-ban provision over the fully secret auction arrangement. This preference, however, is not strong enough to rule out the fully secret auction arrangement.

D. *Corrective Measures*

The unreasonableness proviso introduces a relaxation into our fee-forfeiture provision in order not to exert chilling effects on potential class attorneys. Litigation outcomes are difficult to forecast. Attorneys and judges may form divergent assessments of those outcomes. The prospect of losing the fee by suing for an amount that exceeds the sum ultimately recovered by the class members may, therefore, be too threatening for many attorneys. As a result, fewer attorneys would attempt to investigate violations and file class actions. The fact that some attorneys are risk-averse would further intensify this reluctance.[139]

To the extent that this prospect is real, its deleterious effects must be

137. *See Auction Houses*, 197 F.R.D. at 74, 84 (ordering a secret-bid auction for class attorney services).

138. *See supra* note 48 and accompanying text.

139. Generally, risk-aversion among prospective class attorneys is not a factor that should affect the formulation of class action rules. Up to a certain level, class attorneys are paid for being risk-neutral: rules regulating their fees account for the litigation risks that they assume. *See, e.g.*, TASK FORCE REPORT, *supra* note 11, at 706. Furthermore, an attorney is free to demand a higher fee if she is averse toward risk. Ultimately, the forces of supply and demand operating in the market will determine the fee that class members will pay (together with their attorney's identity).

counteracted by corrective measures. The unreasonableness proviso is one such measure. Under this proviso, a class attorney would not forfeit her fee just by winning a lesser amount than originally filed, as would happen under the *Auction Houses* formulae for attorney auctions. The court would have to compare the amount originally filed with the parallel amounts offered by other attorneys in the auction. The class attorney would thus be denied her fee only if one of those amounts came closer to the sum ultimately awarded by the court. She should indeed suffer that penalty because she filed an unreasonably high demand which enabled her to improperly overtake a more suitable attorney in the contest for control over the class action. Conscientious attorneys with adequate professional skills consequently would not be discouraged from filing and prosecuting class actions.

In some cases, the runner-up offer in the auction would only be slightly below the attorney's winning bid. As a result, if the defendant's settlement proposal comes near that offer, the class attorney might not be able to accept the proposal. The defendant's proposal may be reasonable, but the attorney would turn it down if accepting it entails her loss of the proximity-of-recovery contest and the corresponding loss of her fee. In any such case, the class attorney would ask the defendant to slightly increase the settlement amount, which would not be an unreasonable demand, given the proximity of the two amounts and the trial expenses that the defendant would be willing to save. The attorney may also contract to sacrifice part of her fee in order to increase the amount that the class members would recover.[140] The class members' interests would thus be adequately protected.

Another corrective measure featured by our model is even more significant. Any chilling effect that might be exerted upon prospective class attorneys by the fee-forfeiture provision may always be offset by fee-raising. To counteract such chilling effects, courts may raise class attorneys' fees to a higher percentage level. The required fee raise should correspond to the increase in the risk to which the fee-forfeiture provision exposes prospective class attorneys. This corrective measure would attract more skillful and experienced attorneys, whose work as class representatives would produce greater benefits for the class members.

During the course of litigation, the class attorney may come across new information that was not available at discovery that preceded the auction.[141] Based on that information, the attorney may find out that her auction bid was overly optimistic. In this scenario, the amount of recovery that the attorney finds herself able to obtain for her clients falls far below her stated amount, so

140. Indeed, opening these possibilities to the class attorney is yet another reason for preferring our settlement-ban proposal over fully secret auctions.

141. In our subsequent discussion, we offer a pre-auction discovery mechanism that reduces this possibility to the extent feasible. *See infra* Part VI.

the attorney is going to lose the proximity-of-recovery contest along with her fee, regardless of whether she settles the case out of court or litigates it through to the final judgment. At the auction stage, this scenario was as likely as the opposite scenario in which the attorney's bid turns out to be overly pessimistic. Indeed, at that stage there is no reason to believe that information which is yet to become known will be systematically slanted in a particular way. At the auction stage, therefore, the probabilities of such optimistic and pessimistic scenarios are equal. This, however, is not the case with the expected returns that the auction bidders must affiliate to those probabilities: a bid that turns out overly optimistic risks the attorney's fee, a risk that pessimistic bids do not entail. Consequently, the attorneys would have to reduce their filing offers, and this downward adjustment of the bids seemingly damages the suing class.

We believe that this danger is unreal. First, the attorneys' competition would place limits on that adjustment. Eager to win the auction, the competing attorneys would attempt to outbid their competitors by offering to sue the defendant for the highest possible amount. Second, attorneys who run portfolios of cases (including class actions) would not steeply reduce their filing offers. Instead, they would diversify the risk by working on the correct assumption that new information will damage them in one case, but will benefit them in the other. Third, raising the percentage of the attorneys' fee would further offset the downward adjustment danger.

One should, however, consider another relevant danger that we have already mentioned in connection with the *Auction Houses* formulae: after discovering her inevitable fee-loss, the class attorney would discontinue her resource investment in the case. From her perspective, bringing her clients an amount of recovery that goes below the amount originally filed is both as good and as bad as bringing them a zero amount. The attorney's reputational concerns may soften this cynical thought, but would still fail to secure the class members' adequate representation. The attorney therefore clearly needs a better incentive for further expending her opportunity costs on her clients' case.

Authorizing courts to remunerate such attorneys on exceptional grounds is one possible way of setting such an incentive. To obtain this exceptional remuneration, the attorney would have to convince the court that the amount of recovery that she brings to her clients is reasonable, and that the higher amount, originally stated in her winning bid, originated from an honest miscalculation which she could not practically prevent because of the scarcity of information that existed at the time of the auction. In other words, the attorney would have to convince the court that the new information that became available only at the trial could not reasonably be obtained prior to the auction. To pass this threshold, the attorney would have to demonstrate by a preponderance of the evidence that other auction participants also did not have this information. If she succeeds in doing so, the court would award her a fee in the amount that it deems equitable under the circumstances. Normally, the court would reduce the attorney's original fee in order to strengthen the attorneys' incentive to seek information before the auction.

Admittedly, this discretion might dilute the importance of the proximity-of-recovery contest and correspondingly inflate the attorneys' bids at the auction. We therefore move from rewards to punishments and recommend a *supplemental incentive* for counteracting both the attorney's shirking temptation and her reliance on the court as a potential rescuer of her fee. Future exclusion from similar auctions and, correspondingly, from class representation is the incentive that we recommend. If an attorney delivers her clients a recovery amount that goes far below her filed amount, judges should abstain from appointing her as a class attorney in future cases for a certain period. The excluded attorney would consequently be unable to generate earnings from class actions. Moreover, because the exclusion would adversely affect the attorney's portfolio of contingent-fee cases, the attorney's ability to diversify her litigation risks would also be diluted. These prospects would induce the attorney to overcome her fee-related frustration and to zealously prosecute the class action.

Indeed, because no attorney has a vested right to represent class action clients who did not hire her personally, judges are authorized to conduct a pre-auction screening of prospective class counsel.[142] Note that information about class counsel performance is readily available to judges and attorneys. Both legal and business communities maintain efficient communication channels through frequent publications, such as *New York Law Journal*, *Wall Street Journal*, and other periodicals. These publications report about class actions and often comment on the attorneys' performance.[143] Judges may further enhance this communication by commenting on the class attorney's performance in their decisions, disseminated by both law reports and the professional databases, such as LEXIS and Westlaw.[144] Judges may also supplement this market mechanism with an attractive alternative. Their auction conditions may provide, for example, that for every 10% shortfall between the filed and the recovered amounts the attorney will be excluded from similar auctions for a specified period. The attorney would consequently attempt to shorten her future exclusion period by maximizing the amount of the class

142. The *Auction Houses* court conducted such screening of attorneys. *See Auction Houses*, 197 F.R.D. at 72-74; *See also In re* Lucent Techs., Inc., Sec. Litig. 194 F.R.D. 137, 157 (D.N.J. 2000); *In re* Oracle Sec. Litig., 132 F.R.D. 542 (N.D. Cal. 1990).

143. *See, e.g.*, Hamblett, *supra* note 96; Coffee, *supra* note 98.

144. *Cf.* Edward B. Rock, *Saints And Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1063-72 (1997) (demonstrating that professional publications efficaciously channel information about corporate officials' performance within both corporate and legal communities).

members' recovery. As already explained, there is a good reason for letting the attorney sustain the consequent loss. This attorney prevailed in the auction after defeating a better assessor of the class action. Therefore, this attorney was not the best attorney to represent the plaintiffs and her selection frustrated the auction's purpose.[145]

To intensify the competition amongst prospective class attorneys, judges may also require that an appropriate public announcement be made prior to the auction. Such announcements might attract more attorneys to participate in the auction. For obvious reasons, an addition of auction participants would result in a bidding process more beneficial for the suing class.

E. *Who Wins the Auction?*

For reasons articulated above, offers tendered by attorneys participating in the auction would coincide with the attorneys' genuine estimations of the lawsuit's expected return. This basic sum would be determined by the lawsuit's stakes, multiplied by its probability of success. By offering to file a lawsuit for a lesser amount, the attorney would expose herself to a substantial risk of defeat in the auction. If she offers to sue for an exaggerated amount, then, for reasons already given, she might win the auction, but she would lose her fee. The attorney would therefore base her auction offer on the lawsuit's expected return, as she calculated it by using her best professional judgment. The attorney would only be able to increase this basic sum by an additional amount that reflects the defendant's litigation costs. She might find this adjustment attractive in the expectation that the defendant would still be willing to settle the case in order to save part of those costs. However, because these incentives are public knowledge, every attorney participating in the auction would act similarly. Therefore, the adjustment of our attorney's offer would not increase her chances of winning the auction.

The auction therefore cannot be won opportunistically: an attorney can win it only on the grounds that genuinely reflect her appraisal of the lawsuit's expected return. Any such attorney would calculate this sum by multiplying her genuinely estimated full value of the lawsuit by her genuinely estimated probability of success. Nor is it possible for a prospective class attorney to strike a collusive settlement with the defendant prior to the auction. If such an attorney subsequently offers a low lawsuit amount, she would then be overtaken by another attorney, so the collusive settlement would not be

---

145. Arguably, this corrective measure could also improve the auction that took place in *Auction Houses*. This improvement, however, would only be possible if the court based the attorney's loss of her fee on the outcome of the proximity-of-recovery contest. Any other criterion for fee forfeiture would be arbitrary or otherwise problematic. If the court decided to conduct the proximity-of-recovery contest amongst competing attorneys, its auction would then become similar to ours.

implemented. If she offers an exaggerated lawsuit amount in order to win the auction and assume control over the class action, she would then be committed to that amount, which would preclude the possibility of a settlement and force judgment on the merits onto the parties concerned.[146] In accordance with the fee-forfeiture provision, this judgment might also deny the attorney her fee.

Our model therefore precludes the scenario in which an incompetent and disloyal attorney wins the class counsel auction and subsequently delivers a poor representation to her clients. This morbid scenario was one of the principal reasons that supported the Task Force's skeptical report on class counsel auctions.[147] The problem faced by the court in appointing class counsel parallels the problem encountered by employers in recruiting employees. In both cases, the right appointment depends on each candidate's competence and loyalty, but the information about these qualities is not publicly observable and verifiable. This information is hidden or "private":[148] each candidate is privately informed about her professional qualities, but this information is both unobservable and unverifiable because low-quality candidates pool with better candidates and do not reveal this information. Therefore, the problem that arises here is that of asymmetric information.[149] The informational asymmetry that exists between the court and the class members, on the one side, and each candidate for the class counsel position, on the other side, creates an opportunity for lying and cheating. Unscrupulous and incompetent attorneys may exploit this opportunity to seize the class counsel position.

Our model precludes false signaling by competing attorneys by screening out the disloyal and incompetent bids. There is only one type of attorney that can win our auction: an attorney who conscientiously estimated the class members' expected recovery, offered them a competitive fee, and pledged her earnings from the case as a security for her undertaking to provide her clients a both loyal and competent representation. All other attorneys would either be defeated in the auction or forfeit their earnings from the case. Because both of these prospects lie within the bidding attorneys' contemplation, unscrupulous and incompetent attorneys would have no incentive to participate in the auction. Our model thus guarantees a both loyal and professionally adequate representation of class members. This model emulates the rational process by which a single and reasonably informed owner of a lawsuit hires an attorney in a free market and secures loyal and competent representation by that attorney.

146. The defendant may also bribe the class attorney to induce her to betray her clients at trial. As already mentioned, our model does not eliminate such criminal possibilities, leaving this job to the appropriate criminal sanctions, to disciplinary measures, such as disbarment, and to the economic incentives that include holdouts and extortions. *See supra* note 48 and accompanying text.

147. *See* TASK FORCE REPORT, *supra* note 11, at 46, 734, 738-9

148. *See generally* IAN MOLHO, THE ECONOMICS OF INFORMATION: LYING AND CHEATING IN MARKETS AND ORGANIZATIONS (1997).

149. *See id.* at 1-10.

But what about the attorney qualities that go beyond loyalty and basic competency? Admittedly, selecting the best attorney amongst candidates already screened for both loyalty and professionalism often proves to be a formidable task. Beyond this basic screening, our model offers only one criterion for such selection: a competition between the attorneys' net recovery undertakings for class members. This criterion is not perfect, but it seems to be the only one available. At the very least, our model guarantees class members a medium-quality combination of loyalty and professionalism. All other means of selecting class counsel do not even guarantee that.

F. *Eliminating the Conflict-of-Interests Differential*

Our model affects the class attorney's opportunity costs (as defined above) in a way that eliminates the minimum conflict-of-interests differential, indexed as $C(1-f)/f$. To repeat: this differential originates from the attorney's presently existing incentive to settle the case without litigating it, as long as the settlement yields her a fee equal to (or greater than) $fPR - C$.[150] The attorney would thus settle the case for any amount equal to (or greater than) $PR - C/f$. The class members would then recover $(1-f) \times (PR - C/f)$, as opposed to their expected recovery amount $PR(1 - f)$. The difference between these two amounts—denoted as $C(1 - f)/f$—is the conflict-of-interests differential that needs to be eliminated.

The attorney's search and preparation efforts, together with other costs already expended in connection with the lawsuit, are sunk costs that already equal zero. As for the attorney's other costs, their fate would depend on whether the case is settled or tried. Under our model's conditions, the case can only be settled when the settlement amount equals the expected return from the lawsuit (PR). This would also be the filed amount, to which the attorney committed herself at the auction. The attorney would therefore be unable to settle the case, to her clients' detriment, for $PR - C/f$ in order to gain $fPR - C$ without litigating the case. If she did so, her fee would be subject to forfeiture. This means that the attorney irrevocably committed herself to not sacrificing the sum of C/f, that belongs to her clients, in order to induce the defendant to settle. Absent that inducement, the defendant would have to decide whether to settle the case by paying the class members PR or go to trial. Other possibilities are not open to the defendant.

This framework of rules and incentives places the class attorney's opportunity costs outside her control. These costs are pledged for the benefit of

150. To recall: in this formula, P denotes the probability of the lawsuit's success; R denotes the full amount of money to be recovered by the class members if the lawsuit succeeds; f denotes the attorney's share in the action (that is, her contingent fee); and C denotes the attorney's opportunity costs.

the class members, and it is only the defendant who can remove this pledge by paying the class members the expected value of their lawsuit as a minimum settlement amount. The defendant may also decide not to pay this amount, which would force the class attorney to expend her opportunity costs on the ensuing litigation. In the first scenario, the class members would receive $(1 - f)PR$ and the attorney would gain fPR. The conflict-of-interests differential would thus disappear due to the defendant's decision to save the class attorney's opportunity costs. Formally, when the settlement prospect is assessed from the class attorney's perspective, this implies that $C = 0$. In the second scenario, the defendant's decision to litigate burns out the attorney's opportunity costs. Formally, this prospect also implies that $C = 0$ because those costs will unavoidably sink. At *any* stage in the proceeding, the class attorney's opportunity costs which are not yet sunk would thus either sink or be saved in their entirety, depending on what the defendant—not the class attorney—decides to do. For that reason, these costs would always equal zero in the attorney's settlement calculation; and because $C = 0$, the conflict-of-interests differential—$C(1 - f)/f$—would also equal zero.

In this way, our model eliminates the first type of collusion that exploits the minimum conflict-of-interests differential by allowing the class counsel to acquire a share in the action without paying for it with her opportunity costs. Previous attempts at resolving the same problem undertook a more comprehensive and consequently more ambitious task: their objective is to align the interests of the class counsel with those of the class members. Formally, a successful implementation of this objective would guarantee that $f = 1$. If this project were to succeed, the conflict-of-interests differential would also fade away. Furthermore, the success of this project would eliminate the opportunity for the second type of collusion, since there would be no incentive for the class counsel to enlarge her share in the action through reduction of her clients' share. However, this apparent advantage of the $f = 1$ project turns out to be a disadvantage. This project is too ambitious and therefore unlikely to be successfully implemented in practice. The specific shortcomings of this project's various offshoots have been outlined in our preceding discussion.

Our set of rules would also foreclose the second type of collusion. The auction provision publicly affixes the lawsuit its highest market value. The fee-forfeiture provision commits the selected class attorney to this publicly stated amount. The settlement-ban provision prevents the defendant and the class attorney from striking a settlement that would reduce this amount. The defendant would thus be unable to assist the class attorney in executing her self-seeking plans. Under the already existing class action rules, the class attorney's share in the lawsuit (f) is subject to the court's approval and is therefore translucent.[151] The class members' share in the lawsuit can therefore no longer be embezzled by a collusive settlement.

G. *The Likelihood of a Settlement*

Promotion of settlements is yet another feature of the proposed model. This model would increase the settlement rate by motivating both the class attorney and the defendant to correctly evaluate the expected value of the lawsuit. If the attorney who prevails in the auction correctly determines the lawsuit's expected return and subsequently sues the defendant for that amount, the defendant may or may not offer her a settlement. If the defendant's estimation of the lawsuit's expected return is similar or close to that of the attorney, settlement would become virtually inevitable. The defendant would then simply offer the attorney to settle the case for the sued amount. From the defendant's viewpoint, such a settlement would be obviously attractive: by entering into it he would save his litigation costs. The defendant would thus remove the threat posed by the class action and purchase the *res judicata* protection from future lawsuits at the lowest possible price. If the defendant's estimation of the lawsuit's expected return substantially differs from that of the class attorney, the case would go to trial. This prospect would entail considerable risks for both the class attorney and the defendant. The class attorney would risk losing her fee, which would impel her to zealously prosecute the lawsuit. The defendant, in turn, would face an unremovable threat of being defeated at trial, which entails substantial losses. The class attorney and the defendant would therefore seek common ground. They can therefore be expected to cooperate in order to reduce the extent of the asymmetric information and strategic bargaining problems as impediments to a settlement.[152]

After the auction, however, this cooperation might be unfruitful, since the class attorney would have already committed herself to the sued amount by making a unilateral estimation of the lawsuit's expected return, with which the defendant may rationally disagree. It would therefore be more rational for a prospective defendant to negotiate a settlement before the auction in order to initiate a class action settlement proceeding in collaboration with the class attorney.[153] Any such negotiation and the ensuing settlement would, of course, be conditional on the auction's outcome, since the settlement offer jointly made by the defendant and the cooperating attorney might still be overbid by another attorney participating in the auction. The defendant and the cooperating

151. *See* FED. R. CIV. P. 23(e); NEWBERG & CONTE, *supra* note 53.

152. *Cf.* Miller, *supra* note 130, at 26-28 (arguing that reducing the parties' optimism is essential for attainment of efficient settlements).

153. *See, e.g.*, Coffee, *supra* note 46, at 1378-82 (describing and criticizing the class action settlement practices in the area of mass torts).

attorney would therefore attempt to agree on a settlement amount that would defeat other offers in the auction. If they agree on such an amount, and if their joint offer subsequently defeats other offers at the auction, the resulting settlement would then adequately reflect the class action's expected return. This would guarantee adequate compensation for the class members. Moreover, a considerable amount of litigation expenses would be saved and dockets would be cleared. The proposed model therefore not only resolves the class action agency problem, but also promotes general efficiency in the resolution of class action disputes.

VI. THE DISCOVERY MECHANISM

Our model would produce the desired effects only if courts supplement it with an efficient mechanism for pretrial discovery. Without such a mechanism, prospective class attorneys would hardly be able to estimate the expected return of the lawsuit. Many attorneys would consequently decide not to search for and prosecute violations, and those who would still be willing to do so would base their auction offers on a fair amount of guesswork. Under the existing discovery doctrine, courts may enable prospective class attorneys to conduct the required discovery.[154] However, under our model's set of rules, none of the attorneys would have a strong enough incentive for conducting comprehensive discovery. Class action discovery is a costly proceeding that requires substantial time and effort. Few attorneys (if any) would be willing to incur the costs of this proceeding before securing their appointment as class counsel. The "winner's curse" problem, to which we refer earlier in this Article,[155] further intensifies the attorneys' reluctance to invest in discovery.

Furthermore, since no attorney would acquire a proprietary interest in the information that she would produce through discovery, the well-known common pool problem would emerge. Each of the attorneys would contemplate free-riding on the information generated by others, and she would also anticipate that other attorneys would take a free ride on the information that she would produce. In equilibrium, therefore, none of the attorneys would engage in producing the relevant information. This danger further strengthens the case for a collectivized mechanism of discovery.

For these reasons, we propose to appoint an attorney not participating in the auction as a discovery master.[156] This master and the attorney who prevails in

154. *See* FED. R. CIV. P. 26(a).

155. *See supra* note 59 and accompanying text.

156. Rule 53 of the Federal Rules of Civil Procedure authorizes appointment of such masters. *See supra* note 30. Because the master would economize the class members' discovery expenses, utility and fairness both justify its engagement in class actions. Note that, in litigation, discovery expenses are inevitable, as opposed, for example, to the costs that Alon Klement offers to expend on the monitoring of class attorneys. *See* Klement, *supra* note 25.

the auction would have to commit themselves in advance to the following set of rules. The master will conduct the discovery and subsequently sell its products, for an agreed price, to the attorney who won the auction. Before this transaction, the discovery products will be available to each attorney participating in the auction. Every auction participant will thus be able to base her filing offer on the information obtained through discovery (in addition to the information that she obtained independently). If the master and the auction winner fail to reach an agreement concerning the discovery products' price, the court will determine that price at a special hearing. Because discovery is an essential legal practitioner's job, one can expect professional judges to adequately assess its value. Alternatively, the court will determine that price and keep it unannounced until the master and the auction winner submit their offered prices in sealed envelopes. The court will then open the envelopes, and the sum that comes closer to that of the court will be the price for which the auction winner will purchase the discovery products from the master.[157]

This set of rules prevents both overpricing and under-pricing of the discovery products. Under this set of rules, the master will submit to the court his highest price that approximates the judge's anticipated valuation of the products. The attorney, in turn, will submit her lowest price that approximates the same valuation. Because the attorney and the master will compete with each other over the proximity of their respective prices to the judge's anticipated valuation, the attorney will submit her maximal purchasing price, while the master will offer his minimal selling price. The two prices will thus come close to each other, and the judge's valuation will identify the price that is more reasonable than the other.

The master will consequently have an adequate incentive for conducting comprehensive discovery. To obtain future engagements, the master will also be keen to establish a reputation for his work as both thorough and reasonably priced. In turn, each of the auction participants will have an adequate incentive for winning the auction in order to represent the suing class. Each of them will submit her auction bid subject to an assurance that the price for the discovery products will be reasonable.[158]

---

157. Arbitrators successfully used this method in resolving the Baseball League salary disputes. *See, e.g.*, Jason Micah Ross, Note, *"Baseball Litigation": A New Calculus for Awarding Damages in Tort Trials*, 78 TEX. L. REV. 439, 448-50 (1999) (presenting and discussing the baseball arbitration method).

158. Professor Lisa Bernstein suggested that we examine the possibility of allowing the discovery master to sell his products to the highest bidder in a separate auction. That bidder would subsequently be able to use these products if she also won the main auction. If that bidder did not win the main auction, she would sell the products to the attorney who won it. The given set of rules would allow the winner of the main auction to use the discovery products only after purchasing them. Seemingly, this framework would create optimal incentives for pretrial discovery.

However, this possibility is problematic. One of the participants in the auction for discovery

VII. CLASS COHESION AND INTRACLASS CONFLICTS

No class action mechanism would operate fairly and efficiently if a single attorney or a group of attorneys[159] were allowed to represent diverse groups of claimants with conflicting interests. If obtaining a benefit for one group of claimants entails a disadvantage for another group, an attorney representing both groups would act under a conflict of interests.[160] Such an attorney would therefore be unable to promote the interests of all her clients both fairly and efficiently. To eliminate intraclass conflicts, courts have to divide heterogeneous groups of claimants into homogeneous subclasses. Under the Federal Rules of Civil Procedure, class certification inquiry is a procedural device by which courts perform the required division.[161] Subclassing, however, also entails a danger for the class action's economy of scale. As Professor Coffee observes,

> If subclassing is required for each material legal or economic difference that distinguishes class members, the Balkanization of the class action is threatened. Such a fragmented class might be unmanageable, certainly would reduce the economic incentives for legal entrepreneurs to act as private attorneys general, and

---

products may decide to outbid others strategically in order to make the subsequent purchase of the products unattractive. Because the products' price might be too high for the winner of the main auction, this winner might decide not to represent the suing class. Consequently, the purchaser of the discovery products would acquire control over the class action and subsequently use it to her advantage. Thus, if she is prepared to earn a lesser fee, she would attempt to strike an early settlement with the defendant at the expense of the suing class. By suing the defendant for a lesser amount, previously stated in her main auction offer, this attorney would be able to escape the fee-forfeiture provision. An attempt to resolve this problem by requiring the discovery products' purchaser to file the action for the amount offered by the winner of the main auction would create another difficulty. Attorneys participating in the auction for discovery products would face the prospect of losing money (due to their inability to sell the products for their full price to the selected class attorney or, alternatively, due to their involvement in a non-profitable class action). The attorneys would therefore reduce their bids. Anticipating this reduction, the discovery master would reduce his efforts. The quality of discovery products would consequently be reduced to the detriment of the suing class.

159. A group of attorneys would also include counsel who represent different claimants, but pool their fees. *See* Coffee, *supra* note 25, at 398 (noting that "subclassing as a remedy for class action collusion may accomplish little if plaintiffs' attorneys for different subclasses could by pooling their fees effectively cancel the incentives that the law means to create for them to zealously represent their clients").

160. *See generally* Deborah L. Rhode, *Class Conflicts in Class Actions*, 34 STAN L. REV. 1183 (1982).

161. FED. R. CIV. P. 23(c)(4)(B). The Supreme Court's recent jurisprudence indeed underscores judicial vigilance in detecting manipulated definitions of the class. *See* Amchem Prods., Inc. v. Windsor, 521 U.S. 591 (1997) (requiring subclassing of mass tort plaintiffs with conflicting interests and striking down an otherwise fair settlement); Ortiz v. Fibreboard Corp., 527 U.S. 815 (1999) (applying the same principle and striking down a settlement in a limited-fund class action proceeding). For discussion of these decisions *see* Issacharoff, *supra* note 60 (criticizing both *Amchem* and *Ortiz* for their rule-formalism and offering to tackle conflicts of interests that arise in class actions by legitimate governance standards); George M. Cohen, *The "Fair" Is the Enemy of the Good:* Ortiz v. Fibreboard Corporation *and Class Action Settlements*, 8 SUP. CT. ECON. REV. 23 (2000) (observing that the *Ortiz* decision was correct as a matter of formal legal principle, but insufficiently sensitive to pragmatic concerns). *See also* Susan P. Koniak, *Feasting While the Widow Weeps:* Georgine v. Amchem Products, Inc., 80 CORNELL L. REV. 1045, 1051-86 (1995) (demonstrating how class attorneys may gerrymander the class to augment their private profits).

could be extremely difficult to settle if each subclass (and its attorney) had an incentive to hold out for more.[162]

Our model features no explicit mechanism for securing class cohesion and for eliminating intraclass conflicts. Yet, it does offer a competitive environment that would facilitate class certification inquiries. In that environment, courts would be able to conduct such inquiries after the discovery and before the auction. At this stage, information obtained through discovery would be supplemented by the information that each competing attorney would provide in order to prevail over her competitors in the subsequent auction. This proceeding would take place under the court-imposed rule that prohibits representation of heterogeneous classes by a single attorney or by a group of attorneys. For obvious reasons, each attorney participating in this proceeding would be interested in increasing her chances of winning the subsequent auction. Each attorney would therefore be interested in any subclassing that would be economically attractive from her perspective. Any such subclassing would both increase the number of auctions in which she can participate and decrease the number of competitors that could prevail in those auctions. The attorney's chances of winning one of those auctions would consequently increase.

This proceeding would also generate information that individual claimants would subsequently be able to use as a basis for their participation in the class action. Individual claimants would also be able to utilize that information in deciding about opting out from the action and hiring their own counsel. The proposed proceeding would therefore fortify the class members' right to both "voice" and "exit," which, in turn, would produce greater loyalty on the part of class attorneys. This proceeding would thus promote the "voice," "exit," and "loyalty" objectives that two class-action experts, Professor Coffee and Professor Issacharoff, have recommended in their recent articles.[163]

Finally, attorneys representing any existing claimant must not be allowed to participate in the auction. Auction competitors should therefore be required to certify their non-engagement in any existing or future representation of any claimant eligible for joining the class action. This strict condition for participating in the auction is necessary for our model's proper operation. Alternatively, courts would be required to evaluate any potential conflicts of interests on a case-by-case basis.[164]

---

162. *See* Coffee, *supra* note 25, at 398.

163. *See id.*; Issacharoff, *supra* note 60, at 366-80.

164. *Cf.* Samuel Issacharoff, *Class Action Conflicts*, 30 U.C. DAVIS L. REV. 805, 832-33 (1997) (advocating, inter alia, "a strong presumption against class certification in which plaintiffs' counsel are able to unload an inventory of preexisting cases [and] against class certification in any type of case in which there are preexisting contractual relationships between plaintiffs' counsel and one segment or section of the proposed class and no preexisting contractual relationship between the plaintiffs' counsel

VIII. CONCLUSION

Class action was designed to empower individual victims harmed by formidable corporate power. Under this mechanism, plaintiffs give up control over their lawsuits, theoretically, in exchange for guaranteeing their substantive rights. This mechanism, however, gives class attorneys an ample opportunity to earn their fees without expending much time and effort on behalf of their clients. Moreover, corporate wrongdoers and unscrupulous class counsel may enter into collusive settlements that deprive plaintiffs of their just remedies. In addition to causing obvious injustice to the victims, such settlements are economically inefficient. Under such settlements, corporations would pay too little for the harms they inflict and, consequently, would invest sub-optimally in precautions.

Our analysis of the class action agency problem has identified two distinct paradigms within which the available solutions to that problem fall. Under the Ownership paradigm, the class attorney becomes the master of the action. Under the Servantship paradigm, the attorney is closely monitored by competitive market and other mechanisms, carefully designed to eradicate the conflict of interests between the attorney and the suing class. After demonstrating the failure of the Ownership paradigm, we have proposed a new solution to the problem. The proposed solution falls into the Servantship paradigm. This solution consists of three rules: auction, fee forfeiture and a ban on inadequate settlements. We have demonstrated that the synergetic working of these rules guarantees both economic efficiency and justice to the individual victims.

and another section of the class").