Outline of Testimony by

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A PRIMER ON CLASS AUCTIONS
(academic jargon deleted)[1]

Introduction

Auctions to determine the class counsel who will represent the plaintiff class have been either recommended or criticized by a variety of commentators for a variety of reasons. At the outset, it seems sensible to begin with the possible reasons that a court might wish to use an auction procedure and then turn to the most common objections.

Among the reasons that motivate some courts and commentators to recommend an auction procedure, the following stand out:

[1] Academic jargon has a legitimate purpose, and the following articles use it well to discuss various aspects of the auction debate. See Macey and Miller, The Plaintiff's Attorneys Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. Chi. L. Rev. 1 (1991); Thomas and Haugen, Auctioning Class Action and Derivative Lawsuits: A Critical Analysis, 87 Nw. U. L. Rev. 423 (1993); Macey and Miller, A Market Approach to Tort Reform, via Rule 23, 80 Cornell L. Rev. 909 (1995); Fisch, Aggregation, Auctions and Other Developments in the Selection of Lead Counsel Under the PSLRA, 64 Law and Contemporary Problems 101 (2001) (forthcoming); Niebler, In Search of Bargained-for-Fees for Class Action Plaintiffs' Lawyers: The Promises and Pitfalls of Auctioning for the Position of Lead Counsel, 54 Bus. Law. 763 (1999). The first article to discuss and evaluate counsel auctions appears to have been Coffee, 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) (discussing but rejecting the idea).

1. Economy. Auctions should economize on the counsel fees paid by the class to their attorneys, which fees seem today to be often based on non-competitive benchmarks and formulas that may sometimes result in windfalls.

2. Incentives. Auctions may better align the interests of class counsel with those of their clients and may better motivate counsel to seek a greater recovery for the class. Existing fee award procedures have well-known deficiencies: the lodestar formula creates an obvious incentive to stretch out the pace of litigation and hence erode the discounted value of the recovery (as an earlier Third Circuit Task Force recognized twenty years ago), and the percentage-of-the-recovery approach is thought by some to create an incentive for premature settlements that may be "cheap" in proportion to the action's actual litigation value.

3. Competition. Auctions introduce competition into a legal marketplace that sometimes seems dominated by a relatively small number of plaintiffs' firms, which may have incentives to collude, rather than compete. New entrants can enter the field through competitive bidding in auctions, whereas they would be unlikely to win elections as class counsel if the selection were resolved by the vote of participating counsel.

4. A Remedy for "Pay-to-Play." Auctions may protect the selection process from the impact of political contributions and political preferences. Although this point has not yet been much emphasized, the increasing prevalence of public pension funds as lead plaintiffs in securities class actions raises the danger that political contributions to the elected public official who in many states and municipalities determines the policies of the pension fund may determine the choice of counsel.

These goals are diverse, and it should be obvious that an auction procedure or formula that maximize one goal may minimize another goal. Goals therefore need to be ranked and prioritized. This memorandum will suggest that rational class members would want the court to use the fee formula that maximizes the net recovery to the class, not the fee formula that minimizes the actual fee paid to the class counsel.

Objectivity requires, however, that we first survey the standard objections to auctions as a means for selecting class counsel. These include the following:

1. In an auction, the lowest bidder will often be the bidder with the lowest opportunity cost. If so, auctions will systematically assign the role of class

counsel to the least qualified bidder (among those permitted to bid).

2. Auctions do not reward the original attorney who undertook search costs to discover a violation of law; hence, an auction system implies a reduced incentive for private attorney generals to seek out violations of law.

3. Auctions will result in the undervaluation of the legal claims and reduced settlements, because the claims are effectively valued before discovery is undertaken. This danger is particularly exacerbated to the extent that a declining percentage of the recovery fee formula is used.

4. Auctions often attract too few bidders for their results to be equated with a true market rate.

5. Auctions are inconsistent with the intent of the Private Securities Litigation Reform Act ("PSLRA"), which was intended to substitute "client-driven" litigation for "lawyer-driven" litigation. In "client-driven" litigation, clients normally select counsel, and seldom conduct auctions.

6. Auctions intensify the conflict between class counsel and the class and, under some formulae, starkly oppose their interests.

7. "True" auctions are not possible, because case law already has required an ex post review of the attorney fee, and such review precludes a meaningful auction. See In re Cendant Corp. Prides Litigation, 243 F.3d 722 (3rd Cir. 2001).

8. Auctions are vulnerable to the "winner's curse" and may systematically allocate control over class actions to the most over-optimistic attorney.

To state these objections is not to accept them at face value. Their merits vary, but each is a serious objection to the use of some forms of auction procedure in at least some contexts. Nonetheless, this brief survey will suggest that there is a role - - albeit, a limited one - - for class auctions in some class action contexts (but not in others).

II. The Diversity of Auctions

The concept of an auction for the role of class counsel is not self-defining. Since the first use was made of auction procedures a decade ago in In re Oracle Securities Litigation, 131 F.R.D. 688 (N.D. Cal. 1990), a number of procedural variations have been utilized by different

courts. The original pioneer, U.S. District Judge Vaughn Walker, specified various settlements time frames (e.g., before the conclusion of discovery, before trial, during trial, etc.) and invited sealed bids that indicated the fee the bidding counsel would expect to receive depending upon when the case was resolved. Critics have argued that this approach effectively resurrects the lodestar formula and codifies its worst features, because so long as the bidding is framed on such a time-segmented basis, counsel has an incentive to stretch out the litigation to obtain the higher fee. Also, there is another perverse effect: once plaintiff's counsel limits its fee to an estimated number of hours, it becomes vulnerable to defendants who deliberately seek to "over-litigate" the case because they know that plaintiff's counsel will not be rewarded for the excess hours of work and additional expenses that defendants may be able to impose on them. Thus, plaintiffs' counsel may be induced to settle more cheaply when they can be forced to do uncompensated work. Accordingly, other courts have preferred a percentage of the recovery approach, and awarded the case to the lowest percentage bidder. Here too, there have been significant variations, with several courts having indicated a preference for a declining percentage of the recovery formula. Conversely, at least two decisions (In re Cendant Corp. Litig., 182 F.R.D. 144 (D.N.J. 1998) and In re Auction Houses Litig., 197 F.R.D. 71 (S.D.N.Y. 2000)) have employed an increasing percentage of the recovery.

The early (and admittedly fragmentary) evidence does seem to show that incentives count - - and heavily. When in In re Amino Acid Lysine Antitrust Litig., 918 F.Supp. 1190 (N.D. Ill. 1996), the winning bidder placed an upper boundary of $25 million on the recovery that would

generate it a fee,[2] other bidders objected that this would leave it no incentive to seek to obtain more than $25 million. Although the court refused to recognize the perverse incentive that thereby arose, the case did ultimately settle at just over this $25 million ceiling. Had the ceiling been higher (or had there been no ceiling), it seems a fair inference that plaintiff's counsel might not have settled at this level so quickly. The message here is probably that any sharply declining percentage of the recovery formula probably hurts the class (although it does protect the court from seeming to award a "windfall" fee).

Conversely, an increasing percentage of the recovery formula was used in the Cendant Corp. Securities Litig., which formula started at a very low percentage (2%)and rose to a maximum of 9% on amounts recovered over $1 billion. The ultimate recovery in Cendant was $3.1 billion, the largest recovery in the history of class actions, but it came to only 8.275% of the total recovery. Similarly, in In re Auction Houses, Judge Kaplan asked the various bidders to specify the recovery level up to which they would take no fee and then mandated that the winning bidder would receive 25% of the recovery above that point (in effect, this amounted to an "increasing" percentage of the recovery, one which rose from 0% to 25%). In Auction Houses, the highest bidder bid $400 million - - and ultimately obtained an over $500 million recovery. Yet, the average bid in that case (according to Judge Kaplan) was only slightly above $100 million, and several other experienced antitrust counsel, who had also bid in the auction, testified to the court at the fee award hearing that they had not anticipated a recovery

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[2] The winning bidder proposed a 20% fee out of the first $5 million recovered, plus 15% of the next $10 million, and finally 10% of the next $10 million. This is an standard example of a "declining" percentage of the recovery formula (although the "cap" on the recovery is unusual).

approaching one half of what was ultimately obtained. These very few experiments with the increasing percentage approach may supply evidence that an increasing percentage formula does incentivize plaintiff's counsel to obtain a higher recovery. However, the Auction Houses example also reveals that the "winner's curse" problem, which is much discussed in the academic literature about auctions, does have real world analogues, because the highest bidder there bid way beyond all other bids and roughly four times the average bid. Finally, Auction Houses also shows the importance of a robust market and multiple bidders, because the average bid of $100 million in that case would have implied a fee award of $95.4 million, not the $26.75 million fee that Boies, Schiller & Flexner actually obtained.[3]

Still, given the joint outcomes in Cendant and Auction Houses, the most likely hypothesis is that a flat or increasing percentage works better than a declining percentage to induce counsel to resist early settlement offers and obtain the highest recovery for the class. Phrased more generally, the message of these cases may be "that high-quality legal representation can be obtained at auction only by [the court] selecting bids that propose fee structures which incorporate self-enforcing incentives for class counsel to actually furnish quality services."[4]

III. Evaluating The Objections to Auctions

[3] Of course, this fear of a windfall fee assumes that the other bidders would also have obtained a settlement of over $500 million. I consider this unlikely and believe that the exemplary settlement and the unique fee formula in that case were causally related.

[4] See Andrew Niebler, In Search of Bargained-for-Fees for Class-Action Plaintiffs' Lawyers: The Promises and Pitfalls of Auctioning the Position of Lead Counsel, 54 Bus. Law. 763, 764 (1999).

A. <u>The Lowest Bidder Objection</u>. The fear that the low bidder will be an unqualified recent law school graduate with little real-world experience does seem overstated. All courts using this procedure to date have limited the field of bidders to those that they consider qualified for the complexity of the task. Moreover, some fee formulae are less vulnerable to this problem. For example, Judge Kaplan's approach in <u>Auction Houses</u> effectively asked the bidders to bid in terms of their relative confidence about the case, and it seems less likely that the least qualified counsel would bid the highest recovery level from which that counsel would take no fee. In any event, the Task Force could recommend guidelines (for example, no firm should be allowed to bid for the class counsel role who had not previously served as lead counsel for the class in a prior action that was successfully resolved).

In truth, the claim that the client always wants the "best" lawyer regardless of cost ignores the behavior of sophisticated corporate clients, who frequently hold "beauty contests" in which defense counsel are asked to bid against each other. To be sure, in those cases, there may be a cost/quality tradeoff which cannot be duplicated in a pure auction. Possibly then, the court might be given some discretion in guidelines to prefer a bidder whose bid was within some defined percentage (say 5%) of the "best" bid if the court concluded that there was a significant disparity in quality.

B. <u>The Search Costs Objection</u>. This a more substantial objection, but it only applies to some class actions. If the attorney has diligently researched the action before filing it (as happens in some mass torts and consumer frauds class actions), the attorney has staked out a claim based on the attorney's efforts, which an auction inherently preempts. This is claim-jumping, and it reduces the incentive to search. There are, however, two possible answers: (1)

find some way to compensate out of the recovery the original counsel who undertook the investigatory work that discovered the law violation (or make the successful bidder compensate the initial attorney as of the auction date), or (2) develop guidelines that permit auctions only in cases unlikely to be characterized by such pre-filing search efforts. For example, in securities class actions, the case is often precipitated by a sudden stock drop in the defendant's stock price. This implies that the market, not the attorney, discovered the violation (or at least the alleged facts underlying it). Similarly, in many antitrust class actions, either a governmental investigation or an announcement by the defendant precedes the filing of any class action (this was the case in Auction Houses and probably explains why the court was willing to replace the counsel it originally selected as provisional lead counsel). Again, guidelines seem able to distinguish these two contexts and indicate that auctions were not appropriate in cases necessarily involving extensive pre-filing investigations.

C. Undervaluation. Because the auction occurs prior to discovery, the competitors do not know the true value of the action at the time they bid (whereas such value is better known at the time of settlement).[5] Logically, competitors would want a larger percentage of an action that they undervalue than of an action that they correctly value. Alternatively, to the extent that the action is undervalued, attorneys may invest less in litigating it. Hence, undervaluation can become a self-fulfilling prophecy. Still, if underinvestment in the action is likely, this is less an argument for abandoning auctions than for using a fee formula that compensates for this problem (i.e., an increasing percentage of the recovery formula).

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[5] See R. Thomas and R. Haugen, Auctioning Class Action and Derivative Lawsuits: A Critical Analysis, 87 Nw. U. L. Rev. 423 (1993).

In any event, there is an inconsistency between this claim that auctions will result in underinvestment in the action and the "winner's curse" hypothesis (discussed below), which posits that the most over-optimistic bidder tends to win the auction. I find this latter possibility more plausible.

D. Too Few Bidders. This is a real problem, and it has arisen in some of Judge Walker's auctions where only three or four bidders appeared (with many experienced firms declining to bid once the auction format was announced). This disinclination to bid may reflect a perception that the court intends to under-compensate the successful attorney, or it may reflect collusion among bidders. The court can, of course, restrict joint bids by multiple firms (and Judge Walker has done this). From the Task Force's perspective, the practical answer may be to adopt a recommendation or guideline that no auction be held, absent a minimum number of qualified bidders (say, at least six). Of course, there is a danger that this may only elicit token bids from firms seeking to assist the winning bidder.

E. PSLRA. I agree there is a conflict between the PSLRA and auctions. In particular, auctions may deter major institutional investors from serving as lead plaintiff if they cannot pick their own counsel. For example, in Cendant, the lowest bidder (who was eventually disqualified) had charged that the "lead" institutional investors had been bribed with political contributions. One cannot reasonably expect to force a marriage between such antagonists. A possible compromise is that used in Cendant: permit the counsel selected by the lead plaintiff to match the lowest bid. Yet, while this may work in one case, it tells all future bidders that they are not participating in a true auction. As a generalization, such a rule creates a de facto right of first refusal, and it has long been recognized that rights of first refusal limit the marketability of

an asset.

Of course, it is imaginable that a given lead plaintiff might prefer to use an auction. Still, pending any such unlikely event, I would urge the Task Force to recommend that auctions not be used in securities class actions. This still leaves antitrust and similar high public visibility class actions (for example, an Exxon Valdez-type oil spill) as instances in which the auction format could be used.

F. Conflicts of Interest. Consider again the facts of the Auction Houses case where the winning bidder bid $400 million (meaning that it would not receive any fee on the first $400 million recovered). Suppose now that the defendants are adamant that they will not settle at more than $300 million (which was in fact well above the level that other counsel in the bidding saw as the likely recovery range). Assume further that a $300 million settlement is more in the interests of the class than a highly risky trial. At this point, a conflict arises the interests of counsel and the class it represents. The more competitive the auction, the more likely that this conflict will arise - - if courts again use Judge Kaplan's fee formula.

Nor is this example unique. A declining percentage of the recovery has long been thought to encourage premature settlements, because counsel will not accept the high risk incident to a trial in order to obtain only a modest improvement it its fee.

The truth is that most fee formulas can create conflicts, but these conflicts are exacerbated when radical discontinuities are built into the fee formula (such as the "zero-percent-up-to-the-bid-level-and-25% thereafter" formula used by Judge Kaplan). A more graduated rate of increase or a flat percentage would tend to minimize these ultimately unavoidable conflicts. However, this is an area where the lead plaintiff has a potentially superior

advantage because it can reject settlements it sees as unattractive (if we assume that the lead plaintiff's interest are will aligned with those of other class members).

G. Ex Post Review. An ex ante auction is inconsistent with the ex post review seemingly mandated by the Third Circuit in In re Cendant Corp. Prides Litigation, 243 F.3d 722 (3rd Cir. 2001). Worse, the apparent suggestion in Cendant Prides that a lodestar multiplier of three should normally set a ceiling on the maximum permissible fee award would take us back to where we were when the original Third Circuit Task Force recommended that the lodestar be dumped. The incentive to delay and stretch out the case has now been revived.

H. The Winner's Curse. The Auction Houses bidding process illustrates that one isolated bidder may well bid a multiple of what the next highest bidder bids, and as a result the case may be assigned to the most over-optimistic bidder. Economics has an answer for this problem; it is called the "Vickery Auction" (after a Nobel Prize winning economist who devised it), and it awards the auction to the highest bidder but at the second highest price bid.[6] The result is to duplicate what would have happened in an open outcry auction (if there was no risk of collusion). It deserves consideration if the idea of auctions is being taken seriously by this Task Force.

IV. Conclusion and Recommendations

The idea of auctions to determine class counsel merits further use and experimentation, but only in selected cases and probably only in courts outside the Third Circuit (where true auctions can be run undeterred by the sweeping impact of the Cendant Prides decision). The

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[6] See William Vickery, Counterspeculation, Auctions and Competitive Sealed Tenders, 16 J. Fin. 8 (1961).

unfortunate irony is that the Third Circuit has been the only federal circuit foresighted enough to see the need for study and guidelines concerning auctions and also the only circuit to have aborted their further development. I also suspect that plaintiff's attorneys may well tend to avoid the Third Circuit in choosing where to file for the near future.

To the extent auctions are to be conducted, I would recommend that guidelines specify that they are inappropriate where:

(1) the action arises under the PSLRA;

(2) the action involves significant pre-filing investigation or would not likely have been brought except for information discovered by the original plaintiff's attorney; or

(3) less than a specified number of qualified bidders submit bids.

The critical issue involved in the design of auctions involves the bidding rules. While Judge Kaplan developed a more sophisticated model which both economizes on cost and incentives the plaintiff's attorney, its radical discontinuity between zero percent and 25 percent exacerbates the always latent conflict between the interest of the class and those of its attorney. A gradually increasing percentage that starts low and then grows with the recovery (such as the 2% to 9% rise in Cendant) seems preferable and likely to achieve the same goals. Yet, I am not optimistic that courts will adopt it, because it can result in high fees that may be perceived as windfalls.

Here, the ultimate conflict comes into view: Do courts want to adopt a fee formula that is likely to maximize the net recovery to the class? Or, do they want to adopt a formula that protects them from public criticism? If the former is the goal, then an increasing percentage makes sense; if the latter, a decreasing percentage (or the lodestar ceiling used in Cendant

Prides) will be preferred. But under the latter, we should expect that the settlements in Cendant and Auction Houses would have been a fraction of what they were. And possibly these cases would still be in litigation today.