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THE UNFAITHFUL CHAMPION: THE PLAINTIFF AS MONITOR IN SHAREHOLDER LITIGATION

JOHN C. COFFEE, JR.*

I

INTRODUCTION

When the legal history of the 1970's is written, it will note a significant shift in the way courts perceived shareholder litigation. Only a generation ago, the Supreme Court described the derivative action as "the chief regulator of corporate management."[1] Even into the 1960's, those issues involving shareholder litigation that percolated up to the Supreme Court were typically resolved so as to extend the availability of a litigation remedy by removing arbitrary or overbroad barriers to the plaintiff.[2]

During the 1970's, the pendulum swung sharply in the other direction. In particular, the Supreme Court tilted the balance of advantage against the plaintiff in securities litigation by (1) declining repeatedly to imply private causes of action under the federal securities laws, at least absent a clear

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1. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949).

2. This period is well summarized in Dykstra, *The Revival of the Derivative Suit,* 16 U. PA. L. REV. 74 (1968). Dykstra reports that between 1956 and 1966, the number of reported derivative suits increased significantly over the previous decade and that courts perceived the derivative suit as an important mechanism for ensuring corporate accountability. Among the Supreme Court decisions of the era that simplified the burdens facing the plaintiff in a derivative action were: Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966), which in effect trivialized the verification requirement in FED. R. CIV. P. 23.1 (providing that "the complaint shall be verified"); Smith v. Sperling, 354 U.S. 91 (1957), which clarified the issue of the corporation's status as a defendant and thereby facilitated the plaintiff's ability to establish diversity jurisdiction; and J.I. Case v. Borak, 377 U.S. 426 (1964), which permitted a shareholder to assert federal proxy rule violations in a derivative action. Probably the last of these expansive decisions was Mills v. Electric Auto-Lite Co., 396 U.S. 375, 396 (1970), which strongly endorsed the private attorney general concept. Lower federal court decisions of this era reveal a similar tendency toward enabling the plaintiff to evade statutory obstacles. *See* McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.), *cert. denied,* 368 U.S. 939 (1961) (holding state security for expenses statute inapplicable to derivative action asserting a federal cause of action); Gottesman v. General Motors Corp., 268 F.2d 194 (2d Cir. 1959) (demand held unnecessary where action charged illegal acts); Rogers v. American Can Co., 305 F.2d 297, 317 (3d Cir. 1962) (majority ratification held ineffective where complaint alleges acts that "are public wrongs").

statement of congressional intent;[3] (2) reading a scienter requirement into Rule 10b-5;[4] (3) limiting standing under Rule 10b-5 to actual purchasers and sellers of securities (thereby excluding defrauded holders);[5] (4) curtailing suits for corporate mismanagement under the federal securities laws;[6] and (5) recognizing broad exemptions and reducing the damages under § 16b of the Securities Exchange Act of 1934.[7] Likewise, in decisions over the same period not involving securities litigation, the Court also constrained the effectiveness of private attorneys general by (a) tightening the procedural requirements applicable to class actions;[8] (b) reaffirming the American rule on fee awards under which the successful plaintiff still must generally bear his own legal expenses;[9] and (c) accepting the special litigation committee as a means by which derivative actions could be quickly terminated with only minimal judicial review.[10] None of these decisions was particularly surprising, and each had an understandable doctrinal logic. Yet, in the course of reaching these results, the Court also articulated a philosophy that was profoundly skeptical of the plaintiff. This attitude was most clearly displayed in 1975, when in *Blue Chip Stamps v. Manor Drug Stores,*[11] the Court refused to allow any exception to be grafted onto the well-recognized rule that only a purchaser or seller had standing to sue under Rule 10b-5. It justified this result on the grounds that narrow limitations on standing were necessary to reduce the leverage that a strike suit otherwise gave the plaintiff to harass management and disrupt "normal business activities."[12] The same perception of the plaintiff's underlying motives was also apparent a year earlier in *Bangor Punta Operations, Inc. v. Bangor & Aroostock R.R.,*[13] when the Court seemingly called into serious question the traditional deterrent rationale for the derivative action. The deterrent justification, it said, proved too much and might result

3. *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977); *cf.* Cort v. Ash, 422 U.S. 66 (1975).

4. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

5. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

6. Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

7. *See* Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972).

8. The critical decision was Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974), which required individual notice to all class members whose address could be ascertained. In addition, other decisions have tightened class certification requirements. *See, e.g.,* East Texas Motor Freight Sys., Inc. v. Rodriguez, 431 U.S. 395 (1977); General Tel. Co. v. Falcon, 457 U.S. 147 (1982) (denying class certification).

9. Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975).

10. Burks v. Lasker, 441 U.S. 471 (1979).

11. *See Blue Chip Stamps,* 421 U.S. 723.

12. There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit.

Id. at 739.

13. 417 U.S. 703 (1974).

in an excessive rate of litigation.[14] In overview, the common denominator between these and other decisions throughout the 1970's was consistently the fear of hyperlexia—the sense that unless litigation remedies were stringently limited, the lid on Pandora's box would be lifted and a torrent of frivolous litigation might be released.

An ideological interpretation can, of course, account for all these decisions by glibly explaining that the "good" Warren Court had given way to the "bad" Burger Court. Yet, although ideological shifts may have played a significant role, the decisions cannot be explained this easily, both because the pattern has not been uniform[15] and because some of the Justices who composed the majority during the Warren era have since sided with the new majority as it shifted the balance of advantage against the plaintiff.[16]

What else then can account for the pattern? Not surprisingly, multiple theories can be offered. First, the shift toward "independent" boards of directors may have convinced the courts that there is less justification to rely on shareholder litigation as a monitoring device.[17] Corporate governance, it can be argued, has improved, and thus needs less judicial oversight. Second, to a lesser extent, courts may today believe that market remedies, including the hostile takeover, are adequate to hold managements accountable.[18] Third, public enforcement agencies, most notably the SEC, but also U.S. Attorneys, have increasingly undertaken to monitor sensitive areas of corporate conduct where previously only private enforcement was available. Fourth, caseload pressure may have forced courts to begin to ration justice,

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14. *Id.* at 717-18 ("Our difficulty with this argument is that it proves too much. If deterrence were the only objective, then in logic any plaintiff willing to file a complaint would suffice. No injury or violation of a legal duty to the particular plaintiff would have to be alleged."). This language surely indicates little sympathy on the part of the current Supreme Court for the lawyer as bounty hunter.

15. For example, in Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984), the court dispensed with the demand requirement in the case of shareholder suits against the management of an investment company. This decision overturned the majority of the precedents that had required demand on the board. *See, e.g.*, Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928 (3d Cir. 1982). Although *Daily Income* cited special congressional policies underlying the Investment Company Act, these policies had not convinced lower federal courts. Another explanation is that the special structure of investment companies and the inherent conflict of interest surrounding the compensation of their investment adviser by a board that the adviser typically appoints may have convinced the Court of the relatively greater need for judicial oversight in this context (as compared with that of the typical industrial corporation).

16. For example, Justice Marshall concurred in the decisions in Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1972), Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), and Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), and Justice Brennan authored the Court's opinion in Burks v. Lasker, 441 U.S. 471 (1979).

17. Several surveys have reported that a substantial majority of large publicly held corporations have boards composed of a majority of "outside" or nonmanagement directors. *See* A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03 comment (Tent. Draft No. 1, 1982) (reviewing studies by Korn/Ferry, New York Stock Exchange, Heidrick & Struggles, and Financial Executives Institute).

18. In Edgar v. Mite Corp., 457 U.S. 624, 643 (1982), the Court at least recognized that a market discipline enforced through the mechanism of the hostile takeover tended to protect shareholders of those companies whose stock underperformed the market. Others believe that the Supreme Court has increasingly taken on an economic perspective. *See* Cover, *The Supreme Court, 1982 Term—Foreword:* Nomos *and Narrative,* 97 HARV. L. REV. 4 (citing Easterbrook).

with shareholder litigation receiving only a low priority. Finally and·most relevant to the concerns of this article, courts may have come to doubt that the litigation remedies available to shareholders achieve in practice any useful end.[19] On this last question, courts have a first-hand perspective, and to the degree that they see few real plaintiff victories (either by way of judgment or settlement), they may conclude that such actions impose costs on shareholders in excess of their benefits. Given that our legal culture has always had an uncomfortably ambivalent attitude toward the plaintiff's attorney in the derivative action, this last hypothesis of judicial frustration with shareholder litigation makes more understandable the turn of the tide against the plaintiff.

To state the foregoing explanations for judicial deference to corporate management is not to accept them as adequate justifications. All mechanisms of corporate accountability potentially can be frustrated, and an extensive literature has analyzed the inherent limitations on each of these modes.[20] Although the relative merits of these rival mechanisms could be explored at great length, this article will focus instead on the last explanation given above for judicial disenchantment with shareholder litigation—the sense that it may today be doing little good and some harm. Whatever the shareholder's need for legal protection, there is no doubt that a bad remedy benefits no one.

To acknowledge this possibility that a remedy can be worse than the disease it was meant to cure may seem mean-spirited and ill-timed at a moment when the very survival of the derivative suit appears to hang in the

19. For highly skeptical assessments of the antitrust and securities plaintiffs' bar, see *In re* Fine Paper Antitrust Litig., 98 F.R.D. 48 (E.D. Pa. 1983), *rev'd on other grounds*, 751 F.2d 562 (3d Cir. 1984); *In re* Armored Car Antitrust Litig., 472 F. Supp. 1357, 1381-82, 1388-89 (N.D. Ga. 1979); Barnett v. Pritzker, 73 F.R.D. 430, 434 (S.D.N.Y. 1977); *In re* Penn Cent. Sec. Litig., 416 F. Supp. 907, 925 (E.D. Pa. 1976), *rev'd on other grounds*, 560 F.2d 1138 (3d Cir. 1977). It is not only courts which have grown wary of the confident premises of the theory of the private attorney general. Some empirical studies have also reported little evidence that the class action is today achieving its deterrent objectives. *See* DuVal, *The Class Action as an Antitrust Enforcement Device: The Chicago Experience (Part II)*, 1976 A.B.F. RES. J. 1273, 1327 ("Judged by results, the class action has proved a rather feeble engine of antitrust enforcement."); Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study*, 14 HOUS. L. REV. 769 (1977); Rosenfeld, *An Empirical Test of Class Action Settlement*, 5 J. LEGAL STUD. 113 (1976); Wolfram, *The Antibiotics Class Actions*, 1976 A.B.F. RES. J. 273. For a general overview that focuses principally on the antitrust class action, see Coffee, *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983).

20. The academic literature has emphasized the time and informational constraints under which the outside director functions. *See, e.g.*, Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1976). Professor Brudney has also criticized the overly facile assumption that the outside director has the requisite incentive to be an effective monitor. Brudney, *The Independent Director: Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); *see also* Solomon, *Restructuring the Corporate Board of Directors: Fond Hope-Faint Promise?*, 76 MICH. L. REV. 581 (1978). Few today would argue for shareholder voting as a significant protective remedy, or analogize the shareholder to a citizen in a democracy, in view of the high transaction costs and the "free rider" problem that cripples shareholders' activism. Finally, whatever the potential of the hostile takeover to serve as a mechanism of accountability, it is evident that the currently high level of takeover premiums (roughly 40% to 60% above the market price) limits its reach and shelters a considerable margin for managerial failure. For a review of this and other problems, see Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984).

balance, as courts continue to defer uncritically to the decisions of special litigation committees.[21] Still, a candid assessment of the impact of the derivative action today cannot ignore the plain fact that derivative actions seldom result in litigated victories, but rather tend overwhelmingly to be resolved through settlements, a substantial percentage of which produce little tangible benefit for the corporation.[22] Although it is never surprising in any area of law that settlements tend to predominate over litigated outcomes, the derivative action is distinctive in that, within the category of litigated outcomes, reported decisions tend to favor the defendant by an overwhelming ratio.[23] This pattern seems to conflict with recent theory, which predicts that litigated outcomes normally should split in a roughly equal manner between plaintiff and defendant victories.[24] To the critics of shareholder litigation, this disproportionate ratio between defendant and plaintiff victories has long been seen as evidence that such actions are typically "strike suits" brought to extort a payment from the corporate treasury.[25] Proponents have replied that the high rate of settlement shows to the contrary that the corporation does

21. For an overview of the rise of the special litigation committee as a means for dismissing derivative litigation without substantive review, see Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform,* 81 COLUM. L. REV. 261 (1981). For recent cases declining to review the substance of the committee's findings, see Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Pogostin v. Rice, 480 A.2d 619 (Del. 1984).

22. According to the fullest empirical study done to date, approximately 70% of all class and derivative actions filed against corporate officers and directors are settled; in another 5%, some relief is obtained following the commencement of the action, even though no formal settlement results. Only in 1% was a litigated judgment in favor of the plaintiffs observed. This result implies a ratio of over 20:1 in favor of the defendants. *See* Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits,* 60 B.U.L. REV. 542 (1980).

23. *See supra* note 22. Of course, the 20:1 ratio observed by Professor Jones is affected by the defendant's ability to win a pretrial judgment through a motion to dismiss, or a motion for summary judgment—a motion that the plaintiff can also make in theory, but can almost never win. In effect, the defendant can take multiple bites at the apple. This procedural anomaly appears not to have been discussed by the theorists discussed *infra* note 24; in part, it affects their conclusions because such motions have a signaling function as the court hints through them its view of the merits.

24. These theorists argue that trials occur only in those cases in which the litigants have different expectations about the outcome, because if the adversaries have the same view of the litigation odds, the case will be negotiated to avoid the needless expense of trial. *See* Priest & Klein, *The Selection of Disputes for Litigation,* 13 J. LEGAL STUD. 1 (1984). *But see* Cooter, Marks, & Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior,* 11 J. LEGAL STUD. 225 (1982); Wittman, *Is the Selection of Cases for Trial Biased?,* 14 J. LEGAL STUD. 185 (1985). What appears to have been overlooked in this rather abstract discussion of litigation is that where client control of the attorney is weak, the attorney is the relevant decisionmaker and has little interest in effecting cost savings by avoiding a trial. That is, if the attorney is effectively unconstrained by any client (as he classically is in the derivative action), he may prefer to go to trial, at least when he is compensated on the basis of his time expended because an early settlement is not as profitable to him. In this light, the pattern of collusive settlements discussed in this article might arguably be seen as bribes by the defendant to make the plaintiff's attorney behave as would a normal attorney who is constrained by a client.

25. This was the principal conclusion of the "Wood Report" prepared for the Chamber of Commerce of the State of New York in 1944. F. WOOD, SURVEY REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS (1944). Wood found recoveries for plaintiffs in only 13 cases out of 573 derivative suits involving publicly held corporations; in addition, some 33 other cases resulted in court-approved settlements. For a fuller review of Wood's findings and the criticisms by others of his work, see Garth, Nagel & Plager, *Empirical Research and the Shareholder Derivative Suit: Toward A Better-Informed Debate,* LAW & CONTEMP. PROBS., Summer 1985, at 137.

benefit.[26] In fact, this debate has been more ideological than empirical, because neither side has satisfactory data about the adequacy of the settlement in the typical derivative action.[27]

This empirical void is unlikely soon to be filled. Although some efforts have been made to measure the stock market's response to the termination of a derivative suit,[28] the methodology underlying these studies seems

26. *See* Conard, *A Behavioral Analysis of Directors' Liability for Negligence,* 1972 DUKE L.J. 895, 901 n.21; Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York,* 32 CALIF. L. REV. 123, 127-28 (1944).

27. The most extensive recent empirical study is Jones, *supra* note 22. Although Jones' work is a useful study, it unfortunately made no attempt to distinguish between class and derivative actions or to collect data systematically about the size of the settlement fund. For a reanalysis of its findings, see Garth, Nagel & Plager, *supra* note 25, at 145-47.

28. *See* Fischel & Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis (forthcoming). Fischel and Bradley computed the daily abnormal return to the shares of firms in whose name a derivative action has been brought following either a judicial termination of the derivative suit or a judicial decision to permit the action to continue. Their data show that market reaction was consistently negative for all the time periods studied, but they interpret these results as not statistically significant. In contrast, the abnormal returns following a decision to permit the action to continue were consistently positive, but again they view these results as not statistically significant. In the absence of statistically significant results, they conclude that derivative actions have negligible effects. However, others believe that, properly read, their results have statistical significance.

Above all, the Fischel and Bradley data do not adequately address the issue of general deterrence. The most plausible theory under which the derivative action benefits shareholders is by deterring certain forms of managerial misconduct that other mechanisms of corporate accountability do not deter as effectively. The derivative action would thereby reduce the "agency costs" associated with the manager/shareholder relationship. *See* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305 (1976) (defining the term "agency cost" to include the cost of monitoring plus any residual loss that cannot thereby be prevented). Yet this thesis is difficult to test because general deterrence is hard to observe. If one examines only whether the stock price of a corporation in whose name a derivative action is brought rises or falls in the wake of the action's filing or settlement, one overlooks the general deterrent impact on corporate managers generally. Quite possibly, the stock price could fall because the market expected that the costs of the action that the corporation would bear to exceed any likely recovery to it. To conclude from this fact that derivative actions injured shareholders, however, would be as naive as to measure the effect of the criminal law on its intended audience by comparing only the mean costs of apprehending, convicting, and imprisoning offenders in relation to the mean costs the same offenders would have imposed on others had they remained at liberty. The fallacy in any such oversimple comparison lies in the confusion of specific deterrence with general deterrence. Even if every derivative action invariably caused its subject corporation a net cash loss, it would remain possible in theory that the institution of the derivative action benefitted shareholders as a class, because shareholders, to the extent that they were at least partially diversified, could gain on balance if corporate managers (other than the actual defendants) were deterred from unfair self-dealing.

In theory, one might solve this problem by studying the stock prices of corporations incorporated in different jurisdictions having contrasting legal rules concerning the availability of the derivative action. If a decision in one jurisdiction broadened or limited the availability of the derivative action, one would look to see if the share prices of stocks incorporated in that jurisdiction rose or fell on average. Those having perfect confidence in the efficiency of the market will in time predictably report what their computer tapes on stock prices show as happening in the wake of recent decisions. Still, a host of problems again confounds any such attempt. First, there may be less difference today between the governing legal rules in the principal state jurisdictions than is generally thought. After Aronson v. Lewis, 473 A.2d 805 (Del. 1984), it is today doubtful that the laws of New York and Delaware are significantly different with respect to the power of a litigation committee. Second, even if apparently substantial differences exist among jurisdictions in terms of the legal rules applicable to derivative actions, the market's failure to capture these differences by revaluing the securities of corporations incorporated in these jurisdictions could be explained in one of several ways that confuse any attempt to draw useful conclusions about the derivative action's overall impact: (1) the market may have been too insensitive to detect the real differences in effect between different legal profoundly flawed for three principal reasons: First, if we make the standard assumption that stock market prices anticipate future events, unless they are unforeseen, then it follows that a negligible market reaction to the judicial termination of a derivative action need imply no more than that the market expected that the action would be terminated; only the unexpected decision should not have been discounted in advance. Because such studies tell us principally what the market expected the court would do, it is only in cases where the market is surprised that we can decipher its judgment as to the wisdom of the result from an event study. Second, most derivative actions seek recoveries that are trivial on a per share basis. This fact does not mean that the action is valueless, but only that the principal benefit is a preventive one because, absent an adequate deterrent, the same de minimus violation might recur until a significant loss resulted. Finally, econometric "event studies" of the effect of a suit's filing or termination on the stock price of a single firm cannot measure the general deterrent effect of such actions. To measure this, one would in theory need to compare over the relevant period the market prices of all corporations incorporated in the jurisdiction whose legal rule changed with the market prices of other corporations incorporated in other jurisdictions having different rules.[29]

By no means does this claim assert that empiricism has no value; rather, it suggests the need to focus empirical studies more selectively. What can and should be studied are the sources of pathology: namely the incentives (or disincentives) that legal rules today hold out to the plaintiff's attorney and that cause him to perform his function as a private enforcer marginally better or worse. Such an inquiry limits itself to relative questions (better or worse) and avoids the bottom line issue of the potential utility of shareholder litigation. Put differently, because severe limitations exist on the ability of empirical research to resolve the potential of the derivative action as an effective monitoring mechanism, we are at the stage when the real need is not for more, inherently ambiguous empirical data,[30] but instead for a clear

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rules; (2) corporate managers may have been too insensitive to the nature of these legal rules to detect any differences and so were deterred to a roughly equivalent degree, regardless of whether they were in fact subject to a realistic threat of successful litigation; or (3) the infrequency of derivative actions, *see infra* note 45, may have made their impact, whether positive or negative, too insignificant for the market to consider. Only a process of inference could tell us which conclusion to draw.

Finally, it should be remembered that empirical data inform us at most only as to current operation of a legal rule in the eyes of the market, and do not address whether a legal remedy could (or should) be redesigned to improve its operation.

29. To date, I am aware of only one such study that attempts to do this with respect to any set of corporate legal rules. This study, now being completed by Professors Elliott Weiss and Lawrence White, follows the stock market price of Delaware corporations as a group following several important recent Delaware decisions on corporate law (which decisions Professor Fischel has vigorously criticized). To date, I am informed by Professor Weiss that this study has found no statistically significant market movement following any of these cases.

30. In so arguing, I do intend only a mild disagreement with the agenda for research proposed by Professors Garth, Nagel, and Plager elsewhere in this volume. I am not optimistic about their proposal for the in-depth study of special litigation committees, because the overriding fact is that the outcome of the special litigation committee process is almost invariably a recommendation for dismissal. In this light, a close empirical study seems more likely to produce a report on the subtle

model by which to predict how changes in legal rules enhance or reduce the ability of private enforcement to reduce agency costs. Specifically, the model should seek to predict how the plaintiff's attorney as the key actor in any strategy of private enforcement will adapt to these rules.

In pursuit of this goal, this article makes three basic claims: First, the legal doctrines that have been formalized over the last two decades (including therein both the liberal 1960's and the more conservative 1970's) have in combination moved us closer toward the worst of all worlds: one in which the possibility of a significant corporate recovery in a derivative action is minimized, while the likelihood of costly and time-consuming litigation remains high. Second and more paradoxically, any attempt to rehabilitate the private attorney general concept can succeed only if we move from viewing the plaintiff's attorney in exclusively normative terms as a fiduciary who must faithfully serve his clients and instead analyze him from an ex ante perspective as a risk-taking entrepreneur who predictably will act to maximize his expected return and to minimize his risk. Third, there exist some relatively simple and costless reforms that could better align the interests of the plaintiff's attorney with those of the shareholders he represents.

The claim that we should view the plaintiff's attorney as a risk-taking entrepreneur will seem offensive to some and must be explained in greater detail as a threshold matter. If we view the plaintiff's attorney in derivative and related shareholder litigation as a rational decisionmaker who acts according to the same utility-maximizing criteria as do other businessmen, this implies that the decision to bring a derivative or class action is a capital budgeting decision that will be assessed in terms of the lawyer's opportunity costs, his expected return, and his level of risk aversion. This perspective is descriptive, rather than normative. It assumes neither that we should tolerate substantial conflicts of interest between the attorney and the class he represents, nor that all attorneys will act in a purely self-interested fashion. Rather, the only assumption underlying this perspective is that economic incentives will have a marginal impact upon the behavior of private enforcers and that therefore the law should seek to fashion the incentives that it holds out so as to align better the interests of the plaintiff's attorney with those of his clients.

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tactics of rationalizing a foregone conclusion. Greater priority should be given, I submit, to studying the calculus of factors that the plaintiff's attorney balances, but at an earlier stage than they suggest: namely, at the stage when the plaintiff's attorney decides whether to "invest" in an action not yet commenced. Because litigation is a continuing investment decision, *see* Trubek, Sarat, Felstiner, Kritzer, & Grossman, *The Costs of Ordinary Litigation*, 31 U.C.L.A. L. REV. 72 (1983), it would be also useful to follow plaintiffs' attorneys as they make subsequent decisions about discovery, settlement, or appeal. On the defendant's side of the aisle, the principle that "man bites dog" is the more interesting story suggests that the focus should be on studying the dynamics in those instances where the board or committee has not rejected the plaintiff's action (or has itself sued). My own understanding of these few cases, however, is that they principally involve actions against departed executives (usually at the middle-management level) where the real party in interest is the insurance carrier.

This article is divided into four parts. Part I offers an economic analysis of why frivolous actions are worth bringing. This issue is not as simple as it sounds, because the conventional theory of the strike suit is incomplete and some "reforms" intended to eliminate nuisance actions may in fact increase their incidence. This section presents the argument that to understand the behavior of the plaintiff's attorney we cannot look simply at the individual case, but rather must consider the portfolio of actions in which he has in effect "invested." Part II then focuses on the issue of the appropriate fee formula that can best align the attorney's self-interest with that of his client shareholders. Part III examines the financing and organization of the plaintiff's action and the relationship among competing plaintiffs' attorneys. Again, the focus is on how public policy should increase the expected return to the private enforcer and reduce his level of risk aversion. Part IV addresses the special problem of a remedy by which to preclude collusive settlements. Finally, brief consideration is given to the possibility of a more radical alternative for the reform of class and derivative actions: the use of an auction procedure.

II

UNDERSTANDING THE "STRIKE SUIT": THE LAW AND ECONOMICS OF NUISANCE ACTIONS

The standard theory of the "strike suit" was succinctly stated by Justice Black when he characterized the "strike suit" as one brought "by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them."[31] The assumption is that it is cheaper to settle than to fight so long as a cheap, quick settlement is possible. Yet this premise is not self-evident; the problem with this theory is that the plaintiff cannot litigate costlessly. In fact, discovery and pretrial skirmishing are not clearly less expensive for the plaintiff's attorney, who does, after all, bear the burden of proof and who is typically underfinanced in comparison with his adversaries. Nor is the plaintiff's attorney invulnerable to counterattack. Today, under recently amended Rule 11 of the Federal Rules of Civil Procedure, a federal court may hold the plaintiff's attorney liable for the defendant's costs (or some portion thereof) if he is found to have brought an action that lacks factual or legal merit.[32] Other state and federal procedural rules concerning pleading requirements and security for expense bonds also

31. Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966).

32. *See* FED. R. CIV. P. 11. Rule 11 provides that an attorney must sign the complaint and that such signature constitutes his certification that he has investigated the allegations and believes them to be well-grounded. The court may award attorney fees on its own motion under Rule 11. A trend appears to be developing toward more frequent awards under this rule. *See, e.g.*, Gordon v. Heimann, 715 F.2d 531 (11th Cir. 1983); Taylor v. Bear Sterns & Co., 572 F. Supp. 667, 683 (N.D. Ga. 1983); *see also* Note, *Pleading Securities Fraud with Particularity under Rule 9(b)*, 97 HARV. L.REV. 1432, 1441 (1984) (noting such a trend).

The court may also assess attorney fees under the "bad faith" exception to the American rule. *See* Roadway Express, Inc. v. Piper, 447 U.S. 752 (1980); *see also* 28 U.S.C. § 1927 (1982).

enable weak cases to be dismissed at an early stage, thereby further reducing the plaintiff attorney's ability to bring a strike suit for its nuisance value.[33] As a result, it may seem puzzling that defendants do not behave strategically by seeking to resist frivolous derivative actions in order to reduce their future incidence. Such a strategy of reciprocal escalation might make considerable sense over the long run, even if it would be cheaper in the short run to settle the individual case. Accounting firms in particular seem to behave in this fashion and strive to maintain their reputation as tough, hard-nosed litigators who will not settle weak cases.[34] Given that the defense bar often proclaims its view that derivative actions represent a form of legalized extortion, the anomaly is that defendants do not act as they talk by adopting the logical countermove to attempted extortion: a strategic policy of adamant resistance in order to make the meritless case appear a less attractive opportunity to the plaintiffs' bar. The simple reality is, however, that the rate of settlement in derivative actions appears higher, while the rate of litigated plaintiff's victories is strikingly lower, than in other forms of contingent fee litigation.[35] Once an action survives the preliminary motions to dismiss, there is a strong probability that it will be settled, even though plaintiff's verdicts remain statistical rarities.

A more complete theory of the strike suit thus seems necessary. One possible explanation for the high rate of settlement was advanced by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores.*[36] In that case, Justice Rehnquist distinguished two components of an action's settlement value, one "legitimate" and the other not:

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33. With respect to the special pleading requirements applicable to securities and other actions alleging fraud, see Note, *supra* note 32. The rule is frequently invoked when corporate directors are made defendants in actions alleging bias or fraud. *See* Segal v. Gordon, 467 F.2d 602, 607 (2d Cir. 1972); Lincoln Nat'l Bank v. Lampe, 414 F. Supp. 1270, 1279 (N.D. Ill. 1979).

For an overview of the effect of security for expenses bonds, see Note, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J. LAW & SOC. PROB. 50 (1968).

34. *See* Klott, *Uneasy Period for Anderson*, N.Y. Times, Nov. 11, 1984, at D1 (noting that other "Big Eight" accounting firms were concerned that the willingness of Arthur Andersen to settle large actions against it in the wake of several large jury verdicts would adversely affect them by convincing plaintiffs that the industry would no longer take cases to trial; previously, Arthur Andersen "had a reputation for taking cases to the mat [but] had become gun-shy" in the wake of these verdicts, according to these other firms).

35. According to the empirical survey made by Jones of cases brought between 1971 and 1978, plaintiffs won litigated verdicts in less than 1% of the 531 class and derivative actions he studied. Yet, in some 70% of the cases, there was a settlement, and in 75% of the cases some form of relief was recovered. Jones, *supra* note 22, at 544-47. In other forms of tort litigation, the breakdown between plaintiffs and defendants in terms of the rate of litigated verdicts has been much closer and sometimes in the plaintiffs' favor. Thus, one study of accident cases litigated to judgment in New York City found that the defendant won in only 40% of the cases that went to verdict. *See* Franklin, Chanin, & Mark, *Accidents, Money, and the Law: A Study of the Economics of Personal Injury Litigation*, 61 COLUM. L. REV. 1, 14 (1961). This close-to-equal victory rate is consistent with the standard economic theory that the parties will settle any case as to which they can agree on the litigation odds and will go to trial only when they have different perceptions as to the likely outcome at trial. *See* Priest & Klein, *supra* note 24. The experience with derivative actions is an aberrational exception to this pattern, which is probably best explained by the fact that the stakes are asymmetric with the plaintiff's attorney having less to gain than the defendants have to lose.

36. 421 U.S. 723 (1975).

> [I]n this type of litigation . . . the mere existence of an unresolved lawsuit has settlement value to the plaintiff not only because of the possibility that he may prevail on the merits, an entirely legitimate component of the settlement value, but because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial . . . .[37]

Translated into a more economic terminology, this argument becomes a plausible claim that defendants have a higher opportunity cost than do the plaintiffs. Because their time is worth more, defendants can less afford to waste it in litigation. Indeed, the calculating plaintiff's attorney may even be able to arrange his discovery schedule so as to maximize this interference. Still, this thesis cannot by itself supply an adequate explanation of the relative difference in settlement rates between derivative actions and other forms of class and contingent fee litigation. The same corporate officials appear to behave differently in antitrust, securities, and products liability litigation, which collectively interfere at least as much with their time and may disrupt business planning to an even greater degree.

In this light, another possible interpretation is simply that the strike suit is a mirage—"an over-the-hill dragon, puffed into life to frighten the courts away from deciding substantive issues."[38] This view has been essentially taken by those who point to the high rate of settlements in derivative actions and infer that there must have been merit associated with the majority of these actions. Once again, this type of "where-there-is-smoke-there-must-be-fire" reasoning assumes what is to be proved. The high rate of settlements in proportion to the low rate of plaintiff victories is the puzzling variable that must be explained, rather than, itself, the explanation that resolves all public policy issues. Thus, although self-interested rationalizations by defendants should be viewed skeptically, it is too simple to conclude that the strike suit is an illusion if a realistic scenario can be offered under which plaintiffs would bring actions having little prospect of eventual success and defendants would settle them, even though they expected to win at trial.

In fact, several coherent explanations are possible for the apparent empirical pattern of few plaintiff victories but many settlements. As background, it is useful to understand the unique rules on fee shifting applicable to derivative actions. Theorists have observed that the effect of our "American rule," which requires that each side normally bears its own legal expenses,[39] is to maximize the frequency of suits having little prospect of success at trial, because the plaintiff is not generally exposed to liability for

37. *Id.* at 742-43.

38. W. CARY & M. EISENBERG, CORPORATIONS: CASES AND MATERIALS 888 (5th ed. 1980). There is some undeniable merit to this claim, and I do not doubt that legislative and judicial overreactions have occurred (both in the common security for expenses statute and in the degree of judicial deference given to litigation committees). Nonetheless, I doubt that this is an adequate explanation.

39. *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240 (1975). There are, of course, numerous statutory and judicial exceptions to this rule. *See, e.g.*, 42 U.S.C. § 1988 (1982).

the defendant's legal expenses.[40] Under the converse "English rule," which shifts the victor's expenses to the loser, the less the chance of a favorable verdict, the more the reciprocal possibility grows that the plaintiff will be held liable to the defendant for the latter's legal fees. In effect, the English rule encourages the plaintiff to bring an action having a high prospect of success, while the American rule might discourage him (to the degree that his own expected legal costs reduced the size of the net recovery). Conversely, the American rule encourages actions having a lower prospect of success that the English rule would discourage, because the plaintiff need not fear liability for the defendant's costs if he is unsuccessful.

Although this contrast between the effect of the two rules applies across the landscape of American litigation (and thus provides no special explanatory power with respect to the derivative action), the derivative action is governed by a unique set of procedural rules that amount to a compromise of the English and American rules. In effect, fee shifting is authorized for both sides, but not necessarily against the opposing party. Under settled precedent, the successful plaintiff's attorney is entitled to look to the corporation for his legal fees.[41] Standing alone, this feature of the derivative action does not significantly enhance the incentive to bring a nonmeritorious action, because the plaintiff must still discount his likely expenses from the action by the possibility of an adverse judgment. If, for example, the plaintiff sees only a ten percent chance of success, he has a reciprocal ninety percent chance of bearing his own expenses. In addition, under legislation in effect in many states, the plaintiff must post a security for expenses bond to cover the corporation's reasonable expenses from the action.[42] This provision in effect amounts to a partial adoption of the English rule. To the extent such a bond is required, the plaintiff knows that the defendants will have indirect recourse against him if an adverse judgment is entered. Thus, we have a strange hybrid: the defendant can have partial recourse against the plaintiff, while the plaintiff can shift his fees to the corporation in both cases if the outcome is favorable to the side seeking recovery of its expenses.[43] In contrast, if there is a settlement, both sides can shift their reasonable fees and expenses to the

40. Shavell, *Suit, Settlement and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 59-62 (1982); Mause, *Winner Takes All: A Re-Examination of the Indemnity System*, 55 IOWA L. REV. 26 (1969).

41. *See* Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784 (1939); Sugarland Ind. v. Thomas, 420 A.2d 142 (Del. 1980); Bosch v. Meeker Coop. Light & Power Ass'n, 101 N.W.2d 423 (Minn. 1960).

42. *See, e.g.*, N.Y. BUS. CORP. LAW § 627 (1980); N.J. STAT. ANN. § 14A:3-6 (1969); TEX. BUS. CORP. ACT ANN. art. 5.14(c) (1980). *See also* Note, *supra* note 33. The enforceability of these statutes in a federal diversity action was upheld in Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541 (1949).

43. Under the typical statutes covering indemnification of litigation expenses incurred by officials and directors in connection with a derivative action, a corporate official may not receive indemnification for these expenses if there is an adverse judgment under which he is "adjudged to have breached his duty to the corporation . . . ." *See* N.Y. BUS. CORP. LAW. § 722(a); CAL. CORP. CODE § 317(c)(1) ("adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation . . . ."); *see also* J. BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE ¶ 6.03[3] (1981). Because a settlement does not adjudge the

corporation—a fact that obviously helps explain the prevalence of settlements.

Against this backdrop, the factors that distinguish the derivative action from other forms of contingent fee litigation can be grouped under four headings.

A. The Cost Differential

The costs that plaintiff and defendant will typically incur are asymmetric, with the defendant's costs being considerably greater than the plaintiff's. This cost differential may make it cheaper for the defendant to settle than to fight. Several factors support the assertion that the plaintiff can litigate more cheaply than the defendants. First, the financial burdens associated with discovery fall more heavily on the defendants. Without much time or effort, the experienced plaintiffs' attorney can prepare a voluminous list of interrogatories and demand production of crates of documents. Responding to these requests takes more time; files must be searched, answers drafted, and objections made. Witnesses must also be prepared for deposition, and this can involve a rehearsal process that exceeds the length of the actual deposition. Second, the defendants will frequently need to engage multiple counsel: one for the parties involved in the specific transaction, another for the outside directors who approved it, and special counsel for the corporation (and possibly another for its special litigation committee).

Overhead is a third difference. Typically, the principal defendants will be represented by the corporation's normal outside counsel (because it is familiar with the transactions at issue); this institutional firm will typically have expensive hourly rates and a professional tendency toward meticulous preparation for any litigation, whatever its size. In contrast, because the plaintiff's attorney is the engine that runs the derivative action, he is better able to minimize his own out-of-pocket expenses and may engage in only minimal pretrial preparation when his real goal is an early settlement. The contrast here is between extensive pretrial preparation on the defendant's side and a form of feigned litigation that sometimes occurs on the plaintiff's. Although the plaintiff's side may make extensive discovery requests, it does not follow that the plaintiff's attorney will always review carefully the documents he requests. To be sure, he must appear to be serious about the case or he will sacrifice some negotiating leverage, but the distance between appearance and reality can be considerable. Meanwhile, defense counsel, who is typically paid by the hour, has considerable monetary incentive to spend a great deal of time preparing his client's case. In short, the real time and expense that the plaintiff's attorney expends may be less than he claims, particularly because he will be the master of the discovery program with the defendants largely responding to his requests.

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defendant liable to the corporation, litigation expenses may be indemnified by the corporation after the settlement.

Although this disparity in costs will not be a significant factor if the defendant can be certain of indemnification from the corporation, most states by statute preclude indemnification of litigation expenses by the corporation if the defendant is adjudged liable to the corporation. To illustrate the effect of these rules, let us assume an action where the plaintiff has only a twenty percent chance of success at trial. If the defendant has incurred (or will incur) $1,000,000 in legal costs, he faces a discounted legal cost of $200,000 if he goes to trial; conversely, if he settles, he can typically expect to be fully indemnified, thus yielding an expected cost of zero and a net difference of $200,000 in favor of settlement. Meanwhile, the plaintiff may have incurred out-of-pocket expenses of only $100,000, which amount reduces to an expected legal cost of $80,000 (on the same assumption of a twenty percent chance of victory). Although this disparity in expected legal costs depends upon an extreme disparity in the costs each side must actually incur before trial, it realistically describes at least some cases in which the plaintiff expends little time or effort because he believes the action has only a low prospect of success if litigated to a final judgment. Indeed, to the extent that the law chills derivative actions by, for example, giving the corporation's board the ability to terminate the action without close judicial review, the plaintiff's attorney will by definition see only a limited prospect of success and so should be more prepared to engage in "feigned" litigation at low cost to himself, while actually pursuing a settlement.

This example also illustrates a related factor pressuring the defendant to settle: litigation costs can overshadow his settlement cost. If the margin between the defendant's expected legal costs incident to a settlement and those applicable to a trial exceeds the difference between the amount he would have to pay to negotiate a settlement and the expected loss he would sustain at trial, he is better off settling, even at a price that exceeds the expected recovery at trial. For instance, on the facts in the foregoing example, there would be a $200,000 margin between the defendant's expected legal costs incident to a settlement (zero, because of the near certainty of indemnification) and those applicable to a trial ($200,000). Even when the expected discounted recovery at a trial would be only $200,000, the defendant would be best advised to settle the action for $300,000, if necessary, because in the case of a trial, his total expected outlay would be $400,000: the $200,000 expected legal costs plus the $200,000 expected recovery. In short, even a risk neutral defendant would sometimes be logically willing to pay more to settle a case than he would expect to lose at trial.

B. Risk Aversion

A second basic explanation for the strike suit is a differential in risk aversion between plaintiffs and defendants. If we examine first the plaintiff's attorney as the real party in interest, persuasive arguments suggest that he is more likely to be risk neutral than the defendant. By definition, he is a professional, a repeat player who is accustomed to facing litigation risks and who probably has a portfolio of other actions that diversify his risks.[44] Moreover, the potential gain and loss is asymmetric. For the plaintiff's attorney, his maximum gain is only a portion of the recovery that the class or corporation will receive, while his maximum exposure to loss is the sum of his opportunity cost for his own time and his out-of-pocket expenses (unless sanctions are imposed by the court or a security for expenses bond is required). In contrast, the individual defendant may face a catastrophic loss (only some of which may be either insured or indemnifiable) plus reputational injury. If we assume that there is a declining marginal utility to money, the possibility of this greater loss should make him more risk averse. In addition, defendants are not repeat players; the available empirical evidence suggests that the average public corporation is a party in a derivative action or securities class action only once every seventeen years.[45] Although directors may serve on multiple boards, it is doubtful that many directors are experienced "repeat players" at derivative litigation, simply because it would be irrational to remain an outside director in return for relatively modest compensation if one were recurrently sued. This factor distinguishes the defendants in a derivative action from, for example, the corporate defendants in the typical products liability class action where each side has played the game before.

Although it may be thought that the availability of insurance alters this conclusion (because the insurer is a repeat player by definition), the correct analysis should be that the insurance available to corporate officials actually heightens the contrast. Either by statute, decision, or industry practice, insurance does not cover any "personal benefit" that the insured is found to have improperly received.[46] In consequence, the defendant sued in a duty of loyalty case (i.e., one alleging in effect that he received such an improper benefit) faces a serious risk that insurance will not cover his loss if he is found liable, but this risk is substantially lessened if he settles.[47] Even in a due care

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44. Professor Galanter has made the important point that "repeat players" at litigation should be less likely to act in a risk averse fashion than "one shotters." *See* Galanter, *Why the "Haves" Come out Ahead: Speculation on the Limits of Legal Change,* 9 L. & SOC. REV. 95, 99-100 & n.11 (1974). *See also* H. ROSS, SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENTS 214 (1970).

45. *See* Jones, *An Empirical Evaluation of the Incidence of Shareholder Derivative and Class Action Lawsuits 1971-1978,* 60 B.U.L. REV. 306, 312-13 (1980). Only about 30% of the large publicly held corporations surveyed by Jones were involved in any form of shareholder litigation during the eight-year period he studied. After adjusting such data for multiple actions, he estimated that such corporations would be involved in shareholder suits on the average of once every 17.6 years.

46. *See* N.Y. BUS. CORP. LAW § 727(b) (1984) (insurance may not cover payments if judgment established that insured "personally gained in fact a financial profit or other advantage to which he was not legally entitled"). There are also common law limits on the enforceability of insurance for intentional misconduct. *See, e.g.,* Portaro v. American Guar. & Liab. Ins. Co., 210 F. Supp. 411, 416 (N.D. Ohio), *aff'd,* 310 F.2d 897 (6th Cir. 1962). Most standard "D&O" policies have similar exclusions covering "dishonesty" and "personal benefit," even when not required by statute. *See* J. Bishop, *supra* note 43, at §§ 8.03-.04; *see also* Hensey, *The New Lloyd's Policy Form for Directors and Officers Liability Insurance—An Analysis,* 33 BUS. LAW. 1961 (1978).

47. Once again, a settlement means that there is no "judgment or other final adjudication adverse to the insured" that under N.Y. BUS. CORP. LAW § 727(b) would preclude payment of

case, the coinsurance provisions and dishonesty exceptions applicable to most "D&O" (directors' and officers') insurance policies may still leave the defendant facing a significant loss (although in such cases, it would be difficult to say that the defendant had more at stake than the plaintiff's attorney).

C. Risk Spreading

A third and less obvious explanation for the possible prevalence of strike suits involves the behavior of the plaintiff's attorney. If we view him as a rational entrepreneur who is deciding whether to invest his time and money in a high-risk investment, such as a derivative action, then we should expect that he will rationally seek to hedge his bets by diversifying his portfolio. Potentially, the attorney can reduce his exposure to risk in several ways: (1) by seeking other legal business on a noncontingent basis; (2) by joining a firm that has a diversified practice and will accept his high-risk practice on a basis that is satisfactory to him; or, finally, (3) by spreading his risk over a substantial number of actions and avoiding significant investments of time or effort in any single action. As a matter of choice, the plaintiffs' attorney might prefer to spread his risks by either the first or second technique described above, but these options do not appear to be generally possible. Almost invariably, plaintiffs' firms are significantly smaller than firms that specialize in defense work. By one reasonable recent estimate, there were 250 firms in the United States having 80 or more attorneys.[48] Yet, as of the end of 1984, the largest firm regularly representing plaintiffs in class and derivative actions had only 37 attorneys, and even it had relatively little noncontingent business.[49]

Why is it that sophisticated plaintiffs' attorneys who typically handle complex class and derivative actions are not organized in larger firms? This question is particularly puzzling when one recognizes that the large firm offers the plaintiffs' attorney a desirable means of spreading his risk; indeed, it seems the tailor-made answer to the cash flow fluctuations that the solo or

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insurance. Similarly essential is the common law's limit against insurance covering "intentional" wrongdoing. *See supra* note 46 and accompanying text. Existence of intention is not established by a settlement. Nor in an action having multiple causes of action is it clear which legal theory justified the settlement. Although the insurance company could in theory resist payment on these grounds, its reputation would be adversely affected by any discretionary refusal to pay. For them, it is easier to raise the premium prospectively.

48. *See* Reed, *The Use of Permanent Staff Attorneys*, Nat'l L.J., Mar. 25, 1985, at 14.

49. The largest plaintiffs' firm specializing in the complex field of securities and derivative litigation is generally agreed to be Milberg, Weiss, Bershad, Spectrie & Lerach, a New York firm. Fortune Magazine describes it as "king of the class action domain." *See Lawsuit Fever*, FORTUNE, Nov. 26, 1984, at 151. Yet, it had only 37 lawyers at the end of 1984 (up from 29 lawyers in the prior year). *Id.* at 152. According to a New York Times profile of the firm, only about 20% of the firm's work was not on a contingency basis. *See* Lewin, *Class Actions Pay for Some Lawyers*, N.Y. Times, Dec. 5, 1983, at D1. As a result of this heavy dependence on contingent fees, even Milberg, Weiss is left "in an uncertain cash-flow position." *Id.* at D2. The New York Times story then makes a connection that seems obvious but is actually illogical: "Because of the financial uncertainties, firms that specialize in contingency-fee work have traditionally remained small." *Id.* According to the Fortune article, the overall compensation level at Milberg, Weiss for the partners appears to be as high as at most large New York firms. Although profit and stability do not necessarily coexist, this article will argue that a larger plaintiffs' firm actually provides a superior mechanism for risk sharing and evening out the fluctuations in cash flow.

small firm practitioner unavoidably confronts if he pursues a time-intensive case over an extended period. A partial answer probably involves the social stratification of the American bar; the plaintiffs' attorney is viewed by many within the institutional firms as their natural enemy. The very epithet "strike suit lawyers" is intended to suggest a social outcast, operating at, or beyond, the periphery of the established bar. Another possible answer is that the plaintiffs' attorney might be substantially disabled if he were to affiliate with an institutional firm, because legal ethics would prohibit him from suing the firm's clients. Ex ante, the plaintiff's attorney does not know whom he will want to sue in the future and, to preserve his options, he must avoid entanglement in the web of potential conflicts of interest that the institutional firm represents.

Yet, this explanation does not account for why plaintiffs' attorneys do not themselves affiliate into large permanent firms composed only of other plaintiffs' attorneys, instead of the ad hoc groupings that they today form to litigate a specific case. One possible answer is that plaintiffs' attorneys face complex organizational and monitoring problems, which to date they have been able to resolve only within the short run context of a particular case. To establish a firm there must be agreement on either a formula or an institutional structure by which to divide the firm's earnings. Reaching such agreement is a particularly difficult process in a plaintiffs' firm where some attorneys are sharing earnings they realized during the current period with other attorneys who are devoting all, or most of, their time to pursuing an expected, but risky, return in the future. The allocation process is further complicated by the basic fact that the value of an expected future return depends on one's level of risk aversion, and here the firm's partners may not agree. In addition, there is a monitoring problem: Is the partner shirking who claims to be working on a major action, which he predicts will yield a substantial return in the future? It is difficult for anyone not close to the action to know. As a result, because the partners cannot easily monitor each other or agree on the level of risk associated with the expected return from a major action, the only practical solution may often be to split up the firm and thereby spin off the risky asset to those who value it most highly.[50]

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50. Small firms frequently experience difficulty and sometimes dissolve over the issue of how to compensate those attorneys who have undertaken a long-term litigation on a contingent fee basis. *See, e.g.*, Lewin, *Belli Says Law Firm Thrives Despite Fights*, N.Y. Times, Mar. 19, 1984, at D1 (noting internal dissension and fission with Melvin Belli's firm). An even better example is supplied by the *Corrugated Container* antitrust litigation (which ultimately resulted in a record recovery), in which the lead counsel, Stephen Susman, and several of his partners were obliged to separate from their original law firm and form a new firm to continue the case. *See* Lempert, *Antitrust Lawyer Hopes Fee Will Confirm Vision*, Legal Times, May 17, 1982, at 1, 11. The new firm invested 75% to 80% of its time on the *Corrugated Container* case during its first year. Thus, if these same partners had expended a similar portion of their time in their former firm, they would have represented a severe cash flow drain for such a firm. Nor would their former partners, who may not have been experienced in antitrust litigation, have necessarily been in a position to monitor them. Absent an adequate monitor, no firm can in theory prevent "shirking." *Cf.* Alchian & Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

Finally, the institutional cement that holds large firms together appears not to exist in the case of plaintiffs' firms. In the language of economics, this cement is known as "firm specific capital"; it exists when the expected future returns to the firm as a whole are greater than the aggregate of the future returns that each partner could expect individually.[51] Such a surplus may arise because of a firm's reputation; the prestige of a Cravath or a Sullivan and Cromwell is greater than that of all their partners individually. Yet, in the world of the plaintiffs' bar, reputations are personal. Hence, there is little to deter a "star" partner from moving laterally to another firm, taking his pending actions with him. This greater lateral mobility in turn makes it more difficult to convince partners to invest in each other's long term projects. To be sure, the law governing partnership affairs may give the firm some right to an accounting if the partner who has been so subsidized later attempts to "steal" this action by moving to another firm, but at present the nature of the property rights in this area has been inadequately specified. In consequence, a reasonable conjecture is that plaintiffs' attorneys are reluctant to make other than transaction-specific deals among themselves, and they thus resist the longer term commitment that the establishment of a firm represents.

Whatever the reason, the empirical reality is clear: most plaintiffs' attorneys are either solo practitioners or are associated with relatively small firms. This state of affairs matters little in the context of most tort litigation, where, for example, personal injury cases are quickly resolved and a high volume practice is characteristic. But, within the context of shareholder litigation, the plaintiff's attorney must make a substantial commitment of time and money to an individual case and has no assurance that any settlement will result. As a result, the plaintiff's attorney specializing in this area needs to diversify his risks by some other technique. Put simply, he cannot afford to devote all or nearly all his time to a single large case which, if litigated to a final judgment, has a high probability of being decided adversely to him (given an overall plaintiff victory rate that appears to be under one percent for derivative actions that are litigated to judgment.)[52]

One risk-minimizing course of action for the plaintiff's attorney is logical, but not socially desirable: rather than invest significant amounts of time in a single action, the plaintiff's attorney can spread his risk by litigating a large number of actions, devoting little time or energy to any one, in the hope of settling a reasonable percentage of them for a modest amount per case. In effect, he hedges his bets and invests in a broad portfolio of actions. Of course, this description is also the classic profile of the strike suit: a slapdash action, inadequately researched as to either the facts or the law, brought by an

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51. *See* Gilson & Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, Stanford Law and Economics Working Paper No. 16, at 44-62 (1984) (arguing that "firm-specific" capital precludes or restrains partners in large firms from transferring laterally if they feel they are undercompensated). In contrast, a plaintiffs' firm might break up more easily over compensation disputes if it lacked such "firm-specific" capital (such as a reputation highly respected by institutional clients).

52. *See supra* note 22 and accompanying text.

attorney who is currently the attorney of record in a large number of similar pending actions. In courtrooms in New York, Philadelphia, and Wilmington, where derivative actions are frequently litigated, it is common knowledge who these attorneys are, and they represent a distinct subspecies of the plaintiffs' bar who typically are held in low regard even by their colleagues.

Still, the key point is that this refusal to invest heavily in a single case is rational behavior in economic terms. Here, private and social welfare can diverge. What is rational, and indeed optimizing, behavior for the attorney can be injurious to society, because such nuisance actions consume scarce social resources, produce only an unfocused form of deterrence, and yield little, if any, compensation to the corporation.

D. Joint Fee Shifting: The Derivative Action as a Non-Zero Sum Game

In any class or representative action, there is always the possibility that the plaintiff's attorney will exchange a cheap settlement for a high award of attorney fees.[53] Yet, largely because the adversaries are wary of each other, it is unrealistic to expect that a blatant offer will be made by either side to exchange a high fee award in return for a low settlement. Instead, the process typically involves a subtler form of body language as the defense counsel offers a low settlement and the plaintiff's attorney expresses resistance—until a generous fee award is thrown in.

This conflict of interest is endemic to class actions generally, but there is a special twist in the case of the derivative action. Although under the American rule each side normally pays its own legal fees, a standard exception to this rule is recognized when a common fund is created as a result of the plaintiff's efforts; in such instances, principles of unjust enrichment require that the plaintiff's legal fees come out of this common fund.[54] The law applicable to the derivative action carries this doctrine one step further: a successful plaintiff is entitled to be awarded his legal expenses from the corporation.[55] Correspondingly, when there is a settlement, the defendant can also safely anticipate that he will be indemnified for his legal expenses incurred in connection with the action by the corporation. If the defendant is

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53. In Alleghany Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting), *aff'd per curiam en banc by equally divided court,* 340 F.2d 311 (2d Cir. 1965), *cert. denied,* 383 U.S. 28 (1966), Judge Friendly put the matter succinctly:

> The plaintiff stockholders or, more realistically, their attorneys have every incentive to accept a settlement that runs into high six figures or more regardless of how strong the claims for much larger amounts may be . . . . [A] juicy bird in the hand is worth more than the vision of a much larger one in the bush, attainable only after years of effort not currently compensated and possibly a mirage.

See also Saylor v. Lindsley, 456 F.2d 896, 899-900 (2d Cir. 1972) (Friendly, J.):

> There can be no blinking at the fact that the interests of the plaintiff in a stockholder's derivative suit and of his attorney are by no means congruent . . . . The risks in proceeding to trial vary even more essentially. For the plaintiff, a defendant's judgment may mean simply the defeat of an expectation, often of relatively small amount; for his lawyer, it can mean the loss of years of costly effort by himself and his staff.

54. *See* Boeing Co. v. Van Gemert, 444 U.S. 472 (1980).

55. *See supra* note 41 and sources cited therein.

adjudged liable to the corporation, however, statutes typically preclude corporate indemnification of the defendant's legal expenses.[56] Thus, an expensive settlement could be more attractive to the defendant than a lesser judgment, if his legal fees will exceed the margin between the two amounts.[57] The upshot is a situation unique to the derivative action whereby both sides have a right to be reimbursed their legal expenses when there is a settlement, but not when there is an adverse judgment. These rules obviously create a strong pressure for settlement and explain why even a plainly frivolous action may sometimes be settled.

Of course, the defendant's calculus must include not only his legal expenses but also the contribution he must make to the settlement fund. Here, again, a special doctrine applicable to the derivative action increases the potential for collusion. Over the last twenty years, a "liberal" rule has evolved that a nonpecuniary settlement can justify an award of attorney fees in a derivative action.[58] Typically, such nonpecuniary settlements involve "therapeutic" reforms, such as revised auditing systems, corrective disclosures, or changes in the structure and composition of the board.[59] This doctrine can, however, be easily exploited. If the two adversaries are so minded, they can reach a nonpecuniary settlement under which the defendants do not make any cash contribution (or only contribute a nominal amount).[60] Each side can then shift its legal fees to the corporation through, respectively, a fee award or indemnification. For the adversaries, this is a painless way to resolve litigation—if they can convince the court to approve such a settlement. Of course, the court may sometimes resist acceptance of a settlement in which the corporate recovery seems trivial or out of proportion to the requested fee award. Nonetheless, the possibility of judicial resistance logically means only that the settlement process will be extended until the parties tender the minimal settlement that the court will accept, not that the outcome will reflect true adversative bargaining.

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56. *See supra* note 43 and accompanying text.

57. For an example, see *supra* p. 18.

58. For a review of the cases, see Note, *Attorneys' Fees in Shareholders Derivative Suits: The Substantial Benefit Rule Reexamined*, 60 CAL. L. REV. 164 (1972). For decisions finding a substantial benefit in "corporate therapeutics," see United Operating Co. v. Karnes, 482 F. Supp. 1029 (S.D.N.Y. 1980); Lewis v. Anderson, 81 F.R.D. 436, 439 (S.D.N.Y. 1978) (finding benefit even though action was dismissed); Tanzer v. Huffines, 345 F. Supp. 279 (D. Del. 1972); Fischman v. Wexler, 309 F. Supp. 976 (D. Del. 1970). Earlier cases expressed a different attitude and were reluctant to find a "substantial benefit" where the nonpecuniary relief could not easily be quantified. *See* Schechtman v. Wolfson, 244 F.2d 537 (2d Cir. 1957).

59. For a representative case, see Weisberg v. Coastal States Gas Corp., 1982 FED. SEC. L. REP. (CCH) ¶ 98,716 (S.D.N.Y. 1982) (fees in excess of $200,000 paid for relief consisting of revised corporate procedures and disclosures to shareholders, but no cash recovery); *see also* cases discussed *infra* at notes 68-79.

60. It is not only the private bar that is attracted to nonpecuniary attorneys. Public servants also have conflicts of interest with their clients. In a recent antitrust case involving Levi Strauss, the California Attorney General's expenses totaled $3 million out of a $12.5 million settlement, and a significant portion of these expenses, which depleted the recovery to the class, was the cost of mailing a letter to "all Californians" informing them that then-Attorney General Deukmejian, now the Governor of California, had won a legal victory benefitting them. *See* Jenkins, *The Law: Heads of the Class*, TWA AMBASSADOR, October 1983, at 22-23.

In overview, the nonpecuniary settlement fits the paradigm of the non-zero sum game. Normally, in litigation, the winning side's recovery equals the losing side's losses, much as in poker. But in this variety of non-zero sum game, an absent third party, the corporation, bears the expenses of both sides. Meanwhile, the litigation is dismissed with prejudice, and principles of collateral estoppel prevent the underlying claim from being relitigated by a more faithful champion.

One can thus understand why the nuisance suit can (and probably will) survive the appearance of the special litigation committee. From the defendant's perspective, a costless settlement is as attractive as a dismissal and may be obtained more quickly and with less risk. If the defendant insists on seeking the vindication inherent in a dismissal (as he sometimes does), he thereby accepts the possibility of a costly and stigmatizing defeat.[61] Even from the corporation's perspective, it may be considerably cheaper to agree to settle and pay a fairly modest fee to the plaintiff's attorney than to conduct an expensive and potentially embarrassing inquiry by its litigation committee. Put simply, if the plaintiff's attorney can underbid the cost of the special litigation committee, it becomes financially more attractive for the corporation to settle the action than to dismiss it, even if dismissal were certain. As a result, strike suits should survive even in the face of a hostile legal climate so long as the cost of the special litigation committee procedure is substantial.[62] Derivative actions become less profitable, but not less numerous; indeed, their frequency could even increase, although the return to both the corporation and the attorney should fall. The available empirical evidence is at least consistent with this prediction, as insurance industry data show that the frequency and costs of liability claims against directors and officers have risen, even though the prospect of a litigated adverse verdict has fallen.[63]

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61. The point here is not simply that the defendant risks his insurance coverage by going to trial (either because the ceiling on the policy could be exceeded or an exclusion in the policy may apply), while any settlement would necessarily involve the insurance carrier's agreement to honor the policy; in addition, the defendant risks his reputation, because he can always deny guilt if there is a settlement (even one approaching 99 cents on the dollar).

62. In Kaplan v. Wyatt, 484 A.2d 501, 511-12 (Del. Ch. 1984), Chancellor Brown of the Delaware Chancery Court candidly summarized the practical effect of the special litigation committee: "It sidetracks derivative litigation as we have heretofore known it for approximately two years at a minimum while the Committee goes through its functions and while the plaintiff awaits his chances to resist them." This delay is, of course, costly to both sides and thus makes a quicker resolution through settlement attractive.

However, this process may be changing. One implication of Aronson v. Lewis, 472 A.2d 805 (Del. 1984), is that the board will not in the future need to appoint a special litigation committee; instead, it can simply move to dismiss on the ground that demand was required (as in *Aronson*) without conducting any more than a cursory inquiry into the allegations. This would reduce the cost of defending the action and also thereby reduce the plaintiff's attorney's ability to underbid the costs of dismissal by proposing a cheap settlement.

63. According to the *1984 Directors and Officers Liability Survey* published by The Wyatt Co., an insurance industry consulting firm, both the frequency and costs of liability claims against officers and directors have recently risen. This survey of 1,652 corporations found a 10% increase since 1982 in the probability of suit against an officer or director. *See* Myrick, *Corporate Officers, Directors Face Rise in Suits, Legal Fees*, Legal Times, Feb. 4, 1985, at 3. According to this survey, the average payout in such suits was $1,618,000, of which $715,000 was attributable to legal fees. The leading cause of

If we wish an explanation for the prevalence of cheap settlements in derivative actions, the fact that the corporation can pay the legal expenses of both sides certainly accounts for much of the collusive behavior that even casual observation reveals. An obvious question therefore suggests itself: Why should both sides be permitted to have their legal expenses paid by the corporation? Surely, there is no corporate benefit from paying both sides, and the predictable result is an extraordinarily strong urge to settle. Easy as it is to pose this question, it is more difficult to frame a policy proposal that responds sensibly to it. In theory, the law could permit only one side to have its expenses paid; in the case of a settlement, this prohibition would permit the parties to inform the court as to which side's expenses would be paid, but partial reimbursement to both would not be permitted. The latter restriction would prevent the parties from inflating their fees to obtain reimbursement of their real expenses. Still, simple as this solution sounds, its practical effect is likely to be minimal, given the prevalence of liability insurance covering the defendants' litigation expenses. Because the corporation pays the premiums on these policies (and could do so indirectly in the form of higher compensation, even if it were forbidden to pay the premiums), it still would indirectly fund the defendants' litigation expenses. Thus, the parties could evade the intended impact of this proposal by simply agreeing to have the corporation pay only the plaintiff's expenses while the defendants looked to their insurance policies. Only the form, and not the substance, would be changed. Given that the problem cannot be solved this easily, it is next necessary to consider the feasibility of two more indirect answers: first, the requirement of judicial approval of the settlement, and, second, the attorney fee formula itself.

E. Judicial Approval: A Case Study

Defenders of the status quo have a standard response to arguments such as those made above that collusive settlements are possible in derivative actions. Such cynical exchanges of high fees for a low recovery cannot take place, they reply, because the court must approve the settlement, typically after notice to the class and an opportunity for objectors to contest the settlement's adequacy. Although ideally a sensible judge will not approve a settlement in which the fees appear disproportionate to the benefit obtained, it sadly does not follow that the judicial approval requirement is a significant barrier to collusive settlements. First, as Judge Friendly concisely explained long ago,[64] the trial court's approval is a weak reed on which to rely once the

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these increased costs was viewed as the "increased complexity and longevity surrounding such claims." *Id.* This analysis dovetails with that of Chancellor Brown in Kaplan v. Wyatt, 484 A.2d 501. Of particular relevance is the conclusion of a Wyatt vice president that, although it is "becoming harder to win one of these suits, defendants are more likely [to] be slapped with a suit." Myrick, *supra*, at 3.

64. Alleghany Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting), *aff'd en banc by an equally divided court*, 340 F.2d 311 (2d Cir. 1965), *cert. denied*, 384 U.S. 28 (1966) (noting that "all the dynamics conduce to judicial approval of the settlement" once the adversaries lock arms and approach the court).

adversaries have linked arms and approached the court in a solid phalanx seeking its approval. In addition, the court may have incentives of its own not necessarily consistent with the public interest—namely, to clear a potentially messy and burdensome case from its docket. Even if the court were not so motivated, the general infeasibility of trying to force litigants who wish to settle their case to try it instead will be apparent to the court. Also, even the diligent and sophisticated judge may feel obliged to approve a settlement in which the attorney fees appear suspiciously disproportionate to the financial recovery obtained, because the judge may believe that existing precedents mandate such a fee award.[65] Alternatively, the court may believe that the requisite "substantial benefit" necessary to justify the award of plaintiffs' attorney fees can be found in the fact that costly burdensome litigation is being resolved that would otherwise drain the corporation's treasury.[66] Finally, the court may simply believe that it should defer to the business judgment of the corporation's independent directors who wish to see the action settled. Although none of these justifications seems truly persuasive, they each permit conscientious judges to take the course of least resistance and approve settlements that seem inadequate coupled with the fee awards that seem disproportionate.

Is there any empirical evidence to confirm this hypothesis? The Garth, Plager, and Nagel article in this volume reinterprets earlier empirical studies and finds that nonpecuniary recoveries appear to account for a substantial proportion of all settlements in derivative actions.[67] Indeed, for several reasons, the rate may be even higher than they suggest.[68] Still, surveys are not as convincing as a close look at actual cases. Good illustrations are provided by two recent cases discussed below.

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65. Under the prevalent "lodestar" formula for the determination of the appropriate attorney fees, *see infra* notes 93-95, it is not an explicit factor that the fee requested would deplete the recovery fund. In some decisions involving fee awards under federal fee shifting statutes, the fee has exceeded the recovery. *See, e.g.*, Copeland v. Marshall, 641 F.2d 880 (D.C. Cir. 1980) (en banc) ($160,000 fee approved for $6,169.80 back pay recovery). More importantly, where only nonpecuniary relief is obtained, the court has little alternative but to award a fee based on the time the attorney expended, unless the attorney has either failed to maintain adequate records or demonstrably wasted time.

66. *See, e.g.*, Lewis v. Anderson, 81 F.R.D. 436 (S.D.N.Y. 1978); United Operating Co. v. Karnes, 482 F. Supp. 1089 (S.D.N.Y. 1980). This is, of course, a bootstrap argument under which the "benefit" consists of the plaintiff's attorney going away, and in effect it amounts to virtually a judicially awarded bribe. Still, it appears to persuade some courts.

67. *See* Garth, Nagel & Plager, *supra* note 25, at 146. Reanalyzing the data provided by Jones, *supra* note 22, they find 32 settlements of derivative actions, of which 10 involved nonmonetary relief and 2 had indeterminate monetary relief. In other words, roughly one-third of the actions in which the settlement's terms could be ascertained involved essentially nonpecuniary settlements. In still other cases, a nonpecuniary component may have been used to inflate the settlement in order either to secure judicial approval or a larger fee award.

68. For example, the Jones data are based on the 1971 to 1978 period. Because the lodestar formula did not come into widespread use until the middle of this period, the incentive to structure nonpecuniary settlements also did not arise until the latter portion of this period and indeed may not have been immediately perceived by counsel. More importantly, Jones obtained settlement data on only a minority of the cases whose outcomes he reported; it should not be assumed that the missing data would show the same proportion of nonpecuniary settlements. In fact, the classic "sweetheart" settlement would be the settlement whose terms would least likely be reported widely.

In re General Tire & Rubber Co. Securities Litigation[69] was one of many cases that grew out of the SEC's "illegal payments" investigations of the late 1970's. Initially, the SEC brought a civil action against General Tire, alleging "ubiquitous corporate improprieties and apparent illegalities,"[70] and it obtained a consent decree permanently enjoining General Tire from similar practices in the future. Unlike a host of similar cases, the story did not end there; instead, the FCC picked up where the SEC left off and refused to renew broadcast licenses held by RKO General, a subsidiary of General Tire, as a direct result of these improprieties. Ultimately, a highly valuable broadcast license was forfeited, resulting in a loss to General Tire that the Sixth Circuit estimated at over $100 million.[71] Predictably, plaintiffs brought derivative actions to recover these damages.[72] Because these actions sought recovery of a relatively precise and quantifiable loss that had proximately resulted from knowing illegal behavior, it seems reasonable to believe that the plaintiffs had a stronger case on the merits than in most other illegal payments cases where the nature of the damages is more perplexing.[73] In response to these derivative actions, General Tire's board followed the standard operating procedure and appointed two new directors whose lack of involvement in the prior illegal activities was clear, and then named them to a special litigation committee to investigate the actions' merit. In due course, these new directors reached the usual determination that the actions should be dismissed.

At this point, the course of events deviated from the standard script: before the motion to dismiss based on the committee's report could be resolved, the actions were settled. Under the settlement, General Tire did not recover any monetary damages, but the plaintiffs' attorneys received a fee award of $500,000 which was duly approved by both the district court and Sixth Circuit (over a strong dissent).[74] Apparently, the only arguable benefit to General Tire from the settlement was a provision requiring the appointment for three years of two "outside" directors to the board of its subsidiary RKO.[75]

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69. 726 F.2d 1075 (6th Cir. 1984).

70. *Id.* at 1078.

71. *Id.* at 1080.

72. Actions were brought in New York and Delaware state courts, federal courts in the Northern District of Ohio, the Southern District of Ohio, New Jersey, and the Eastern District of Pennsylvania. *Id.* at 1078 n.1 & 1079 n.4. This trend illustrates the problem of interdistrict competition discussed *infra* at notes 138-66. Although the federal cases could be consolidated (and were), the state actions could not be.

73. Arguably, an illegal payment in some cases may have averted a greater loss to the corporation (such as confiscatory nationalization) or may have produced a greater benefit (such as a profitable concession). These problems raise difficult issues as to the burden of proof on the question of damages, which issues were not reached in *General Tire.* For a discussion of these issues, see A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 7.06 (Tent. Draft No. 1, 1982). *See also* Note, *Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions,* 64 COLUM. L. REV. 174 (1964).

74. 726 F.2d at 1088 (Wellford, J., dissenting).

75. *Id.* at 1079. The settlement also acknowledges "the plaintiffs' role in implementing remedial action to prevent future improprieties." Whatever this "remedial action" may have been,

One need not be a cynic to call such relief cosmetic or to doubt that it justified a significant fee award. Even if therapeutic relief is sometimes valuable, the real moving force in uncovering the improprieties in this case was not the plaintiff, but instead was, depending on one's perspective, the SEC, the FCC, or perhaps even General Tire's board itself. Yet, it would be too cynical to assume that either side believed subjectively that it had not served its clients well. How then should we account for this seemingly empty settlement coupled with a substantial fee award? First, from the defendants' perspective, a logical possibility is that the extent of tangible, easily proven damages in this case plus the fact that the district court had authorized broad discovery created considerable anxiety for them.[76] They could not be certain that the court would accept the committee's recommendation, even though Ohio law seemed favorable to them. Moreover, a substantial award of attorney fees was costless to them, because it would be paid by the corporation. Conversely, plaintiffs also faced a difficult and uncertain prospect if the case proceeded further; they would have to overcome the special litigation committee's findings and also convince the court that the defendants should be held liable for the unexpected action of the FCC in cancelling RKO's broadcast licenses. Yet, even if both sides can justify such a settlement to themselves, the social benefit of such an action is minimal because there is neither deterrence generated nor compensation recovered.

General Tire is not an aberrational case; other examples can be cited.[77] To focus on just one other contemporary instance, the Delaware case of *Good v. Texaco, Inc.*[78] initially represented a substantial triumph for plaintiffs. It arose when Texaco selectively repurchased approximately 25.6 million shares of its

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the intervening passage of the Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd, 78dd-1, 78dd-2, 78ff (1982), did far more to prevent any repetition of the original incidents, and this reference seems to be rhetorical surplusage.

76. The district court had ordered discovery as to the litigation committee's report on the issue of the independence of the committee members and "had requested supplemental briefing on the effect of the termination of RKO's licenses." 726 F.2d at 1079. The latter substantive focus on the injury may have foreshadowed an intent to engage in substantive review of the justifications underlying the committee's rejection of the suits. In any event, approximately three months after this broad discovery order, the parties presented a stipulation of settlement to the court for its approval. *Id.*

77. *See supra* notes 59-60. For the broader survey evidence, see *supra* note 67.

Surveys of reported cases may also understate the extent of collusive settlements because some practices—such as a settlement of a threatened action that is never filed or an exchange of a generous fee payment in return for a decision not to appeal a dismissal of the action—may escape detection. Yet such tactics are not uncommon. Recently, Judge Whitman Knapp of the District Court for the Southern District of New York ordered two New York law firms (one of which was the firm headed by Roy Cohn) to repay $230,000 to Ford Motor Co., which they had received from Ford without judicial approval after a derivative action brought by Cohn alleging misappropriation of funds by Ford's senior management had been dismissed on procedural grounds. The action was never refiled, possibly as a result of this payment. A subsequent derivative action brought by the Public Citizens Litigation Group resulted in the court's order directing that Ford be repaid because the requisite state court approval of the fee payment was not obtained. *See Inadmissible: Take My Fees . . . Please*, Legal Times, May 20, 1985, at 3.

78. No. 84-7051 (Del. Ch. May 14, 1984). *Good* seemed to imply that the Delaware courts would examine closely "greenmail" transactions (i.e., selective repurchases at a price over the market) and would not defer automatically to special litigation committees.

common stock (or roughly 9.9%) held by Bass Brothers Enterprises, Inc. (and certain of its affiliates) at a price substantially over the then market value of Texaco's shares—seemingly, a classic instance of "greenmail." The sellers received approximately $650 million in cash plus 12.6 million shares of newly issued voting Texaco preferred stock, which they agreed to vote in accordance with the directions of Texaco's board for ten years.[79]

Over twenty derivative actions were commenced in a variety of forums to attack this transaction, which seemed both to result in a waste of shareholder funds and to immunize Texaco from further takeover threats by virtue of the Texaco board's power to control the voting of the preferred stock. In May of 1984, the Delaware Chancery Court denied Texaco's motion to dismiss the principal derivative action, finding that demand on the Texaco board was excused because the entire transaction appeared to raise serious questions as to whether the board was seeking to perpetuate itself in office.[80] In overview, *Good* thus appeared to be a case having a substantial settlement value, because it had already cleared the critical "demand excused" barrier.[81] Yet, when the parties reached a settlement later in 1984, the proposed settlement required no financial contribution by the defendants, except for the payment of plaintiffs' attorney fees by the defendants. Instead, the principal relief was nonpecuniary: the provision requiring the Bass defendants to vote the preferred stock as instructed by the Texaco board was deleted. In return for this relief, the plaintiffs' attorneys sought and received legal fees in an amount of up to $700,000 plus expenses, and the defendants agreed to pay these fees if approved by the court.[82] Although several objectors vigorously opposed the settlement's approval, other shareholders sought to intervene and replace the plaintiffs, and over 1400 shareholders opted out from the class action portion of the combined class and derivative action,[83] the court still approved the settlement and awarded the full $700,000 that had been negotiated by the parties.

79. The transaction is described in clearest detail in the notice of settlement sent to shareholders. *See* Notice of Pendency of Actions, Class Action Determination, Settlement, Settlement Hearing and Right to Appear, at 1 (Nov. 14, 1984) [hereinafter cited as *Notice of Settlement*]. This notice also indicated that between March 7 and April 30, 1984, "twenty additional complaints" were filed in Delaware and elsewhere. *Id.* at 1.

80. Chancellor Brown focused on the board's power to vote the preferred shares (as a result of the Bass defendants' agreement to vote the stock as directed by the board): "Since this power to vote the shares of the Bass defendants hereafter is alleged to be a power acquired for the board of directors itself, it follows that all board members are necessarily interested personally in the transaction that they are alleged to have wrongfully approved." Good v. Texaco, Inc., No. 84-7501 (Del. Ch. May 14, 1984) (available Nov. 1, 1985, on LEXIS, States library, Del file).

81. Under Aronson v. Lewis, 473 A.2d 805 (Del. 1984), once demand is excused, the court may substantively review the committee's justifications for dismissal; otherwise, the court may only undertake a procedural review.

82. *See Notice of Settlement, supra* note 79, at 4 ("If the settlement is approved by the Delaware Court of Chancery, the plaintiffs' attorneys intend to apply for an award of attorneys' fees not to exceed $700,000 and for their disbursements . . . . The defendants will not oppose such application and agree that such an award would be fair and reasonable . . . .").

83. Good v. Texaco, Inc., No. 7501, slip op. at 1 (Del. Ch. Feb. 19, 1985). At the settlement hearing, eight law firms appeared to oppose the settlement.

What motivated the court to accept this result in a case where, as it candidly noted, "[t]he proposed settlement is . . . unusual in that, if it is approved by the Court, nothing of consequence will happen other than the dismissal of the suit and the payment of counsel fees."[84] In a lengthy opinion, the court first stressed the serious obstacles that plaintiffs would face if they proceeded with their action. True as this may have been, this factor hardly justifies a $700,000 net fee; indeed, if the weakness of the plaintiffs' case could justify such a fee award, the law would in effect subsidize frivolous actions. Obviously wrestling with this problem, the court at various points acknowledged that the requested fee was "somewhat staggering," had aroused "a sense of shareholder outrage," and would be seen by some as an example of "feemail."[85] Yet, in still finding the fee reasonable, the court relied on three factors: (1) its confidence in the sincerity and abilty of the plaintiffs' attorneys; (2) the fact that the requested fee "compares favorably to the fees normally paid to investment bankers for their participation in such transaction[s]";[86] and (3) the value of the disclosures about Texaco's board's motivation for the repurchase that the shareholders would receive as a result of the settlement.[87] None of these factors should be persuasive. Even able attorneys will find it foolish to litigate a difficult case when they are offered $700,000 to settle on a nonpecuniary basis, and even the most sincere can sometimes rationalize a profitable outcome. Nor should weight be given to the unarticulated factor that the fee was to be paid by the defendants.[88] Indeed, to the extent that these factors are given weight, the end result in *Good* permits defendants in future greenmail cases to use *Good* as a model by which to structure transactions: that is, the defendants could always include some nonessential provision in the greenmail transaction that they would later agree to relinquish in return for a nonpecuniary settlement and a more than generous fee award.

These cases provide evidence for two contentions earlier made: First, although desirable, judicial approval of the settlement is an imperfect safeguard, precisely because courts are often not prepared to force litigation in complex cases when the parties wish to settle. Second, the logical response

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84. *Id.*

85. *Id.* at 38, 40, 25. The term "feemail" was used by one of the objectors, Seagoing Uniform Corp., and this term was characterized by the court as a "strained effort to coin . . . a legal neologism." *Id.* at 25. Still, once coined, the term will predictably be heard again.

86. *Id.* at 41. This curious argument does not address the real issue of whether the services rendered were comparable.

87. *Id.* at 16-18. As part of the settlement, defendants agreed to provide members of the class "with all information relevant to the issues in the various suits proposed to be terminated by disclosing the details of the plaintiffs' investigation and discovery." *Id.* at 16. Plaintiffs argued that this report of the plaintiffs' view of the evidence would "enable the common shareholders to better evaluate the performance of their board . . . ." *Id.* at 18. To at least this author, this technique sounds more like a classic bootstrap argument by which to inflate the value of a cosmetic settlement.

88. Under the settlement, the Bass Brothers were to pay 21.43% of the fee award and the individual director defendants were to pay 78.5%. *Id.* at 17. Because the fee award was not to be paid with corporate funds, the court may have believed that there was little reason to examine the amount closely. In fact, however, there is considerable reason to examine such payments because they may signal that the corporation itself was unwilling to pay the fee and considered it excessive.

of plaintiffs' attorneys to the special litigation committee device may simply be to lower their settlement price. So long as there is either some uncertainty as to a litigated outcome or the cost of dismissing the action exceeds the cost of settling it, defendants predictably will be willing to authorize substantial attorney fees for the plaintiffs. From an ex ante perspective, it matters little whether the offer to exchange a low settlement for a high fee award comes from the plantiff's side or the defendant's; all that counts is that the outcome is predictable.

Cheap settlement should persist then so long as the plaintiff's attorney is able to underbid the cost of the special litigation committee device.[89] In many instances, a full scale inquiry by such a committee will have a cost in the millions of dollars and public disclosure may set other undesired events in motion (as *General Tire* shows), while the plaintiff's attorney will be satisfied with a much smaller fee award. From a public policy perspective, the curious irony then is that nuisance actions should survive the judicial acceptance of the special litigation committee device for the dismissal of derivative actions. The primary consequence of judicial deference to special litigation committees may be not to abolish the derivative action, but to minimize the possibility of a substantial corporate recovery. Ex ante, the plaintiff's attorney today knows two basic facts: First, no matter how meritorious the action is, he faces a significant probability of dismissal as a result of the special litigation committee procedure. Second, even when dismissal is highly likely, he may often still obtain a substantial fee award by offering or accepting a nonpecuniary settlement, in effect by underbidding the costs of dismissal. Knowing these two facts, the rational plaintiff's attorney has some incentive to file a nuisance action for its quick settlement value, but little to invest substantial time and effort in litigating an action more intensively. Hence, frivolous actions may remain, but substantial corporate recoveries become rare—in effect, the worst of both worlds.

The special litigation committee device is not alone responsible for this state of events. Judicial acceptance of nonpecuniary settlements and the use of the lodestar formula for measuring the fee award share substantial responsibility,[90] because they allow the parties to establish with reasonable assurance what the fee award will be and to structure a settlement in which the amount is disproportionate to the size of the settlement. In combination, these three factors minimize the likelihood that any legitimate purpose

89. In *Kaplan v. Wyatt*, *supra* note 62, Chancellor Brown noted that current procedures in Delaware now typically result in three stages of contested hearings (first, a hearing to stay the plaintiff from conducting discovery pending the completion of the committee's study; second, a hearing to grant limited discovery of the report; and third, the hearing on the motion to dismiss). The report, he added, is usually "at least 150 pages in length, exclusive of appendices and attachments" and the entire process takes "two years at a minimum while the Committee goes through its functions." 484 A.2d at 510, 512. All this costs money and makes dismissal based on the special committee procedure expensive. Settlements, such as that in *Good*, may therefore be considerably cheaper.

90. *See infra* notes 93-95 with respect to the lodestar formula. With respect to nonpecuniary settlements, see *supra* notes 58-60, 66, & 68-78.

underlying the derivative action—either deterrence or compensation—will be well served.

III
IS THERE AN OPTIMAL ATTORNEY FEE FORMULA?: A LOOK AT THE TRADE-OFFS

The preceding analysis suggests that the prospect of collusive settlements today often cripples the shareholder suit as an effective monitoring mechanism. If so, an obvious policy prescription would be to compensate the plaintiff's attorney in a manner that better aligns his interests with those of his involuntary clients, the shareholders. For example, if we returned to the once common "salvage value" system, under which the plaintiff's attorney was awarded a percentage of the recovery received by the class,[91] nonpecuniary settlements would no longer be attractive to the plaintiff's attorney, and the exchange of a high fee for a low settlement would be effectively precluded, because the fee would be a direct function of the settlement size. Commentators have correctly pointed out, however, that a simple percentage-of-the-recovery formula also can lead to a conflict between the attorney's interests and those of the class he represents.[92] Accordingly, this section will examine the problematic trade-offs between the two principal formulae now employed by courts: the "lodestar" formula and the percentage-of-the-recovery method.

A. The Lodestar Formula: The Attorney as Regulated Utility

The predominant approach in federal courts for determining the fee award to a prevailing plaintiff's attorney is to use a time-based formula.[93] The court simply computes the hours reasonably expended by the attorney, then multiplies these hours by the attorney's normal hourly billing rate (unless unreasonable or above that generally prevailing in the relevant community), and finally, in the court's discretion, adds a "contingency bonus" to reflect both the risk assumed by the attorney and the deferral of payment incident to

91. *See* Hornstein, *Legal Therapeutics: The Salvage Factor in Counsel Fee Awards,* 69 HARV. L. REV. 658 (1956); *see also,* Hornstein, *supra* note 41, and accompanying text (summarizing actual fee awards). For a representative case, see Pergament v. Kaiser-Frazer Corp., 224 F.2d 80, 83 (6th Cir. 1955) (holding 20% of the recovery was appropriate). Historically, awards appear to have ranged between 20%-30% of the recovery when the recovery was below $1 million, and between 20%-30% of the total recovery when it was more. *See* Cole, *Counsel Fees in Stockholders' Derivative and Class Actions: Hornstein Revisited,* 6 MICH. L. REV. 259 (1972). *See also* Mowrey, *Attorney Fees in Securities Class Action and Derivative Suits,* 3 J. CORP. LAW. 267, 334-36 (1978).

92. *See* Clermont & Currivan, *Improving the Contingent Fee,* 63 CORNELL L. REV. 529, 536 (1978); Schwartz & Mitchell, *An Economic Analysis of the Contingent Fee in Personal Injury Litigation,* 22 STAN. L. REV. 1125 (1970).

93. This is the "lodestar formula." For a detailed analysis, see Leubsdorf, *The Contingency Factor In Attorney Fee Awards,* 90 YALE L.J. 473 (1981). In Blum v. Stenson, 104 S. Ct. 1541 (1984), the Supreme Court adopted the lodestar formula as the appropriate method to be used in determining attorney fee awards under the Civil Rights Attorneys' Fee Award Act, 42 U.S.C. § 1988 (1982). *See also* Hensley v. Eckerhart, 461 U.S. 424 (1983).

a contingent fee system.[94] Although this lodestar approach dates back only to the early 1970's,[95] it has already received the endorsement of the Supreme Court (at least with respect to federal statutes that provide for fee shifting in favor of the prevailing plaintiff),[96] and it has been generally followed by the federal courts in a variety of other contexts.[97]

Criticism of the lodestar method has generally focused on the inevitable incentive that arises, once time is equated with money, for the plaintiff's attorney to conduct a dilatory, unnecessarily prolonged litigation.[98] Defense counsel have complained that their ability to negotiate an expeditious settlement is impeded by the lodestar formula,[99] and anecdotal evidence suggests that it is not uncommon for settlements to be reached among the parties at one point in time, but not presented to the court for approval until a considerably later point after the plaintiff's attorney has engaged in sufficient billable hours of discovery to justify the maximum fee that he expects the court will approve.[100] Substantially accurate as these critiques may be, they prove little of significance. Plaintiffs' attorney fees do not appear to have risen in the wake of the introduction of the lodestar formula and may have

94. Some surveys have found the contingency bonus to have averaged nearly 50% of the time component. *See* Leubsdorf, *supra* note 93, at 479 n.36. In *Blum v. Stenson,* however, the Supreme Court indicated that a contingency bonus would rarely be appropriate, at least in the context of fee awards under the Civil Rights Attorneys' Fee Award Act. 104 S. Ct. at 1547. A year earlier in Hensley v. Eckerhart, 461 U.S. 424, the Court did indicate that a variety of factors could lead to an upward or downward adjustment of the fee award and emphasized that the "results obtained were the most important factor" in this determination. *Id.* at 434.

95. The key decisions were Lindy Bros. Builders, Inc. v. American Radiator & Standard Corp., 487 F.2d 161 (3d Cir. 1973) ("Lindy I"); Lindy Bros. Builders, Inc. v. American Radiator & Standard Corp., 540 F.2d 102 (3d Cir. 1976) (en banc) ("Lindy II"); City of Detroit v. Grinnel Corp., 495 F.2d 448 (2d Cir. 1974). These decisions essentially adopted the "lodestar" criteria from the MANUAL FOR COMPLEX LITIGATION, (5th ed. 1981), which had been revised in 1973 to suggest a time-based formula for fee awards. *Id.* § 1.47.

96. *See* Blum v. Stenson, 104 S. Ct. 1541 (1984). However, *Blum* contains an extraordinary statement that in "common fund" cases (a category that presumably includes most forms of shareholder litigation) the "reasonable fee is based on a percentage of the fund bestowed on the class . . . ." *Id.* at 1550 n.16. This statement would seem to contemplate a percentage-of-the-recovery approach in most securities and derivative actions.

97. Professor Leubsdorf has reported that the clear majority of the federal courts of appeals are employing the lodestar methodology. *See* Leubsdorf, *supra* note 93, at 437 n.1. *See also* A. MILLER, ATTORNEYS' FEES IN CLASS ACTIONS (1980 Federal Judicial Center) (cataloging the various areas in which the basic lodestar methodology is used).

98. Among the many critics (including the author) who have raised this theme are: Wolfram, *The Second Set of Players: Lawyers, Fee Shifting, and the Limits of Professional Discipline,* LAW & CONTEMP. PROBS., Winter 1984, at 293, 302 ("Under the widely employed 'lodestar' method . . . lawyers are under strong economic pressure to work slowly or to perform work that is unnecessary."); Solovy & Mendillo, *Calculating Class Action Awards: Is It Time to Unload the Lodestar?,* National Law Journal, May 2, 1982, at 20; A. MILLER, *supra* note 97, at 270-71. *See also In re* Fine Paper Antitrust Litig., 98 F.R.D. 48, 68, 85 (E.D. Pa. 1983), *aff'd in part, rev'd in part on other grounds,* 751 F.2d 562 (3d Cir. 1984).

99. *See* Herzel & Hagan, *Plaintiffs' Attorneys' Fees in Derivative and Class Actions,* LITIGATION, Winter 1981, at 25-26 ("Our experience and that of other defendants' lawyers has been that stockholder suits have become increasingly difficult to settle at an early stage.").

100. Both defense and plaintiffs' counsel have acknowledged to me having seen such instances, and one federal district court judge has told me that it is often apparent to the court when this occurs because discovery thereafter proceeds placidly without the usual contested motions.

actually declined slightly.[101] In effect, the plaintiff's attorney who stretches out the course of the litigation to maximize his hours may only be protecting himself from a decrease in his expected return from the action because of the transition to the lodestar formula. Although this practice of feigned litigation by which the plaintiff's attorney runs up his hours is unsettling and potentially corrupting to the legal system, the claim that the lodestar formula results in excessive fees is nonetheless a red herring.

The real problems with the lodestar lie elsewhere. Chief among these is the inherent tendency of a time-based formula to exacerbate the problem of collusive settlements discussed earlier. By severing the size of the fee from the size of the settlement fund, the lodestar formula permits the parties to assure themselves with relative confidence what the fee award will be.[102] In this respect, the contrast between a time formula and a percentage-of-the-recovery formula is obvious. For example, if the parties were to agree upon a primarily nonpecuniary settlement in a jurisdiction that followed the percentage-of-the-recovery system, the court might approve the settlement, but it would be hard pressed to justify awarding more than a trivial fee. Under a time formula, however, the presumption is that time expended should be compensated at the attorney's normal billing rate. If the defendant agrees not to object to the plaintiff's fee request, there is little prospect that the court will engage in an elaborate inquiry into the reasonableness of the hours expended by the plaintiff's attorney. Not only does the court have little incentive to undertake such an inquiry, but when the defendants agree not to oppose the plaintiff's fee request they deprive the court of the only adversary who truly knows if the time was reasonably expended. Put simply, it is the adversary and not the court who best understands the justifications (or lack thereof) for the work the plaintiff's attorney has done. Denied this information by the de facto settlement agreement, the court is itself a relatively poor and undermotivated monitor of the plaintiff attorney's performance.

To understand how the lodestar formula facilitates settlements that do not accurately reflect the probable results of a litigated outcome, it is essential to focus on the plaintiff's attorney's position once he has expended substantial time on a case. For example, consider the position of the plaintiff's attorney in the following case on the assumption that he is a rational decisionmaker

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101. *See* Mowrey, *supra* note 91, at 343-48 (noting that courts have awarded approximately the same percentage of the recovery under the lodestar formula as before).

102. There are, of course, limits, because the court will resist depleting the recovery fund excessively to pay attorneys' fees. *See supra* note 100. Yet, to some extent, the wool can be pulled over the court's eyes if the parties negotiate an agreement under which the legal fees will be paid separately by the defendants. For example, the court may approve a settlement under which defendants will contribute $1,000,000 to a settlement fund and will separately pay plaintiffs' attorney fees. After the settlement is approved, fees amounting to another $1,000,000 will be paid, meaning that in effect 50% of the total recovery has gone to attorney fees. Although the *Manual for Complex Litigation* disapproves of these agreements for separate payment, *see* MANUAL FOR COMPLEX LITIGATION § 1.46 (5th ed. 1981), such low visibility agreements appear to be common and probably escape adequate recognition in recent empirical surveys. *Cf. In re* General Motors Corp. Engine Interchange Litig., 598 F.2d 1106, 1130-31 (7th Cir.), *cert. denied*, 444 U.S. 870 (1979).

seeking to maximize his own return. A class or derivative action seeking damages of $20 million is commenced and litigated through the usual preliminary procedural steps for a period of two years or more. By the eve of trial, the plaintiff's attorneys have reasonably expended time that at a normal billing rate would justify an award of $1 million to them. They believe their action has an expected value to the class of $10 million; that is, the class, itself, would not settle for less than this amount. However, there is also a fifty percent risk of an adverse judgment. If the plaintiff's attorneys proceed to trial, they will expend additional time that should enhance their fee from $1 million to $1.2 million; but by proceeding to trial they would also accept the fifty percent risk of an adverse judgment. Thus, the expected value of the action to them, if a trial were necessary, is not $1.2 million, but only $600,000 (or even lower to the degree that they were risk averse). Against this backdrop, it is understandable why the plaintiff's attorneys might accept a settlement offer of $5 million even though their clients would prefer to hold out for $10 million. Why? Simply put, they have nothing to gain and much to lose by proceeding to trial, because the bulk of their time was already expended before trial in discovery and procedural skirmishing. A trial would only subject them to a substantial risk that their investment would be lost.

This example may seem to depend on fortuitous facts, either because (1) the time expended prior to trial was much greater than the time likely to be expended at trial, or (2) the risk of an adverse verdict was relatively high. Yet the example does not depend on any special set of facts. One need only change the moment at which the settlement offer is made to the moment immediately before the jury returns with its verdict to see that now the attorney has absolutely no economic reason not to accept the inadequate settlement offer. At that point, rejecting an inadequate settlement gains him nothing, but jeopardizes the prospect of any fee recovery. To generalize: once time is equated with money, there will always be a point at which the attorney can secure no further gain from the action and would rationally wish to eliminate the risk of an adverse judgment (even if it were only a ten percent risk) by accepting a settlement that his clients would consider inadequate. Indeed, the purely self-interested attorney would rationally accept a settlement offer in an amount no greater than one dollar over his expected fee—if he believed that he could secure judicial approval of such a settlement. In truth, this last outcome is substantially equivalent to the now common nonpecuniary settlement (such as that in *General Tire* or *Good*); both amount to a settlement equal to the attorney's fee plus cosmetic relief.

The more general proposition here advanced is that the lodestar formula gives the attorney an interest in accepting settlement offers that his clients would prefer to reject if they were in a position to instruct their attorney. This incentive is, however, exactly the opposite of that which the popular literature has emphasized in its recurrent focus on the allegedly excessive fees and dilatory pace of litigation under the lodestar formula.[103] These popular

103. *See supra* notes 98, 99.

critiques have tended to assume that by stretching out the litigation in order to maximize his fee, the attorney might reject or jeopardize settlements that his clients would desire to accept. Although the self-regarding plaintiff's attorney does have an incentive to delay the time of settlement under the lodestar formula, he has a much stronger incentive than do his clients to accept a settlement once substantial time has been expended. From his perspective, an adequate settlement can be defined as simply one that covers the amount of his fee. Once this level is exceeded, he might delay the settlement's formal submission to the court to justify the amount of his fee, but he would never rationally cause the offer to be withdrawn.

Once we focus on this conflict between the plaintiff's attorney and his clients under the lodestar formula, it becomes clearer why settlements that appear collusive can occur without any of the participants believing that the process was other than fully adversative and conducted in complete good faith. For example, the defendants in the foregoing example of a $20 million lawsuit may deny liability with the utmost sincerity, but still be willing to offer a small settlement in view of the "nuisance value" of the action or the inherent risk of an unsympathetic jury or judge. If the plaintiffs believe that they have a substantial prospect of success at trial and the defendants believe the reverse, this case would normally be a paradigm of the action likely to go to trial, because the parties cannot agree on the litigation odds. Yet, as the plaintiff's attorney expends more time, increasingly he has nothing to gain and much to lose if the case goes to trial. As a result, a nominal settlement offer made in good faith by the defendants (who believe the case against them is without merit) may be accepted by the plaintiff's attorney, even though his clients would reject this offer. Still, the defendants would be outraged by any suggestion that this settlement was collusive. Nor would even the plaintiff's attorneys recognize such a description as accurate *because there never was any offer on either side that linked the settlement size to the fee award.* The simple truth is that there need not be any such linked offer or any form of exchange of high fees for a low settlement; instead, there can be de facto collusion, which the parties may not even consciously recognize. Indeed, the defendants need not even be aware of what the likely fee award would be. Rather, it is a sufficient condition that the plaintiff's attorney know the approximate fee that the court would award him. All that the defendant must signal is that he will not object to the plaintiff's attorney's fee request in order for the plaintiff's attorney to be in the same position as if he had received a collusive offer from the defendants. Given the information that the lodestar formula conveys about the likely size of the fee, the outcome resembles collusion, even though the process may not. In short, under the lodestar formula, *structural* collusion replaces *actual* collusion.

The onus here should not be placed disproportionately on the attorney for the plaintiff. The sophisticated defense counsel understands that the longer the action continues, the more the plaintiff's attorney will have built up a valuable property right in the action whose realization is contingent upon avoiding an adverse judgment. Thus, under the lodestar formula, a rational strategy for the defendant's attorney is to cooperate in delaying the pace of the litigation and then to make only a last minute cheap settlement offer. Because the plaintiff's attorney is most vulnerable to a cheap settlement offer at the end of the litigation, the defense counsel should realize that the more protracted the litigation becomes, the more the pressures mount on his adversary to accept a cheap settlement. In contrast, the incentives are quite different under a percentage-of-the-recovery formula, where they favor an early settlement, as will be seen later.

The danger of collusive settlements is not the only problem associated with the use of the lodestar formula. Another problem is the sometimes extraordinary demand the lodestar methodology makes upon judicial time to oversee and regulate the plaintiff's fee request. If the court wishes to guard against excessive fee requests (particularly in the settlement context where the defendants will not typically oppose the plaintiff's fee request), the court must spend its own scarce time reviewing and corroborating the plaintiff's fee petition. As recent examples have shown, the tail can wag the dog, and the fee hearing can consume more judicial time than the substantive merits of the underlying action.[104] In addition, when the plaintiff's attorney has won a litigated judgment, the lodestar methodology exposes him to a potential reprisal that can take the form of an attack on his fee petition; in recent instances, he has had to wage a second litigation to obtain his fee award when challenges have been made by those who would chill his willingness to undertake contingent fee litigation against them in the future.[105]

On a more abstract level, the basic approach taken by the lodestar formula treats the plaintiffs' bar as a regulated public utility. The decisions that the court must make in following the lodestar's methodology roughly conform to the decisions that a public service commission must make in determining the rate a utility may charge its customers. A utility regulator must first decide which expenditures to include within the utility's rate base and which to disallow; correspondingly, a court must decide whether the attorney's time was reasonably expended.[106] The issues at this stage have proliferated; for

104. For example, in the *Fine Paper* antitrust litigation, some 41 hearing days were devoted to the fee petitions. Thereafter, the court wrote a lengthy opinion of over one hundred pages. *See* Coffee, *supra* note 19, at 255 n.94.

105. In the *Fine Paper* antitrust litigation, a group of 15 "Business Roundtable" corporations (including Exxon, IBM, and Xerox) intervened to challenge the fees sought by plaintiffs' counsel on the theory that it would reduce their share of the recovery as users of fine paper. *See* Coffee, *supra* note 19, at 254-55. This same group has intervened in other cases. *Id.* at 286 n.153. It would appear patently obvious that these corporations are primarily interested in discouraging plaintiffs' counsel by challenging their fee petitions.

106. As the District of Columbia Court of Appeals emphasized in Copeland v. Marshall, 641 F.2d 880, 891 (D.C. Cir. 1980), "It does not follow that the time actually expended is the amount reasonably expended." *See also* Keyes v. School Dist. No. 1, 439 F. Supp. 393, 410 (D. Colo. 1977) (lawyer devoted 505 hours; court found that 125 hours would have been reasonable). Attorneys seeking a fee award must submit detailed and often voluminous records. In the Second Circuit, contemporaneous records must now be submitted. *See* New York State Ass'n for Retarded Children, Inc. v. Carey, 711 F.2d 1136, 1147-48 (2d Cir. 1983). The court must then review counsel's records. *See* Seigal v. Merrick, 619 F.2d 160, 164 n.9 (2d Cir. 1980); Steinberg v. Carey, 470 F. Supp. 471, 479 (S.D.N.Y. 1979). In particular, the court is expected to compare these fee petitions in order to

example, should research on unsuccessfully asserted theories of liability be disallowed?[107] Should the attorney be compensated for time spent dealing with the media or potential members of the class who want advice (even though neither activity will advance the progress of the class action)?[108] After the rate base is determined, a utility regulator must next determine the appropriate rate of return; correspondingly, the court must determine whether to use the attorney's normal billing rate or a lower rate prevailing within the local community in which the action was litigated. Also, should it use the attorney's current hourly rate or the lower rate that he charged over the actual period in question?[109] Lastly, the utility regulator must decide whether the special risks to which investors in the utility are subject justify an above average rate of return in order to ensure that the utility will be able to

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uncover duplicative work or evidence of overstaffing. Seigal v. Merrick, 619 F.2d at 164-65. *See also* Sun Publishing Co. v. Mecklenburg News, Inc., 594 F. Supp. 1512, 1517-18 (E.D. Va. 1984).

107. *Cf.* Seigal v. Merrick, 619 F.2d at 164-65 (no deduction should be made for work that proved "unfruitful" but was not frivolous, because lawyers must prosecute suits "on the basis of the entire spectrum of theories that show promise").

108. This issue arose in a poignant form in the recent *Agent Orange* litigation. Some of the principal plaintiffs' attorneys in that case spent significant periods of time counseling Vietnam veterans in a fashion that is more easily described as therapeutic than legal. Considerable time was also spent in political lobbying and developing a nationwide organization of veterans. None of this time clearly advanced the class action, and it was disallowed by Judge Weinstein. *See In re* "Agent Orange" Prod. Liab. Litig., 611 F. Supp. 1296, 1335 (E.D.N.Y. 1985); *see also* Society for Good Will to Retarded Children v. Cuomo, 572 F. Supp. 1300 (E.D.N.Y. 1983) (no fee allowance for relations with media), *remanded on other grounds*, 737 F.2d 1253 (2d Cir. 1984).

109. Much litigation has centered on two issues: (1) whether to use the locally prevailing hourly rate in the forum jurisdiction, the rate in the attorney's own district, or a nationwide rate applicable to attorneys having special expertise; and (2) whether to use the attorney's current hourly rate or that lower rate which he charged during the course of the litigation. With respect to the first of these issues, see Blum v. Stenson, 104 S. Ct. 1541, 1547 (1984) (in determining statutory fee awards under 42 U.S.C. § 1988, courts should look to "the prevailing market rates in the relevant community"); New York State Ass'n for Retarded Children v. Carey, 711 F.2d 1136, 1140 (2d Cir. 1983). In multidistrict litigation involving the participation of attorneys from many districts, however, some courts recognize an exception, at least when special expertise is needed (as it often may be in the special context of shareholder litigation). *See* Polk v. New York State Dep't of Correctional Servs., 722 F.2d 23, 25 (2d Cir. 1983); Avalon Cinema Corp. v. Thompson, 689 F.2d 137, 140-41 (8th Cir. 1982) (en banc); *In re* "Agent Orange" Prod. Liab. Litig., 611 F. Supp. at 1335 (E.D.N.Y. 1985). Still, a different rule is sometimes followed when a case is consolidated to a jurisdiction different than the attorney's home jurisdiction. Then, some courts view the attorney as entitled to receive compensation at the rate prevailing within the "home" district when he filed the action in that district and then saw it involuntarily transferred to a foreign forum. *See* Polk v. New York State Dep't of Correctional Servs., 722 F.2d at 25. This rule may force the court to utilize several different prevailing rates at once; to avoid this logistical nightmare, some courts have used a uniform nationwide prevailing rate when faced with multidistrict litigation involving a large number of attorneys. *See, e.g., In re* Fine Paper Antitrust Litig., 98 F.R.D. 48, 83 (E.D. Pa. 1983), *aff'd in part, rev'd in part on other grounds*, 751 F.2d 562 (3d Cir. 1984) (accepting nationwide rate but objecting to evidence used to determine it). *See also* H. NEWBERG, NEWBERG ON CLASS ACTIONS § 6924(e) (1977).

The second issue—whether to use current or historic rates—has also proven difficult to resolve, particularly in cases that extend over several years (as again, shareholder litigation often does). For decisions favoring the historic rate in a variety of contexts, see New York State Ass'n for Retarded Children v. Carey, 711 F.2d at 1153 (requiring use of historic rate); Desimone v. Industrial Bio-Test Laboratories, Inc., 83 F.R.D. 615, 621 (S.D.N.Y. 1979) (same); Weiss v. Drew Nat'l Corp., 465 F. Supp. 548, 552-53 (S.D.N.Y. 1979). Conversely, other decisions have used the current rate, partly on the grounds that it compensates the plaintiff's attorney for foregone interest and for inflation. *See* Cooper Liquor, Inc. v. Adolph Coors Co., 684 F.2d 1087, 1096 n.26 (5th Cir. 1982), *modified on other grounds*, 701 F.2d 542 (1983) (en banc); City of New York v. Darling-Delaware, 440 F. Supp. 1132, 1134 (S.D.N.Y. 1977).

raise capital in the future. Correspondingly, the court must determine whether to award a contingency bonus so that similar meritorious cases will be litigated in the future.[110] The point of this comparison is that the lodestar is an extremely regulatory approach. Not only does it consume judicial resources prodigiously, but there is also little reason to believe that courts are as skilled as an administrative agency might be at making the multiple judgments required by the lodestar methodology. Thus, it is useful to consider next a deregulatory alternative.

B. The Salvage Value Method

If a time-based formula seems to encourage inadequate settlements, the obvious alternative is the percentage-of-the-recovery or "salvage value" method, which historically preceded the lodestar formula but has been substantially (although not wholly) replaced by it.[111] At a stroke, the percentage-of-the-recovery approach appears to give the attorney an interest in maximizing the settlement fund, while also eliminating the seductive attraction of a nonpecuniary settlement. Yet, although this formula may be superior to the lodestar, a closer analysis shows that it too has more problems than appear at first glance.

Three problems complicate the attractions of the salvage value approach. First and most important, awarding a percentage of the recovery does not necessarily align the attorney's interests with those of the shareholders he represents. A well-known economics literature has convincingly made the point that under the percentage-of-the-recovery method the attorney will still have an incentive to accept an inadequate settlement that the class would prefer to reject.[112] A second problem with the percentage-of-the-recovery approach is its political acceptability. According to some accounts, the original impetus for adoption of the lodestar formula came from the seeming windfall that plaintiffs' attorneys received under the salvage value system when cases were quickly settled.[113] Federal courts in particular faced acute

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110. Several different factors are expected to be evaluated in the decision whether to increase or decrease the fee award above or below the time component. Decisions have distinguished a "risk" multiplier from a "quality" multiplier; the delay in payment and the complexity of the legal issues are also said to be relevant factors. New York State Ass'n for Retarded Children v. Carey, 711 F.2d 1140 (2d Cir. 1983); *In re* "Agent Orange" Prod. Liab. Litig., 611 F. Supp. at 1310-13 (E.D.N.Y. 1985).

The court must set forth specific findings of fact supporting any such increase or decrease. Gagne v. Maher, 594 F.2d 336, 345 (2d Cir. 1979), *aff'd*, 448 U.S. 122 (1980). Once again, the district court faces a complicated decision requiring its consideration of a significant range of issues. To the extent that the court prefers to duck these issues, the result will be undercompensation of the plaintiff's attorney. The same point about the amount of judicial time and energy required to implement the lodestar formula could be made with respect to still other issues: the recognition of travel and other expenses, the awarding of interest, the required use or nonuse of paralegals to reduce costs, whether time expended in preparing the fee petition should be considered, etc. In each of these areas, there is little uniformity today and considerable disparity.

111. For the history of this formula, see sources cited *supra* note 91. With respect to its continuing relevance to common fund cases according to *Blum v. Stenson*, see *supra* note 96 and accompanying text.

112. *See supra* note 92.

113. For a brief overview, see Coffee, *supra* note 19, at 241-42. *See also* Laffey v. Northwest Airlines, Inc., 746 F.2d 4 (D.C. Cir. 1984) (debating the rationale underlying the lodestar formula).

embarrassment and public criticism when they were constrained to award multimillion dollar fees to plaintiffs' attorneys in large antitrust class actions when the attorneys had negotiated speedy settlements in the wake of prior indictments filed by the Department of Justice. In such instances, the plaintiff's attorney looks like a free rider who has piggybacked on governmental efforts and now stands to receive a grossly excessive reward in proportion to his efforts. For example, to award such an attorney twenty to twenty-five percent of a settlement that he negotiated within a brief period after the commencement of the prior governmental proceeding will predictably produce a public outcry (some of it possibly aroused by irate defendants).

A final problem with the percentage-of-the recovery approach is that it becomes unworkable when there is no settlement fund.[114] One can easily imagine cases in which the plaintiff's attorney has performed a substantial service in enjoining or otherwise preventing an impending fraud, but then finds that his early intervention caused him to be compensated less generously because no settlement fund was created. If the law were thus to reward the attorney who prevents a loss less well than the attorney who restores the same loss, a perverse incentive would arise under which the attorney would be better advised to wait until the loss had occurred before intervening. In fact, because the loss might often be only partially restorable, the consequence would be to justify a larger fee for the less complete victory.

Of these three problems, the most important is the claim that a percentage-of-the-recovery formula will still leave the attorney with an incentive to accept an inadequate settlement. Although it may seem counterintuitive, this assertion rests on a strong economic foundation. All that we need assume is that (1) the size of the settlement will be a function of the time the attorney expends on the action, and (2) after some point of diminishing returns, the rate of increase in the size of the settlement will grow more slowly and ultimately level off as the attorney expends more time on the

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Clearly, the decisions that orginally adopted the lodestar formula were greatly concerned about the possibility of "windfall" profits and the damaging public appearance of such overly generous awards. *See* City of Detroit v. Grinnell Corp., 495 F.2d 448, 469 (2d Cir. 1974) ("For the sake of their own integrity, the integrity of the legal profession and the integrity of Rule 23, it is important that courts should avoid awarding 'windfall fees' and that they should avoid every appearance of having done so.").

114. One could attempt to resolve this dilemma by valuing the loss that had been averted and then awarding the same percentage of it. This procedure might work in the derivative action, where the corporation in whose name the action is brought pays the attorney fees. The solution is less simple, however, in the direct class action, because there is no way to tax the class that benefits and a common fund does not exist from which the fee can be subtracted. Arguably, one could shift the fee onto the losing defendant (thereby possibly reducing his willingness to settle), but little doctrinal basis exists for combining fee shifting and a percentage-of-the-recovery fee formula. The conceptual basis for the percentage-of-the-recovery formula rests on principles of unjust enrichment; the traditional theory was that if the class that benefited did not share the plaintiff's legal expense, they would be unjustly enriched. *But see* Dawson, *Lawyers and Involuntary Clients in Public Interest Litigation*, 88 HARV. L. REV. 849, 858-59 (1975). This justification cannot apply, however, once the fee is shifted to the defendant, who is hardly unjustly enriched by the plaintiff's efforts and who is in any event probably compensating his own attorney on a time basis.

case. If these highly realistic assumptions are accepted, then the following relationship, expressed below in Exhibit A, will hold true among the size of the settlement, the size of the expected fee, and the attorney's own opportunity cost:

EXHIBIT A

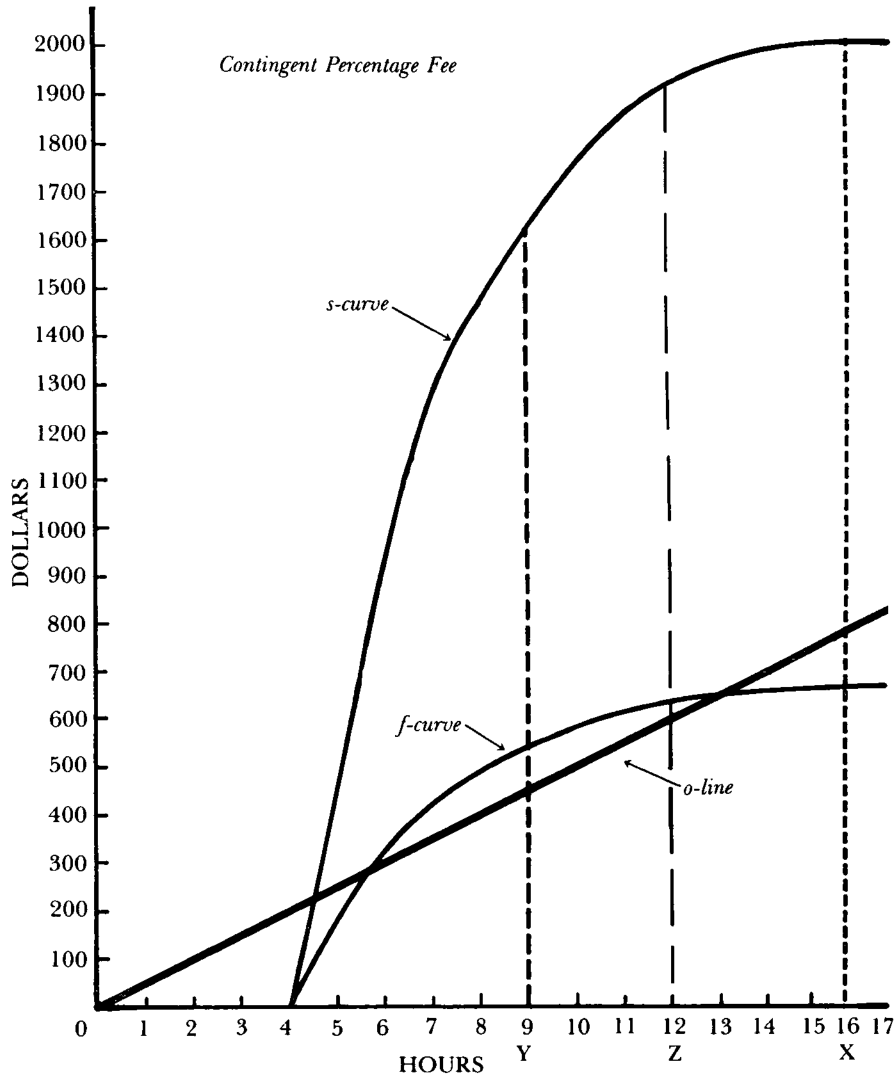

Exhibit A depicts the conventional world in which the amount of the fee (represented by the *f'* curve) is a direct function of the size of the settlement (represented by the *s'* curve) and the attorney's total opportunity cost (represented by the *o'* line) rises over the period at a constant rate.[115] Under

115. This diagram and the explanation of it are derived from Clermont & Currivan, *supra* note 92, at 544. The argument that a contingent percentage-of-the-recovery fee produces premature settlements was first advanced by Schwartz & Mitchell, *supra* note 92.

these standard assumptions, the client is best off at that point where the vertical distance is the greatest between the *f'* curve and the *s'* curve. For example, assume that the fee is set at one-third of the total at which the settlement curve levels off. Then, because sixty-six and two-thirds percent of any marginal increase in the size of the settlement will go to the client, he would want his attorney to continue to work on the case as long as the settlement fund is thereby enhanced (subject only to the inevitable limitations imposed by the time value of money). On Exhibit A, the point where the *s'* curve levels off is indicated by Point *X*.

For the plaintiff's attorney, however, Point *X* is not optimal. He is better off at Point *Y*, which represents the greatest vertical distance between the *f'* curve and the *o'* line, which is his aggregate opportunity cost. Unlike the client, his costs (including both out-of-pocket expenses and foregone opportunities) constantly mount and, as the fee curve levels off, the rate of increase in his costs eventually exceeds the rate of increase in his fee. Point *Y* is thus the point at which the attorney's marginal costs exceed the marginal benefits to him of continuing to litigate the action.

Neither Point *X* nor Point *Y*, however, represents the efficient outcome. That point is instead represented by Point *Z*, which is where the vertical distance between the *o'* line and the *s'* curve is greatest.[116] This point illustrates where the overall marginal costs from continuing the action (that is, the costs to the client and attorney taken as a unit) first equal the overall marginal benefits. Intuitively, this concept is best understood by asking when the client would wish to settle if he were acting as his own attorney. The clear answer to this question is that, if the client were representing himself in the action, he could ignore the amount of his own fee and would rationally focus simply on the expected return from continuing the action (the *s'* curve) as against his expected costs (the *o'* line). Because he would not have to allocate between his expected return as a client and that as an attorney, he would simply wish to maximize the total excess of benefits over costs, which occurs at Point *Z*. If he were to expend additional time after reaching Point *Z*, he would incur marginal costs in excess of his marginal benefits. Therefore, he would prefer to settle at Point *Z*.

Does this theoretical analysis have any empirical confirmation? The assertion is frequently heard that plaintiffs' attorneys practicing in the

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116. Point *Z* is efficient only from the standpoint of the collective private interests of the plaintiff and his attorney. Although it maximizes their joint return (that is, any greater investment of time will produce a lesser joint recovery after subtraction of opportunity costs), it does not necessarily maximize the social benefit from the action. For example, Point *Y* imposes fewer costs on the judicial system which must monitor the action, while Point *X* could yield greater deterrence and thereby produce a greater social benefit, if a lesser private benefit. This consideration is especially relevant when the underlying cause of action was meant to deter (as in the case of private treble damage actions under the antitrust laws). The derivative action also can be analyzed in this light because, to the extent that shareholders are at least partially diversified, they may benefit more from the deterrence generated than from the compensatory recovery. *See supra* note 28.

This analysis also disregards the time value of money, which could in some circumstances make the shareholder prefer a "premature" settlement. However, this problem could be mitigated by awarding prejudgment interest from the date of the action's commencement.

personal injury field tend to accept premature and inadequate settlements, often without conducting any discovery or adequately investigating their clients' cases.[117] Typically, these attorneys are compensated on a percentage-of-the-recovery basis, and the foregoing economic analysis supplies a possible explanation for this pattern. But recent empirical work has not found statistically significant differences between the performance of plaintiffs' attorneys compensated on a contingent fee basis from those paid on an hourly basis.[118] In fact, some evidence even suggests that as the case gets larger in size, the contingent fee attorney will spend more time than the hourly fee attorney.[119] Still, these findings do not directly relate to the special context of shareholders' litigation where client control is weak and the hourly fee is awarded by the court, not the client.[120]

Within the special context of shareholder litigation, there may be more reason to suspect that the salvage value method will produce premature settlements. In Delaware, which does not follow the lodestar approach but instead continues to award fees according to a procedure that resembles a hybrid of the lodestar and salvage value approaches,[121] a colorful phrase has been coined to refer to plaintiff attorneys who specialize in speedy settlements of derivative actions. They are called "pilgrims" because they believe in "early settlements."[122] These "early settlers" appear to be quite candid about their preference for a quick resolution and apparently advertise this willingness. Although no empirical comparison is available, my sense is that "pilgrims" appear to be more prevalent in Delaware than in other jurisdictions where the lodestar methodology reigns, possibly because early settlements would imply a low fee under a time-based formula.

Assuming that the salvage value approach may produce premature settlements, what policy prescription should follow? Other commentators have suggested a compromise of the lodestar and percentage-of-the-recovery systems.[123] For example, following essentially the analysis outlined above, Clermont and Currivan argue for a fee formula that "would be computed by

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117. The empirical data are less than satisfactory and almost entirely anecdotal. Based largely on interviews, Douglas Rosenthal has reported that attorneys compensated on a contingent fee basis do minimize their time investment through a variety of questionable tactics. *See* D. ROSENTHAL, LAWYER AND CLIENT: WHO'S IN CHARGE? 106-15 (1977). For other studies, *see* F. MACKINNON, CONTINGENT FEES FOR LEGAL SERVICES 196-200 (1964); Franklin, Chanin, & Marks, *supra* note 35.

118. *See* Trubek, Sarat, Felstiner, Kritzer, & Grossman, *The Costs of Ordinary Litigation*, 31 U.C.L.A. L. REV. 72, 108-09 (1982).

119. *Id.* at 108-09 (finding that at the $15,000 level in terms of case size, contingent fee lawyers spend more time than hourly fee lawyers). At a lower level, the median hourly fee lawyer did spend more time, but the margin was not statistically significant.

120. One possible explanation for the findings in the above study is that the individual client can exercise considerable control over his attorney in the typical personal injury case, and so the natural incentive under a time formula to multiply the hours expended is thereby restrained by the fact that the client will not pay an exorbitant fee, particularly before the outcome of the litigation is known.

121. *See* Sugarland Indus. v. Thomas, 420 A.2d 142 (Del. 1980) (explicitly rejecting the lodestar formula in favor of a more discretionary hybrid that considered the recovery obtained).

122. I have heard this term frequently used by Delaware counsel to refer to a specific identifiable subset of the plaintiffs' bar. One plaintiffs' attorney who reviewed a draft of this article informs me that there are well-known "pilgrims" within the New York bar as well.

123. *See* Clermont & Currivan, *supra* note 92, at 546-50, 578-600.

adding (1) the lawyer's time charge for the hours worked to (2) a small percentage (say five percent or ten percent) of the amount by which the recovery exceeds the time charge."[124] They argue that this formula "solves the problem of economic conflict of interest between lawyer and client that exists under both the certain hourly fee and the contingent percentage fee."[125]

But does it? Seemingly, any formula that averages in some fashion a time component with a percentage-of-the-recovery component should move us closer to Point *Z* on Exhibit A and hence in the direction of the efficient outcome. Still, at least as applied to shareholder litigation, there is a fallacy in this answer because the time component is also contingent on success and a sophisticated defense counsel can easily exploit this fact. Under any hybrid formula that averages time charges with a percentage of the recovery, defense counsel would still be well-advised to wait until the eve of trial (or later) and make a settlement offer that covered the amount of the fee (as determined under this hybrid formula), but gave little more to the class. For example, suppose a class action is brought for $20 million and both sides recognize that its settlement value based on the litigation odds is $6 million. Assume further that the plaintiffs' attorneys have expended $1 million of billable time and that there is a roughly fifty percent chance of an adverse verdict against them. If defendants now make a settlement offer of $3 million at the last possible moment, the plaintiffs' attorneys could expect a fee of $1.2 million under the Clermont and Currivan proposal (i.e., $1 million of time plus ten percent of $2 million, the net recovery after subtraction of the time charge). Against this certain $1.2 million, they would have to balance their possible fee if they went to trial and won the expected recovery ($6 million), which recovery would produce a fee of $1.5 million (i.e., a $1 million time charge plus $500,000, which is ten percent of the excess of the expected recovery over the time charge). In fact, however, we must still discount the $1 million time charge for the fifty percent risk of an adverse verdict, because it (unlike the $500,000 percentage-of-the-recovery component) does not yet represent an expected value. So discounted, the expected value associated with proceeding to trial falls to only $1 million.[126]

Of course, the logic of the Clermont and Currivan proposal could equally well justify a formula containing a much larger percentage of the recovery component.[127] For example, the formula could combine the time charge with

124. *Id.* at 598.

125. *Id.*

126. That is, the time component would have an expected value of $500,000 and the percentage-of-the-recovery component would be $500,000, which is 10% of the expected value of $5,000,000 ($6,000,000 minus the $1,000,000 time charge). Because the actual recovery could be as high as $20 million, the $6 million figure has already been discounted by the risk of an adverse verdict.

127. Given Clermont and Currivan's premises, their formal logic would apply whether the percentage was 1% or 90%. They do assume, however, that the standard percentage-of-the-recovery is roughly 33 1/3%. Clermont & Currivan, *supra* note 92, at 532 n.3. A model that does not distinguish between 1% and 90% has limited relevance. If one were to follow their prescription, I would recommend that the appropriate percentage-of-the-recovery to be factored into their formula

one-third of the net recovery after subtraction of the time charge. On the foregoing facts, this would mean that the expected fee if the case went to trial and produced a $6 million recovery would be $2,666,666.[128] Again, the $1 million time charge must be discounted by the fifty percent risk of loss associated with a trial, but the resulting figure of $2,166,666 could conceivably compensate the plaintiffs for the higher level of risk associated with a trial. Whether a risky, but expected, fee of $2,166,666 is more attractive than a certain fee of $1.2 million depends on how risk averse the plaintiffs' attorneys are, and different attorneys might make different choices. In addition, the plaintiffs' attorneys would still face a more practical problem associated with the use of a time charge element in the fee formula. In a derivative action, the attorney's fee is typically paid by the corporation, which might seek to contest the reasonableness of the $1 million time charge component in this fee. Ex ante, this possibility of fee dispute after the trial (but not after a settlement) adds an additional element of risk to the attorney's calculus that might deter him from going to trial.

The trade-offs at this point are indeterminate. A variant of the Clermont and Currivan proposal that used a more generous percentage-of-the-recovery component than their suggested ten percent could potentially curb the deficiencies of either the time-based formula or the salvage value formula, but no certainty is possible. Unavoidably, one must make empirical judgments about the level of risk aversion within the plaintiffs' bar, and no global judgment applying to all forms of contingent fee litigation (personal injury, antitrust class actions, securities actions, derivative suits, etc.) is likely to be accurate.

Other alternatives seem at least as attractive. Because the specific percentage of the recovery that is to be awarded need not be fixed in advance, it could be determined ex post by the court based on its assessment of a variety of factors, including the skill and effort shown by the plaintiffs' attorney. For example, the percentage-of-the-recovery formula could authorize the court to award between fifteen percent and thirty-three and one-third percent of the recovery, depending upon the court's assessment of the same factors today specified in the lodestar formula for the award of a contingency bonus.[129] This approach would mitigate some of the difficulty in

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be determined based upon some of the factors that today determine the lodestar "contingency" bonus—that is, the level of risk (at least in the generic type of action, but not the individual case), the period of deferral, and the quality of the services. The result is obviously a formula that resembles the contemporary lodestar formula, which is why I suspect that their proposal (for all its considerable orginality and intelligence) would produce little net change, if adopted.

128. Because one-third of $5,000,000 (i.e., $6,000,000 minus the $1,000,000 time charge) is $1,666,666, the fee award would be $1,000,000 plus $1,666,666, or $2,666,666.

129. The factors most typically considered are (1) the risk of litigation, (2) the complexity of the issues, (3) the demonstrated skill of the attorneys, and (4) the delay in payment. There are objections to the use of each of these factors (except possibly the last), which this article does not address. *Cf.* Leubsdorf, *supra* note 93.

The approach suggested here would not produce the same approximate result as the lodestar, because the time component would either be small or nonexistent. In contrast, the Clermont and Currivan proposed hybrid formula would approximate the lodestar formula in its actual operation, the court's position in the case of a premature settlement, when the court would be embarrassed by having to award thirty-three and one-third percent of a settlement negotiated in a very brief period. In effect, the plaintiff's attorney would have to fear that if the settlement struck the court as unimpressive, it would award only a fifteen percent fee recovery.[130]

Of course, one can question both the legitimacy and practicality of broad judicial discretion to determine the particular percentage to be awarded. It may appear disquieting that the court would award a low percentage when this award in effect signaled that it had doubts about the adequacy of the settlement. But this criticism demands perfect justice. If one recognizes that inadequate settlements are often approved,[131] it seemingly would be better for the shareholders if the court had increased discretion to determine the fee award so as not to reward such settlements.

Other objections to a variable formula are more substantial: broad discretion may only produce broad disparity; in some instances, the parties may be able to submit the settlement in a manner that is conditional upon the court's acceptance of the specific fee award that they have negotiated.[132] Finally, the court may have little incentive, absent an objector's protest, to scrutinize the settlement carefully. Nonetheless, even after conceding the force of these criticisms, the point remains that a shift from a predominantly time-based formula to a variable percentage-of-the-recovery system shifts discretion to the court and away from the parties, who have considerable incentive to collude. Once the court's discretion is protected, it can also be at least partially structured through the promulgation of guidelines that specify the factors on which the court should place special weight. For example, if the deficiency of the salvage value formula is that it may produce premature settlements, this danger is hardly as present in a case litigated to a judgment as it is in a settlement. It would therefore seem appropriate to instruct the court to award a more generous percentage in cases when the plaintiff has gone to trial and thus accepted the risk of an adverse decision. To be sure, a mandatory rule that a higher percentage be awarded after a judgment would be overbroad because, for example, the judgment might have yielded less than a previously offered and declined settlement. Yet, a discretionary rule would reduce some of the incentive that today exists to agree to an early and inadequate settlement. Another guideline that would make considerable sense would be to award a lower percentage when the plaintiff's action essentially piggybacked on a prior enforcement proceeding brought by a governmental agency (such as the Antitrust Division of the Justice Department or the SEC), because in these cases the plaintiff's attorney typically bears less risk and expends less effort. This approach would also

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because their modest percentage-of-the-recovery component would largely duplicate the current contingency bonus component in the lodestar formula.

130. *See supra* note 113 and accompanying text.

131. *See supra* notes 64-84 and accompanying text.

132. *But see infra* notes 206-12 and accompanying text.

reduce the windfall (and resulting public relations problem) that seemingly arises when a settlement is reached shortly after the litigation commences.[133]

To sum up, both the lodestar and the salvage approach can misalign the plaintiff's attorney's incentives so that he is motivated to accept an inadequate settlement, at least when there is a substantial risk of an adverse decision. The flaw in the standard analysis that the lodestar formula produces delayed settlements is the confusion of process with outcome. Logically, it is possible for the lodestar formula to produce both delayed and inadequtae settlements. Proposals such as those advanced by Clermont and Currivan overlook the fact that, at least in shareholder litigation, the fee award is just as contingent under the lodestar formula as under the percentage-of-the-recovery formula.[134] Thus, the plaintiff's attorney remains at risk under either formula and is more vulnerable to an inadequate settlement offer under the lodestar's approach which implicitly assures him that his time will be compensated. In this respect, the percentage-of-the-recovery formula is less imperfect and could be improved through more standardized guidelines. Yet, although there are some scattered hints of judicial disenchantment with the lodestar,[135] no trend away from it is yet evident, as courts persist in pious declarations that ignore the economics of the plaintiff's attorney's position.[136]

IV

RISK AND RETURN: WHY THE RATIONAL PLAINTIFF'S ATTORNEY MUST SETTLE EARLY

The model advanced to this point has been comparatively simple: Essentially, the plaintiff's attorney in shareholder litigation faces unfavorable odds, which have been made even more adverse by the advent of the special litigation committee. Because the attorney who operates on a contingent fee basis cannot afford to invest heavily in a single case in the face of these odds,

133. *See supra* note 113.

134. Essentially, the Clermont and Currivan analysis compares a noncontingent time formula with a contingent percentage-of-the-recovery formula. This is a strange comparison to make, at least if the starting point is the assumption that the client cannot effectively control his attorney. Possibly within the context of personal injury litigation (on which they chiefly focus) this contrast may be appropriate to draw, but within the fields of securities and derivative litigation (and probably throughout the context of class actions as a whole), the receipt of the fee is wholly contingent on a favorable judgment (either by trial or settlement). Clermont and Currivan only consider the concept of a contingent time formula very briefly. Clermont & Currivan, *supra* note 92, at 595-96. Even there, they discuss only the idea of a higher than normal hourly fee that would be contingent on success. What they overlook is that for the class action plaintiff's attorney even his normal hourly fee is contingent.

135. *See, e.g., In re* Fine Paper Antitrust Litig., 98 F.R.D. 48, at 85 (E.D. Pa. 1983), *aff'd in part, rev'd in part on other grounds*, 751 F.2d 562 (3d Cir. 1984); Sugarland Indus. v. Thomas, 420 A.2d 142 (Del. 1980). The more evident trend has been toward closer judicial monitoring of the time records and fee petitions, culminating in the requirement now established in the Second Circuit that contemporaneous records be submitted to the court. *See* New York State Ass'n for Retarded Children v. Carey, 711 F.2d 1136, 1147-48 (2d Cir. 1983).

136. In particular, the Third Circuit's recent reversal of the district court in the *Fine Paper* antitrust litigation suggests that federal courts do not see an alternative to the lodestar formula. Yet, in Blum v. Stenson, 104 S. Ct. 1541, the Supreme Court indicated that in common fund cases, such as antitrust litigation, the percentage-of-the-recovery approach was the norm. *Id.* at 1550 n.16.

he spreads his risks by litigating a substantial number of cases, seeking early settlements in a few and accepting the probability that the majority will be dismissed. This approach is both economically rational and socially undesirable. The relatively recent ability of the adversaries to reach a costless settlement based on nonpecuniary relief simply exacerbates this tendency.

Reaction to this state of affairs has been more visceral than analytic. As a whole, the Bar has come to view derivative actions with an attitude ranging from distaste to disgust, but the only remedy it can agree upon is the use of judicial sanctions in egregious cases.[137] This is an ex post response that, although sometimes appropriate, provides an ineffective remedy, given (1) the infeasibility of sanctions, (2) the ease with which the adversaries can disguise their motives, and (3) the inevitability of conflicts of interest in class and derivative actions. Defendants have a simpler proposal: abolish the derivative action! Although this goal is today within sight (at least in those jurisdictions that defer to the special litigation committee's findings), defendants do not understand that plaintiffs' attorneys still have an adaptive response available to them: they can underbid the cost of the special litigation committee procedure by either offering or accepting a cheap settlement. The result is to reinforce the disincentives that already discourage the plaintiff's attorney from intensively pursuing an individual case. Gresham's Law predicts that bad money drives out the good, and the corollary here may be that the "pilgrims" will drive out those plaintiffs' attorneys able and willing to litigate a case on the merits.

What should be done? In general, if the law wishes to encourage investment in any profit-seeking activity, it must either increase the expected return or reduce the level of risk associated with that return. Some means to this end are obvious: the substantive law could be revised (particularly with respect to the special litigation committee), or the fee formula could be modified, as earlier discussed, to include a more substantial salvage value component. Beyond these reforms, other less visible obstacles to the plaintiff's attorney could be removed or lessened without unfairly prejudicing the interests of defendants. This section next considers several means to this end.

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137. With respect to this new deterrent orientation, see Note, *The Emerging Deterrence Orientation in the Imposition of Discovery Sanctions*, 91 HARV. L. REV. 1033 (1978) [hereinafter cited as Note, *Deterrence Orientation*]; a clear trend is evident toward more liberal use of sanctions. *See, e.g.*, Roadway Express v. Piper, 447 U.S. 752 (1980); McCandless v. Great Atl. & Pac. Tea Co., 697 F.2d 198 (7th Cir. 1983); Nemeroff v. Abelson, 620 F.2d 330 (2d Cir. 1980). The recent amendment of FED. R. CIV. P. 11 to require the attorney to certify his belief that the pleading or motion is "well grounded in fact" is also a similar straw in this wind. *See, e.g.*, Gordon v. Heiman, 715 F.2d 531 (11th Cir. 1983); Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 683 (N.D. Ga. 1983). Also consistent with this pattern is the judicial trend toward strict enforcement of the particularized pleading required of FED. R. CIV. P. 9(b). *See* Note, *supra* note 99, at 1441 (noting both difficulty of complying with this rule in shareholder litigation and trend toward more frequent awards for violations of Rule 11). Still, commentators have suggested that a general judicial reluctance to impose sanctions confounds this approach to the problem of curtailing frivolous litigation. *See* Note, *Deterrence Orientation, supra*, at 1033, 1034-38; Renfrew, *Discovery Sanctions: A Judicial Perspective*, 67 CAL. L. REV. 264, 271 (1979). As a result, this article's view is that a shift away from the lodestar fee formula toward the percentage-of-the-recovery formula could have greater (or at least supplementary) effect.

A. The Problem of Inter-Plaintiff Competition

The plaintiff's attorney in a class or derivative action lacks any property right by which he can exclude other attorneys from essentially free riding on his efforts and claiming a share of the court-awarded fee. In effect, the usual analogy of the plaintiff's attorney to the bounty hunter is inaccurate, because only one bounty hunter is entitled to collect the bounty. In contrast, in recent antitrust and securities class actions, as many as 150 plaintiff's attorneys have appeared to represent the plaintiff class.[138] Indeed, representing the plaintiff class is a game virtually anyone can play. One has only to find a nominal plaintiff, file a class action in his name in any federal district court, and then await the consolidation of all the separate class actions into a single forum by the Federal Judicial Panel on Multi-District Litigation.[139] Alternatively, one can seek to intervene in an action already filed by another attorney. Once all the actions are so joined in a single courtroom, the usual procedure is for the court to permit the horde of plaintiffs' attorneys so assembled to elect their own leadership.[140] The steering committee thus elected assumes control of the case, and the plaintiff's attorney who initially investigated and first brought the case may be either displaced or at least forced to share the economic return that flowed disproportionately from his efforts.[141]

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138. To give some recent examples:

(1) In *In re* Fine Paper Antitrust Litig., 98 F.R.D. 48 (E.D. Pa. 1983), *aff'd in part, rev'd in part on other grounds,* 751 F.2d 562 (3d Cir. 1984), fee petitions were submitted on behalf of 160 individual attorneys. *See* Bruck, *Harold Kohn Against the World,* The American Lawyer, Jan. 1982, at 28-32.

(2) In *In re* "Agent Orange" Prod. Liab. Litig., 611 F. Supp. 1296 (E.D.N.Y. 1985), fee petitions were submitted on behalf of "more than 100 attorneys."

(3) In *In re* Folding Carton Antitrust Litig., 415 F. Supp. 384 (J.P.M.D.L. 1976), 57 law firms sought fee awards on behalf of an unstated (but obviously larger) number of individual attorneys.

(4) In *In re* Corrugated Container Antitrust Litig., 80 F.R.D. 244 (S.D. Tex. 1978), 48 law firms submitted fee petitions. *See* Lempert, *supra* note 50, at 1, col. 1.

(5) In *In re* Armored Car Antitrust Litig., 472 F. Supp. 1357 (N.D. Ga. 1979), 85 attorneys for 20 firms sought fee awards. *Id.* at 1380, 1384.

These are all examples of "ad hoc" plaintiffs' law firms—a large loosely organized and often overstaffed group of plaintiffs' attorneys who have had their separate actions consolidated.

139. For an overview of the Panel and its procedures, see J. MOORE, MOORE'S FEDERAL PRACTICE, MANUAL FOR COMPLEX LITIGATION (2d ed. 1981). Under the Panel's rules, if separately filed class actions involve common questions of fact, they will be referred to a single judge. *See* J.P.M.D.L. Rules 9 and 10, 65 F.R.D. 253, 259-60 (1975). The Panel will also transfer individual actions that are subsequently filed in the wake of a class action. For example, in the *Agent Orange* litigation, some 600 such "tag-a-long" cases were transferred to Judge Weinstein. *See In re* "Agent Orange" Prod. Liab. Litig., 611 F. Supp. at 1301. In the *Fine Paper* litigation, 98 F.R.D. 48, fifteen separate class actions, filed in eight different federal courts, were transferred to the Eastern District of Pennsylvnia.

140. The MANUAL FOR COMPLEX LITIGATION, *supra* note 139, instructs the trial court, where possible, to permit the plaintiff's attorney to select his own lead counsel: "While the court should not, in the absence of exceptional circumstances, select and appoint lead counsel, the court can request the parties to select such counsel and encourage the use of judicial power." *Id.* at 192. For a sample order designating such a lead counsel chosen by the plaintiff's attorney who has filed a notice of appearance, see Moore, *supra* note 139, at 91.192-II.

141. The powers of the lead counsel are far from clearly established, but typically he, or a steering committee of plaintiffs' counsel, controls work assignments. Thus, he will determine which attorneys are assigned to take the principal depositions during the discovery phase of the case. Although the attorney who initiated the case could still attend this deposition and presumably ask questions, his time will not necessarily be billable, because the trial court is expected to deny fees for

Democratic as the process sounds in theory, recent experience shows that it can be corrupted in practice into a brokered political convention, at which rival factions contend for dominance, coalitions are formed, and political deals are struck.[142] More important, even if the process could be made open and fair, it would still be unsound from an economic perspective, because it erodes the attorney's incentive to search for appropriate cases to be brought. By definition, the rational attorney/enterpreneur will invest in search costs only to the extent that he anticipates he can recoup these costs from the expected fee award. Thus, to the extent the attorney must share the fee, he will engage in less search activity. By analogy, the attorney who cannot exclude other late-appearing attorneys from his action is in the same position as a prospector who cannot stake out a claim that the law will protect against claim jumpers or an inventor who is denied the right to patent his invention. From an ex ante perspective, legal rules that contribute to such a result appear irrational; yet, from a naive ex post perspective, the horde of late-appearing attorneys who seek to consolidate their actions with the initiating attorney may appear to be simply zealous counsel anxious to represent their clients. Thus, this pattern could be mistakenly viewed as apparent proof that the plaintiffs' bar is healthy and vigorous, when in fact the evidence, when properly interpreted, suggests economic anarchy.

The sensible prescription is to exclude the free riders by conferring some form of property right on the attorney who truly initiates the case. Once his control over the case is assured, he need share it only with those other attorneys whose assistance he requires to prepare it for trial. The problem is that no simple rule clearly does this. If the property right were automatically conferred on the first attorney to file the action, races to the courthouse, hasty pleading, and poorly researched complaints would be encouraged. Alternatively, giving the court wide discretion to choose lead counsel could lead to cronyism or might result in the true initiating attorney being displaced by better known attorneys who did not incur the search costs that led to the filing of the action.[143] All that can clearly be said is that the worst alternative is the political election process that is now our de facto system for the

duplicative work. *See* Seigal v. Merrick, 619 F.2d 160, 164-65; Sun Publishing Co. v. Mecklenburg News, Inc., 594 F. Supp. 1512, 1517-18. Moreover, a growing trend is evident under which the steering committee files a master fee petition covering all or most the attorneys in the action. *See infra* note 199. Attorneys not included in this fee petition are apt to have their claim for fees viewed more skeptically by the court.

142. For a closer look at this process, see Coffee, *supra* note 19, at 248-52, 256-60 (noting evidence of vote buying by which attorneys are invited to file an action and promised work assignments in return for their vote for lead counsel). Among experienced "repeat players," this reciprocal vote trading can occur across cases, as counsel intervenes in one case to vote for an ally who he expects will do the same for him in another case.

143. This is where the "professional" and "economic" perspectives conflict. From the former perspective, one wants the "best," most qualified attorney to represent the class as lead counsel. But this rule may lead to a "star" system under which attorneys with established reputations could appear at a later stage after the initial "search" work was completed and supersede the younger, less experienced attorney who had initially prepared the case. The result would chill search activity and could produce a suboptimal frequency of suits from a societal perspective. From an economic

selection of lead counsel,[144] because it ensures the selection neither of the most able attorney nor of the attorney who did the basic investigatory work leading up to the action.

Inter-plaintiff competition tends to take a different form in derivative actions than it does in class actions. Although instances can be cited in which steering committees have been appointed in derivative actions,[145] there is seldom the same number of plaintiffs' attorneys involved as in securities class actions.[146] Why this disparity should exist is puzzling since the underlying transaction is often susceptible to challenge by either a securities action, a derivative suit, or both. One possibility is that the derivative action more often involves a race to different courthouses, rather than to a common courthouse, and this race also pits plaintiff against plaintiff. Although the same pattern can sometimes also be observed in actions that are fundamentally based on federal securities law claims,[147] attempts to exploit the state/federal court division in this context are less frequent, because federal courts have exclusive jurisdiction over the federal securities laws. Thus, to escape consolidation by the Multi-District Panel, a plaintiff's attorney

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perspective, it is necessary to recognize and protect a property right in order to encourage investment in search activity.

To the extent that plaintiffs today tend to piggyback on a prior governmental proceeding (for example, antitrust indictments or SEC enforcement actions), however, it may be the case that little search activity is necessary; hence fears of inadequate investment in search would be less justified. This conclusion is debatable because the piggyback pattern under which private actions typically follow in the wake of governmental proceedings may be the effect of inadequate protection of the plaintiff attorney's property right in the first instance. In any event, when the issue is the selection of lead counsel in a private action that followed in the wake of a prior governmental action, there appears little reason not to choose the most competent counsel because the incentive to search need not be protected in these cases where the real search was conducted by the government.

For an instance in which the initial counsel in a consolidated derivative action was displaced by a counsel who filed subsequently, see Rich v. Reisini, 25 A.D.2d 32, 266 N.Y.S.2d 492 (1966).

144. As discussed *supra* note 143, the two models for which an intelligent case can be made are the "professional model" (under which the court would choose the lead counsel on the basis of his reputation and demonstrated ability) and the "property right model" (under which the attorney who principally investigated and "discovered" the case deserves priority—typically, under some form of a "first to file" rule). In contrast, the political model creates an incentive for socially wasteful expenditures on "politicking" and invites the appearance of a new specialist who lacks any social utility: the case "broker" who organizes a majority coalition by striking political deals and is compensated with a share of the fees in return for his efforts.

145. *See, e.g., In re* Continental Ill. Sec. Litig., [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,681 (N.D. Ill. 1983) (combined class and derivative actions); Rich v. Reisini, 25 A.D.2d 32, 266 N.Y.S.2d 492.

146. This author is unaware of any "true" derivative action in which the number of plaintiffs' attorneys has approached the number of attorneys in the antitrust class actions listed *supra* note 138. For securities class actions involving substantial numbers of attorneys and the same problems of overstaffing and duplicative work as has characterized recent antitrust litigation, see *In re* Penn Central Sec. Litig., 416 F. Supp. 907 (E.D. Pa. 1976), *rev'd*, 560 F.2d 1138 (3d Cir. 1977); Barnett v. Pritaker, 73 F.R.D. 430 (S.D.N.Y. 1977); *In re* Equity Funding Corp. of Am. Sec. Litig., 438 F. Supp. 1303 (C.D. Cal. 1977); Blank v. Talley Indus., Inc., 390 F. Supp. 1 (S.D.N.Y. 1976).

147. For example, in the complex litigation involving the Washington Public Power System bond fiasco (*In re* Washington Pub. Power Supply Sys. Sec. Litig., M.D.L. No. 551), a major issue has been the attempt of some plaintiffs to file state court actions alleging malpractice and common law fraud in order to outflank the consolidated federal actions. *See WPPSS Booty Attracts Many Plaintiffs, Lawyers*, Legal Times, Feb. 25, 1985, at 2 (noting that a state action brought by an attorney who did not want to participate in the federal class action "threatens to splinter the WPPSS bondholder proceedings" in federal court).

must allege a purely state cause of action and file it in a state court. This approach has an inevitable cost in that the special protections and procedural rights afforded by federal law are thereby lost. In contrast, a derivative action grounded on a traditional theory of liability can usually be filed in either federal or state court and, in the latter case, consolidation can thereby be evaded. When actions are filed in different state courts, the defendants may be able, of course, to stay the subsequent actions. A clever defendant, however, may instead prefer to promote a competition among the plaintiffs—in effect, inducing them to bid for the right to settle with him. As a result, the first court to decide the case (or to approve a binding settlement) will confer a preclusive effect that the defendants can use to estop collaterally the plaintiffs in the other cases.[148] In short, a potential exists for a race to settlement, with the first plaintiff attorney to settle being in a position to claim at least the lion's share of the attorney fees. This race-to-the-bottom scenario does not require that plaintiffs actually engage in a competition to conclude a settlement; it is sufficient that the attorneys in parallel actions in different jurisdicitons be aware of each other's existence for them to worry about the preclusive effect of other settlements. Even if each in fact behaves fully in accordance with professional ethics, the anxiety will still exist as to what the other might do, thus intensifying the pressures for early settlement.

Instances that fit the foregoing pattern can easily be identified. Some twenty derivative actions were filed in a variety of state and federal courts as a results of Texaco's "greenmail" repurchase of stock held by Bass Brother Enterprises.[149] In the well-known litigation involving Zapata Corporation, which gave rise to the important Delaware Supreme Court decision in *Zapata Corp. v. Maldonado,*[150] companion cases were litigated in federal and state courts in Delaware, New York, and Texas.[151] Although the Delaware Supreme Court ruled that the trial court should employ its own independent judgment to review the reasons for dismissal given by the Zapata board's special litigation committee,[152] the effect of this ruling may have been substantially nullified when a settlement was negotiated in the Texas action and approved over the objections of the other plaintiffs.[153]

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148. Assuming adequate notice to shareholders and no evidence of collusion or inadequate representation, the judicial approval of the settlement operates as a preclusive final judgment on the merits. *See* Smith v. Alleghany Corp., 394 F.2d 381, 391 (2d Cir.), *cert. denied,* 393 U.S. 939 (1968); Nathan v. Rowan, 651 F.2d 1223, 1226 (6th Cir. 1981); RESTATEMENT (SECOND) OF JUDGMENTS §§ 48.1, 86 (1982); Note, *Res Judicata in the Derivative Action: Adequacy of Representation and the Inadequate Plaintiff,* 71 MICH. L. REV. 1042 (1973).

149. *See supra* note 78.

150. 430 A.2d 779 (Del. 1981).

151. For a description of the complex history of these interlocking cases, see Maldonado v. Flynn, 671 F.2d 729 (2d Cir. 1982); *see also* Maher v. Zapata, 490 F. Supp. 348 (S.D. Tex. 1980).

152. *Zapata* announced a somewhat ambiguous two-stage inquiry, under which the court was only clearly expected to review the litigation committee's substantive justifications for dismissal when demand on the board was excused. In Aronson v. Lewis, 473 A.2d 805 (Del. 1984), the ambiguities in *Zapata* were resolved in favor of limiting substantive judicial review to the "demand excused" context.

153. In the aftermath of the Delaware Supreme Court's 1981 decision in Zapata Corp. v. Maldonado, 430 A.2d 779, the parallel action in Texas was settled and dismissed with prejudice in

Inter-plaintiff competition also occurs in at least two other forms. First, when a settlement is negotiated between the parties, it is a common event for another attorney, who may have previously been inactive in the action, to protest it and seek to block its judicial approval. Of course, the objector's motives could be wholly legitimate, because the settlement may be inadequate.[154] In a number of recent cases, however, it appears that the objector may have been engaged simply in an attempt to extort a portion of the expected legal fees by threatening to delay the settlement's approval. The irony is that such abuses are the equivalent to nuisance actions brought against defendants; here, the target is the original plaintiff's attorney and the consequence again is to erode his expected return from the action. A recent federal court decision, *In re Itel Securities Litigation,*[155] illustrates this pattern. There, a New York state attorney who had been "involved on the periphery of [the litigation]" realized that the settlement "agreement appeared to result in . . . [his] receiving no compensation for this work."[156] Aware that the corporation could not emerge from its bankruptcy reorganization until the settlement was approved, he filed a motion just prior to the settlement hearing to redefine the plaintiff class, even though he "was well aware . . . the class definition issue had been resolved three years earlier."[157] The motion never came to a hearing because the corporation agreed that the attorney could seek fees with its implicit consent in a companion derivative action filed in Delaware in return for his dropping the motion. Not content with this success, the same attorney next sought to further exploit his leverage by again objecting to the settlement on a different ground, after finding a different client.[158] Again, the corporation made "further fee-related concessions in order to keep the final settlement of the securities litigation on track,"[159] and this time it received a broad undertaking from the attorney that he would wholly withdraw from the case. Nonetheless, displaying a level of chutzpah possibly unique to New York, this same attorney objected still a third time to the settlement on behalf of a third client, "again trying to essentially extort further fee related concessions."[160] Although the court did impose sanctions on the attorney, the case is noteworthy primarily for the relatively blatant and undisguised nature of the extortion attempted. Its message is not that

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the same year. *See* Maldonado v. Flynn, 671 F.2d 729, 731. The corporation then moved to dismiss the federal court action on grounds of res judicata. *Id.* The Second Circuit remanded the case on the narrow question of the preclusive effect of the Texas settlement. *Id.*

154. *See* Seigal v. Merrick, 619 F.2d 160 (2d Cir. 1980) (settlement fund increased as result of actions of objector and attorney fees awarded to objector). In general the objector is not entitled to a fee award unless its services improve the settlement fund. *See* White v. Auerbach, 500 F.2d 822, 828 (2d Cir. 1974); Green v. Transitron Elec. Corp., 326 F.2d 492, 498-99 (1st Cir. 1964); Milstein v. Werner, 58 F.R.D. 544, 552 (S.D.N.Y. 1973).

155. 596 F. Supp. 226 (N.D. Cal. 1984).

156. *Id.* at 228-30. As a result, the attorney advised his clients that they "should not enter into the agreement" settling the action. *Id.* at 229.

157. *Id.* at 230.

158. *Id.* This new objection was filled on behalf of the daughter of the prior client.

159. *Id.*

160. *Id.* at 232.

extortion is impossible, but that three bites at the apple are too many. When more discretion is shown, the threat of a judicial sanction may be minimal. As a result, the original plaintiff's attorney may feel compelled to accept some cosmetic changes in the settlement's form that allow the objector to claim a share of the fee award in order to forestall his opposition.[161]

The *Itel* fact pattern also illustrates a second mechanism by which the original attorney may be divested of some of his expected return: the practice of filing a companion derivative action that parallels the allegations of the securities class action. In *Itel*, a federal court action, the disciplined attorney was to receive his fee concessions in connection with a related Delaware derivative action, which essentially involved the same disputed events and transaction.[162] From the perspective of the defendants, a package settlement is desired. They cannot afford to pay a substantial settlement and then find that essentially the same issues are to be relitigated in a different forum, only this time as a derivative action instead of a class action (with the result that the first settlement will not collaterally estop the new plaintiffs). Sophisticated defendants will therefore attempt to settle both the securities and derivative claims together. To the extent they cannot, they may feel compelled to hold back some of the recovery and fee award they would otherwise have agreed to pay in order to cover any later action filed by another attorney. The effect of this piggybacking on the efforts of the original attorney in the class action by filing a parallel derivative action is to erode the return to the original attorney.

To an uncertain extent, the original plaintiff's attorney can foreclose the possibility of a parallel action by bringing a combined class and derivative action in the first instance, thus blocking a parallel action by another attorney.[163] This tactic permits a global settlement of all claims and, by protecting the defendants from a second attack, permits them to pay a higher settlement. But a legal obstacle may block this sensible protective step. From a doctrinal perspective, it is awkward to permit one plaintiff (or one attorney) both to represent the class suing the corporation (typically stockholders or bondholders) and also to seek to represent the corporation derivatively; in

161. Despite the general rule that an objector must increase the settlement fund before he is entitled to a fee award, *see supra* cases cited at note 154, some decisions have awarded fees for "aid rendered to the court . . . in bringing every possible objection to settlement" to the court's attention. Pergament v. Frazer, 132 F. Supp. 323, 326 (E.D. Mich. 1954), *modified & aff'd sub nom.* Pergament v. Kaiser-Frazer Corp., 224 F.2d 80, 85 (6th Cir. 1955). More importantly, the use of nonpecuniary relief can be used to "enhance" the settlement and thereby justify a fee award for the late arriving attorney, thus transferring fees away from the principal plaintiffs' attorney (assuming that the aggregate fee that the court will award is limited).

162. *In re* Itel Sec. Litig., 596 F. Supp. at 230. To settle the second objection by the same attorney in this case, Itel agreed to provide the attorney with a declaration that he had in effect conferred a substantial benefit on the bondholders in one of several interrelated actions involving Itel. This agreement illustrates the ease with which the "substantial benefit" concept can be manipulated.

163. Because a settlement of the derivative claims will carry res judicata effect, the tactic of appending derivative claims to the direct securities claims protects the defendant from a second action attacking basically the same transactions. *See supra* note 146. Defense counsel have advised this author that it is important from their perspective to ensure that all foreseeable claims are resolved in this fashion in one global settlement.

theory, the attorney is representing both a plaintiff and a defendant with respect to the same transaction. Although this asserted conflict of interest has been described as more apparent than real,[164] it is precisely the kind of doctrinal obstacle that may interfere with the expeditious resolution of the case and permit free riders to come out of the proverbial woodwork in order to divert fees from the original plaintiff's attorney.

What answers are possible to the broad problem of destructive inter-plaintiff competition? Clearly, the litigation of multiple derivative actions in different jurisdictions wastes both judicial time and the corporation's time, even apart from its effect on settlement value. To deal adequately with this problem, a state body analogous to the federal Multi-District Panel would be necessary to consolidate the cases, but this proposal would probably require an interstate compact. Short of such a visionary step, a presumption might be recognized that courts should normally stay the subsequently filed cases. Additional forms of interstate judicial coordination also need to be explored.[165]

Extortion of the plaintiff's attorney by a threat to delay the settlement is a problem that can be dealt with more successfully. Once again, the best answer starts with the need for greater skepticism of nonpecuniary settlements. Black letter law states that, unless the objector can improve the settlement, he is not entitled to a fee award. Yet, given the cosmetic skills that today are evident in the design of nonpecuniary settlements, this rule is easily manipulated.[166] If courts were more skeptical of nonpecuniary settlements, however, the objector could justify a fee award only if he did in fact cause a real tangible enhancement of the settlement fund—in which event he deserves a fee award on the same basis as the original attorney.[167] Ironically, the ease with which a cosmetic settlement may be struck invites not only frivolous litigation, but also spurious objectors who can similarly extort the original plaintiff's attorney.

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164. Although some state court decisions have declined to allow the same plaintiff to maintain both direct and derivative actions simultaneously because of this asserted conflict of interest, modern federal court decisions have taken a more tolerant attitude and have typically found the potential conflict to be insignificant. *See In re* Transocean Tender Offer Sec. Litig., 455 F. Supp. 999, 1014 (N.D. Ill. 1978); Bertozzi v. King Louie Int'l, Inc., 240 F. Supp. 1166, 1179-80 (D.R.I. 1976).

165. Communications between courts in different jurisdictions might result in one court staying the action before it in preference to the action in the other jurisdiction. More formalized procedures might also be adopted so that attorneys in the pending actions could be assured an adequate opportunity to object to any settlement proposed in a different parallel action. Most importantly, courts in different state jurisdictions could agree on a common steering committee of plaintiffs' attorneys that would manage the actions in both jurisdictions, thereby reducing the potential for interplaintiff competition. This approach would in effect institutionalize a price-fixing agreement to prevent destructive competition.

166. *See supra* notes 154-61, 162 and accompanying text.

167. *See supra* notes 154, 161.

B. Financing the Plaintiffs' Action

For diverse reasons, plaintiffs' attorneys are chronically underfinanced. Given the small size of the typical plaintiffs' firm,[168] its cash flow predictably will be more volatile than that of a larger, more diversified firm, and it will probably have smaller capital reserves. In turn, commercial banks, which are virtually the exclusive source of credit for law firms, will be more cautious in the amount of the loans they are willing to make to such a firm. Because most creditors are not skilled at appraising the value of the contingent future returns from risky litigation, they are willing to lend only against the assets, and not the expected future earnings, of the plaintiffs' firm. As a result, it is the personal credit of the individual attorneys that secures, and thereby sets the ceiling on, bank credit to the small firm attorney.

At the same time, the cost of undertaking a complex action has grown significantly in recent years to the point where it can strain or exceed the borrowing capacity of most plaintiffs' firms. For example, in the recent *Agent Orange* action, the plaintiffs' management committee spent over $1 million between October, 1983 and June 15, 1984, and it estimated that it would have to spend an additional $2 to $3 million to carry the case another nine months to trial.[169] Obviously, if these costs exceed the financial resources of the plaintiffs' team, the result is enhanced pressure to settle early and for a far lesser amount than they could obtain if they could secure additional financing.

The *Agent Orange* case supplies an instructive illustration both of (1) what actually happens when plaintiffs find themselves lacking the finances necessary to continue an action, and (2) the substantial barrier that existing legal rules may pose to one of the most logical ways in which plaintiffs' attorneys can obtain additional financing. At the end of 1983, the plaintiffs' management committee in that case recognized that it "lacked the financial capacity to continue the litigation."[170] At this point, the management committee was expanded and new attorneys able to finance the action were admitted. The reconstituted committee then entered into an internal agreement among themselves under which six creditor attorneys (who together constituted a majority of the nine-member committee) would fund the remaining litigation costs by contributing $200,000 apiece in monthly installments of $12,500.[171] Eventually, over $1 million was contributed by these six members, and the trial court acknowledged the legitimacy of the expenses thus funded.[172] In return, the internal agreement specified that any attorney fees awarded by the court would be redistributed among the

168. Currently, the largest plaintiffs' firm handling securities litigation appears to be Milberg, Weiss, Bershad, Spectrie & Lerach, which had only 37 lawyers as of late 1984. *See supra* note 49.

169. *See* Moore, *Fee Splitting Agreement Draws Attention of Agent Orange Judge*, Legal Times, Nov. 5, 1984, at 2, col. 7; *see also In re* "Agent Orange" Prod. Liab. Litig., M.D.L. No. 381, slip op. at 60 (E.D.N.Y., Jan. 7, 1985) [hereinafter cited as *Agent Orange I*], *modified*, 611 F. Supp. 1296 (E.D.N.Y. 1985) [hereinafter, cited as *Agent Orange II*].

170. Moore, *supra* note 164, at 7, col. 3 (quoting Phillip Allen, one of the plaintiffs' attorneys).

171. *Id.*

172. *Agent Orange II*, 611 F. Supp. at 1330-31 (awarding expenses for the plaintiff's management committee of $1,390,686.18, subject to additional certification).

committee members so that the attorneys who had advanced these funds would receive triple the amount of the funds so advanced. Thereafter, half the remaining fees would be distributed in equal shares among each of the committee members, and the remaining portion of the award would be divided on a basis that primarily reflected the hours worked by each attorney.[173] In net effect, this agreement transferred a substantial portion of the expected fees that the minority of the committee that had already expended substantial time on the case stood to receive to the newly arrived attorneys who would advance the necessary funds for the completion of the action.

On public disclosure of this agreement, controversy erupted. One attorney prominently involved in the case has claimed that the agreement amounts to "300% interest . . . [charged by] your friendly neighborhood loan shark"[174] and has further argued that "[i]t is inappropriate to treat public-interest class action litigation as an investment vehicle."[175] At the hearing on fees, federal district court Judge Jack Weinstein recoiled at the prospect of substantial reallocation of the fees in favor of persons he characterized as "money suppliers."[176] In a lengthy and carefully considered opinion, which recognized both the arguments for deferring to the attorneys' own bargain and those for judicial scrutiny,[177] Judge Weinstein took the position that any redistribution of the fees among the attorneys in a manner

173. *Agent Orange I*, slip. op. at 60.

174. Moore, *supra* note 169, at 7, col. 2 (quoting Victor Yannacone, the attorney who initiated the litigation and was subsequently displaced as lead counsel).

175. *Id.*

176. *Id.* at 1, col. 3.

177. Judge Weinstein's analysis begins with a cogent summary of the arguments for judicial deference to fee sharing arrangements made within the plaintiffs' team that assembles to litigate a large class action:

> The [p]laintiff's management committee may be considered an ad hoc law firm. Like any law firm, it is free to allocate its revenues as it sees fit. Realities of the business aspects of law practice often require that those who bring clients and capital to the firm be better rewarded than those whose talents lie in the area of preparing legal papers and arguments. Rainmakers are usually better rewarded than those who labor in the back room . . . . These factors as well as the principle of freedom of contract argue in favor of 'deference to the parties' contractual agreements' if possible.

Agent Orange I, slip op. at 60-61.

Little quarrel can be had with this reasoning, but in the opinion's very next sentence a conclusion is reached that is in sharp tension with the foregoing logic:

> Nevertheless, the court's obligations to the . . . class members under Federal Rule of Civil Procedure 23(e) require it to review the reasonableness of the internal management agreement . . . [citing cases] . . . . A division of fees without regard to work performed or responsibility assumed is not 'in compliance with the standard' for fixing fees. Prandini v. National Tea Co., 557 F.2d 1015, 1019 (3d Cir. 1979). The 'touchstone for the fee [is] to be the actual effort made by the attorney to benefit the class' [quoting City of Detroit v. Grinnell Corp., 560 F.2d 1093, 1099 (2d Cir. 1977)].

Agent Orange I, slip. op. at 61-62.

In short, although the decision recognizes that justifications exist for deferring to the parties' own agreement, it seems to conclude that the law requires the court to monitor the reasonableness of any fee sharing agreement. Prior decisions appear not to have gone this far, but only to have invalidated agreements between an attorney and a client, *see* Dunn v. H.K. Porter Co., 602 F.2d 1105 (3d Cir. 1979), or agreements involving forwarding fees where the agreement was not disclosed to the court as required by local court rules. *See* Lewis v. Teleprompter Corp., 88 F.R.D. 11 (S.D.N.Y. 1980).

that was substantially disproportionate to the relative value of the work actually done by the individual attorneys could both undermine the intent of the lodestar formula and violate professional ethics.[178] In the face of Judge Weinstein's evident hostility to the agreement, the committee members renegotiated it, retaining the provision for a reimbursement of the sums already advanced according to the same multiple of three, but deleting the further provisions that gave the incoming committee members an additional share of the fees received by the others. As so revised, Judge Weinstein upheld the agreement, although not without some trepidation, relying initially on the fact that the agreement had not been challenged and that the state of the law was "so unformed" with respect to such an agreement as to refute any intent on the part of the involved attorneys to violate ethical or disciplinary rules.[179] In substance, the court both compelled the reformation of a contract that had already been performed by the creditor attorneys and suggested that the prospective validity of such agreements remained questionable. Standing alone, this initial decision left plaintiffs' attorneys in an exposed position, because it implied that any bargain struck among them to redistribute fees was of questionable validity. Either on the ground that the bargain was unfair (as subsequently perceived by the court) or on the ground that the fee shifting was not in proportion to the work actually done, the agreement could be rendered unenforceable long after the creditor side had relied on it.

Matters did not, however, rest at this unsettled stage. One of the original plaintiffs' attorneys whose fees were largely shifted to the incoming team of creditor attorneys formally moved to invalidate the agreement, chiefly on the ground that the fees received under it were not in proportion to the work actually done as required by Disciplinary Rule 2-107(a). In rejecting this motion, Judge Weinstein reached two important conclusions on matters of apparent first impression. He ruled first that the agreement could stand, essentially because the plaintiffs' team constituted an ad hoc law firm, which thus could redistribute fees internally on any basis without violating the terms of Disciplinary Rule 2-107, and, second, that all future agreements of this sort

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178. The decision states a rule that would appear to permit only de minimis deviations:

> When an attorney has performed services for the class but is allocated a portion of the fee award that is far different from the book value of the work done, the allocation may be set aside by the court. Whether the total fee award amount is affected by the allocation is immaterial.

Agent Orange I, slip op. at 62.

In support of this rule, the court relied principally on Disciplinary Rules 2-107(a) and 5-103(A) of the MODEL CODE OF PROFESSIONAL RESPONSIBILITY, which restrict fee splitting among lawyers not members of the same firm and prohibit lawyers from acquiring an interest in a litigation, respectively. *See infra* notes 197-99 and accompanying text.

179. *Agent Orange I*, slip op. at 63, 112-14 (discussing revision in fee sharing agreement). Initially, Judge Weinstein found the substantive legal issues on fee sharing agreements to be unresolved by prior precedent: "The law on this matter is so unformed that it is doubtful that the attorneys were aware when they entered into the original agreement that its validity might be scrutinized." *Id.* at 114.

should be prospectively disclosed to the court at the time they were entered into to permit their review for reasonableness.[180]

The compromise thus struck avoids the danger of retroactive surprise that might chill the willingness of creditor attorneys to finance contingent fee litigation. It also recognizes the basic reality that the litigation of a large scale class action today requires the creation of an ad hoc plaintiffs' law firm, which needs to be able to share fees internally. But it still places the court in the position of a utility regulator, determining if the internal sharing was fair. Should a court undertake this role?

The answer to this question depends in part on whether one looks at the agreement from an ex post or an ex ante perspective. Viewed from the former perspective at the time the court awards fees, it may seem that the incoming attorneys are receiving an excessive return based on the obvious leverage they held over the other attorneys who, although they had worked long and hard on the action, could no longer afford its costs. But is this the appropriate vantage point? If contracts were generally subject to invalidation because one party receives a windfall, the law of contracts would look very different than it does today. In general, contract law normally looks to the bargaining process, not the ultimate outcome. From a perspective that focuses on the bargain at the time it was struck, it seems that there is little basis for suspicion. In *Agent Orange,* the plaintiffs' team was insolvent, and it had to attract new capital to bring the action to trial. Although those members on the management committee who could not advance further funds stood to lose compensation for their considerable time already expended in the action, this time was a sunk cost that would be disregarded by a rational decisionmaker. To put it simply, had additional funds not been secured, this time would probably have had little value because the action would have had to be abandoned or settled very cheaply. While a 300% return may seem excessive in absolute terms, there is no apparent reason to distrust the bargaining among the attorneys that produced this result; those

180. The motion to invalidate the fee sharing agreement reached by the Plaintiffs' Management Committee ("PMC") members was made by David Dean, a committee member who received a court awarded fee of $1,340,437.50, of which the agreement apparently would have shifted $1,009,090.75 to the new "creditor" attorneys who had joined the action when the plaintiffs' team was effectively bankrupt. *See In re* "Agent Orange" Prod. Liab. Litig., 611 F. Supp. 1452, 1453-54 (E.D.N.Y. 1985) [hereinafter cited as *Agent Orange III*]. In this later opinion, Judge Weinstein emphasized that all the members of the Committee had "assumed joint responsibility for prosecution of the class action, and that assumption of responsibility was approved by the court on behalf of the class." *Agent Orange III,* 611 F. Supp. at 1459. This approach satisfied the formal requirement of ABA Model Rule 1.5, but not the New York equivalent to Disciplinary Rule 2-107, which requires that the fees be proportioned to the work done, unless the attorneys are in the same "firm." On this point, Judge Weinstein ruled that the plaintiffs' team was a single firm: "The PMC may be considered an ad hoc law firm, a joint venture formed for the purpose of prosecuting the Agent Orange multidistrict litigation." *Agent Orange III,* 611 F. Supp. at 1458. This characterization is the critical element which makes DR 2-107 inapplicable. Note, however, that the court's ruling would not apparently apply to passive "creditor" attorneys, who did not assume active responsibility for the case.

The disclosure requirement was imposed by amending Local Rule 5 of the Eastern District Civil Rules to require immediate disclosure of the fee sharing agreement. *Agent Orange III,* 611 F. Supp. at 1462-64.

who agreed to subordinate or shift their claims to the newly arrived attorneys had every reason to bargain at arm's length and no reason to pay an excessive return.

From the standpoint of the clients represented by these attorneys, the agreement seems even less objectionable. The worst possible result would be to bar any shifting of fees by agreement among the plaintiffs' attorneys because such a prohibition would deprive the plaintiffs' attorneys of the one form of currency (a contingent right to fees) with which additional capital could be attracted; hence, it would maximize the danger of cheap settlements not in the interest of the class. Precisely because banks and other institutional creditors are unwilling today to appraise the value of a contingent interest in pending litigation, it seems undesirable to discourage other attorneys, who are the one group who can evaluate such a contingent asset, from undertaking the role of financing the litigation. Nor is it sensible to characterize the attorneys who agreed to advance funds as money lenders charging a "usurious" rate of interest.[181] They are better viewed as a class of equity investors whose ability to recoup their investment depends very much on their own efforts. In this light, the entire transaction closely resembles what happens in any number of small partnerships that find themselves lacking adequate capital to continue business. Under such circumstances, the partnership agreement is revised to transfer some (or all) of the equity interest to those existing or incoming partners able to advance additional capital, and nothing in the process attracts judicial attention.

Should courts therefore adopt an attitude of benign neglect toward fee redistribution agreements? Here, a more qualified answer is necessary. Judge Weinstein could well be right that such agreements should be judicially scrutinized for their "reasonableness," but for a different reason. The interest to be protected is not the lawyer's, but the client's. Under a number of circumstances, fee agreements could enhance the danger of a premature, cheap settlement not in the interest of the class. For example, had those advancing funds in the *Agent Orange* case agreed to carry the action to trial in return for a specified percentage of any attorney fees ultimately awarded, these creditor attorneys might have had a strong interest in negotiating an

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181. The possible relevance of the usury laws to a fee sharing agreement was suggested by Judge Weinstein: "[L]aw is a business and within limits of public policy such as those set by the usury laws, lawyers make their own business arrangements as do other business people." *Agent Orange I*, slip. op. at 113.

As the court next noted, however, there was "doubt that the money to fund the litigation could have been obtained on more favorable terms." *Agent Orange I*, slip. op. at 113-14. Thus, if other more attractive sources of credit were unavailable, this analogy to usury has the potential effect of denying credit altogether. In any event, it seems strange to analyze fee sharing agreements in terms of the concept of usury. Usury laws exist to protect the commercially incompetent or disadvantaged, not experienced attorneys who will incur no personal liability in any event. Most states do not apply usury laws to corporate indebtedness, because of the limited liability enjoyed by shareholders. Correspondingly, fee shifting agreements impose no liability on the assignor; rather, he merely gives up an expectancy. Also, attorneys are increasingly incorporated in professional corporations.

early settlement in order to minimize their costs.[182] Alternatively, if the attorneys who assigned some or all of their expected right to compensation from the action were to remain active in the litigation, a problem of incentive might arise: why should these original attorneys work hard for little or nothing?

A countervailing, and possibly more serious, danger involves a moral hazard problem: if the assigning attorney retains only that small portion of the expected fee that will remain once all the creditor attorneys are paid their prior claims, he may prefer to gamble on a bonanza in the form of a very large, but unlikely, recovery at trial. Thus, he would rationally refuse an adequate settlement that his clients would willingly accept. In such a case, his position resembles that of a speculative warrant-holder who can profit only if the recovery exceeds all realistic expectations. Finally, from an even more ex ante perspective, if we do not guarantee the original attorney some portion of the expected fee, he may prefer to negotiate a cheap settlement with the defendants instead of assigning his rights in the action to a new team of plaintiffs' attorneys (as essentially occurred in *Agent Orange*). Although the problem of collusive settlements caused by the impending insolvency of the incumbent plaintiffs' team could be addressed by requiring close judicial scrutiny of settlements and permitting other plaintiffs to intervene when the incumbent team appeared incapable of pursuing the action effectively, our earlier discussion of existing practices at the judicial approval stage provides little basis for optimism. Still, none of these problems was necessarily present on the facts of *Agent Orange,* where control of the case had clearly been transferred to the six-member majority of the management committee who were to invest the needed funds. Yet, to the extent that the incoming attorneys received a present right to an equal share of the fees received by all the committee members (after the trebled repayment of expenses), it is theoretically possible that an immediate settlement could have maximized their own economic position.[183]

The potential danger here is a familiar one to students of corporate law; once ownership and control are separated, there is a danger that the agent may behave opportunistically.[184] Opportunistic behavior could take the form

182. From the standpoint of marginal analysis, this incoming group would look at the marginal revenue from continuing the action as compared with the marginal costs. Because this group is bearing all of the marginal costs of continuing the action but receiving only a portion of the marginal revenues therefrom, however, they could rationally decide to settle the action, although the entire plaintiffs' team as a unit would wish to continue it. For example, if they had struck a bargain under which they would receive 50% of all fees awarded and another year's effort would increase the settlement fund by $800,000 at a cost of $500,000, the incoming team should prefer to settle immediately, because they would experience a marginal loss of $100,000 from continuing the action (i.e., 50% of $800,000 is $100,000 less than the $500,000 expected cost).

183. It was precisely this equal sharing provision that was deleted by the parties to the internal management agreement after Judge Weinstein expressed his initial skepticism about the agreement. *See Agent Orange I,* slip op. at 60, 112.

184. This danger is essentially the same "separation of ownership and control" problem as that described in another context by Berle & Means. *See* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (arguing that corporate managers had achieved dominance over shareholders in the publicly held corporation). For a modern restatement of this

of either the assigning attorney seeking to enter into a premature settlement (if he had little continuing equity in the action but would be forced to incur some further out-of-pocket or opportunity costs) or rejecting an adequate settlement (if he could profit only by seeking to beat the litigation odds at trial). In the vocabulary of modern financial economics, an incentive may arise either to "shirk" or to accept high-risk gambles that the client would decline, because the attorney has nothing to lose.[185] Either way, once the attorney's interests are subdivided between those of creditor attorneys and debtor attorneys, the possibility of a misalignment between the interests of attorney and client is increased.

These problems are at least partially solvable. To the extent that the attorneys financing the action also assume control of it (as they did in *Agent Orange*), the problems associated with a separation of ownership and control fade somewhat in significance, because the debtor group will not be in a position to delay the action or accept an imprudent gamble. When control passes, the practical danger is that creditor attorneys (who have received a partial assignment of other attorneys' interests in the action in return for their agreement to fund expected expenses) might favor a premature settlement in order to minimize their costs.[186] Still, the formula ultimately adopted by the parties in *Agent Orange* (in effect, an agreement to pay interest on the funds actually so advanced) only compensates the creditor attorney to the extent he reasonably expends funds on actual litigation expenses; it thereby creates little incentive for premature settlement. Indeed, at some high enough interest rate, it could even create an incentive for overinvestment and delay. Thus, the one aspect of the fee redistribution agreement that was upheld by Judge Weinstein (namely, the interest rate provision) does seem the least problematic.[187] Conversely, those provisions that he indicated an unwillingness to accept can be said at least to intensify the pressures for premature settlements.[188]

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problem in the vocabulary of financial economics, see Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. & ECON. 305 (1976). Although many economists dismiss the problems associated with the separation of ownership and control in large public corporations because of the existence of efficient capital markets, there is no such market with respect to investments in litigation.

185. Whatever the fee formula used, a "moral hazard" problem arises once those in control of the action stand to benefit only if there is an extremely large recovery. This would be the case if the attorneys had assigned, for example, 95% of their interest in the action to creditors who had funded the action in return for such an interest. Economic theory suggests that the smaller the percentage of the expected fee award retained by a debtor attorney (who is not otherwise personally liable), the greater will be his willingness to gamble. Such an attorney is in the same position as the equity shareholders of a corporation that is capitalized 99% by debt and only 1% by equity. Standard financial theory suggests that the equity shareholders of a thinly capitalized firm would adopt a risk-preferring approach to corporate decisionmaking because they have little to lose and much to gain. That is, the downside risk falls primarily on their creditors, while they receive any upside gain. *See generally* Jensen & Meckling, *supra* note 184.

186. *See supra* note 182.

187. Indeed, rather than seeming suspicious, this form of arrangement may counteract the pressures that otherwise exist for early settlement.

188. Although Judge Weinstein did not invalidate the original agreement, his indicated unwillingness to accept that portion of it under which the incoming attorneys acquired the right to

A case can thus be made for limited judicial review of fee sharing agreements, but not because of any danger that "usurious" interest rates will be exacted. Rather, the argument, founded on economic theory, is for some regulation of the capital structure of the ad hoc plaintiffs' law firm. If this capital structure becomes overly leveraged (in the sense that the attorneys principally handling the action assign or pledge too high a proportion of the expected return), an attorney may have an incentive either to shirk or to gamble imprudently, but he will have little reason to behave as his clients would want.[189] Nonetheless, the remedy for this problem is not judicial regulation of the "reasonableness" of the rate of return received by the creditor attorneys on an ex post basis, because this will only deny credit and produce an underfunded action. Instead, the court should function like a bankruptcy court dealing with the management of an insolvent corporation and replace lead counsel when his minimal remaining interest in the action would give rise to a likely moral hazard problem. In particular, the court should examine the finances of the plaintiffs' team at the settlement hearing. If they appear to be financially strained and unable to carry the action much further, there is considerable reason for the court to be skeptical of the settlement; in such a case, it should determine if other attorneys are willing to intervene and then require that the plaintiffs' team be reconstituted if they are. Such a compelled restructuring is justified because the economic self-interest of the original plaintiffs' team is more likely to point toward a cheap settlement with the defendants than a voluntary sale of the action to a new plaintiffs' team. Inherently, the defendants would rationally pay more for a cheap settlement than other plaintiffs' attorneys would pay for the right to take over the action, because the potential loss to be averted by the defendants exceeds the potential gain to the plaintiffs' attorneys (whose fee is typically a modest percentage of that loss).[190]

Similarly, the court should assure itself that any group assuming control of the action has not struck a bargain under which it has an immediate incentive to settle in order to avoid funding the litigation's expenses. In all likelihood, the parties to any such fee splitting arrangement will be sufficiently sophisticated so as to strike a bargain that minimizes these misincentives, which invariably injure one or the other; thus judicial review will need to focus intensively only on the unusual or aberrant agreement that seems to create

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share equally in legal fees attributable to the time expended by the former lead counsel group resulted in the parties deleting this portion of the agreement. *See supra* note 182.

189. In all likelihood, the typical outcome in these circumstances will be that the creditor attorneys will assume control of the case (if the court permits) at the time they advance funds. Yet, this transition, while probably desirable, could sometimes simply change one set of perverse incentives for another, if the incoming attorneys have an incentive to settle prematurely in order to minimize their costs.

190. For example, assume that an action has an expected recovery of $2,000,000 and that, however the fee is computed, it will range between $200,000 and $400,000. Obviously, the value of this action cannot exceed $400,000 to either team of plaintiffs' attorneys, but the defendants would gladly offer a $500,000 fee for a nonpecuniary settlement. This analysis means that even if a sale of the action between attorneys could be made, outcomes like that in *Good v. Texaco*, No. 84-7051 (Del. Ch. May 14, 1984), should persist.

such a misincentive. Procedurally, the soundest rule is that of Judge Weinstein: namely, the prospective judicial approval of fee sharing agreements before funds are advanced pursuant to them. This procedure both protects the creditor attorneys and forces the court to recognize that the grim alternative, if it rejects the financing arrangements, might be an underfinanced action. Once such an agreement was approved, it would then be possible later to award the fees directly to the plaintiffs' management committee based on a master fee petition submitted by the committee.

C. Legal Ethics Versus the Need for Diversification

The point has been earlier made that both the solo practitioner and the attorney in a small firm face considerable risk when they undertake to represent plaintiffs in a complex case on a contingent fee basis. Each is investing a significant proportion of his time in a risky gamble, especially in the case of the derivative action where the litigation odds appear to be forbiddingly adverse to the plaintiffs.[191] Unless the attorney is the unusual soul who is actually a risk preferer (or one who sees a strategic advantage in winning a highly publicized verdict in order to gain a reputation he can later trade on),[192] the small size of the typical plaintiff's attorney's firm implies that the attorney is likely to be more risk averse than his colleagues in larger firms and thus logically more inclined to accept an inadequate settlement that his clients would prefer to reject. Even when dozens of plaintiffs' lawyers cooperate on a single case and in effect form an ad hoc law firm that spreads the risk, this analysis holds true at least for those attorneys who remain disproportionately dependent on the results of a single case.

The theoretical answer to this problem is simple: to lower the attorney's level of risk aversion, a means must be found to allow him to hedge his bets—in effect, to diversify his portfolio. The attorney practicing in a large firm obtains this benefit automatically, because (at least over the short run) any decline in one department's business may be offset by an increase in another's. In principle, plaintiffs' attorneys could achieve diversification simply by trading participations in each other's cases. Such trading would likely occur only among attorneys who were known to each other, and to a limited extent such trading may already occur through reciprocal work assignments. That is, if Attorney *X* is lead counsel in a large securities class action and Attorney *Y* is lead counsel in an antitrust class action, each may invite the other (or his firm) to participate in his case. The principal motive is probably not to achieve risk spreading, but rather that lead counsel in a large class action typically needs more manpower for discovery and related tasks than his own firm can supply and presumably would prefer to obtain

191. *See supra* note 35 (noting that rate of litigated victories for plaintiffs in derivative actions is under one percent).

192. This is widely believed to be the litigation strategy many plaintiffs' attorneys follow. *Cf.* Ross, *supra* note 44; Rosenthal, *supra* note 117.

assistance from other attorneys whose work he knows and respects. Nevertheless, risk spreading is a desirable side effect of these arrangements.

Still, this technique for achieving diversification encounters a substantial legal obstacle. If, for example, two attorneys were simply to swap twenty-five percent shares in each other's cases, a serious question of legal ethics would arise. Under the ABA's Code of Professional Responsibility (which is still the source of the disciplinary rules in force today in most states), fee splitting among attorneys is only permitted to the extent that the division of fees "is made in proportion to the services performed and responsibility assumed by each" attorney.[193] Thus, if an attorney who was not active in a case reaches an agreement with another who was active, under which he will receive a quarter of the fees awarded to the other, the agreement appears to offend this rule. In fact, courts are divided over this rule's interpretation. Some have been quite relaxed about its enforcement, focusing only on the totality of the fee in relation to the services rendered and results obtained, and have not objected to a redistribution of the fee by private contract among the attorneys.[194] Other decisions have questioned this "doctrine of judicial indifference" to attorney fee sharing arrangements.[195]

Viewed from a distance, one may sensibly ask: What is the harm threatened by private fee sharing arrangements that reallocate fees earned by one attorney to another? One plausible answer involves the danger that the attorney selling his interest will lose his incentive to pursue the action vigorously. For example, if the attorney syndicated away all of his interest, he would have no incentive to pursue the action; instead, it might be abandoned or settled cheaply. This problem is essentially the same "moral hazard" problem discussed earlier with respect to the creditor attorney. Concededly, it is unlikely to arise if those engaging in the exchange had accurate information as to the total percentage of the attorney's interest being sold. Because no rational purchaser would acquire an interest in any asset if the effect of doing so would deprive the manager of the asset of his incentive (and thus the purchased interest of its value), informed investors should not permit the lead plaintiff's attorney to reduce his residual interest in the action below some minimal level. At most, this danger justifies an upper boundary on fee sharing arrangements and probably their disclosure to the court, but not their prohibition.

The historical, but less forceful, justification for the rule against fee sharing is that it appears unseemly: fee splitting conflicts with one's sense of

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193. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 2-107(A)(2) (1971). Although the *Code of Professional Responsibility* has been superseded by the ABA's MODEL RULES OF PROFESSIONAL CONDUCT, which was adopted by ABA's House of Delegates in 1983, the *Code of Professional Responsibility* remains the body of law currently in force in most states, pending eventual revision.

194. *See* Del Noce v. Delyar Corp., 457 F. Supp. 1051, 1055 (S.D.N.Y. 1978); Valente v. Pepsico, 1979 FED. SEC. L. REP. (CCH) ¶ 97,116 (E.D. PA. 1979); *In re* Ampicillin Antitrust Litig., 81 F.R.D. 395, 400 (D.D.C. 1978); *cf.* Dunn v. H.K. Porter Co., 602 F.2d 1105, 1111 (3d Cir. 1979); *see also supra* note 180.

195. Kamens v. Horizon Corp., 1981 FED. SEC. L. REP. (CCH) ¶ 98,007 (S.D.N.Y. 1981); *Agent Orange I*, slip op. at 61-63.

the lawyer as a professional, as a fiduciary to his client who should never consider his self-interest in determining when to settle or litigate an action. The recognition that law is a form of commerce is distasteful to many.[196] Others may feel that fee splitting tends to increase the total fee that the client will bear. Yet, the irony is that these considerations do not apply with much force to the context of class and derivative actions. By permitting fee sharing (within limits), one actually makes the lawyer a better servant of the client by reducing his dependence on a single case, thereby decreasing his level of likely risk aversion and dampening the incentives for early settlement. Also, so long as fees are awarded on a percentage-of-the-recovery basis, the total fee is increased only to the extent the client's recovery is enhanced. Nonetheless, a strict interpretation of existing disciplinary rules would preclude not only efficient diversification of the lawyer/entrepreneur's portfolio but would also bar any financing arrangements (such as those present in *Agent Orange*) that have the effect of distributing the fee award in a manner that is not proportional to the time actually expended by the individual attorney.[197]

Viewed from the client's perspective, even a "forwarding" fee, under which the attorney who is handling the case compensates an attorney who refers an eligible plaintiff to him, seems largely unobjectionable when the court awards the fee, because such an arrangement between attorneys does not expose the client to any increase in the fee, but simply redistributes it among the attorneys. Although such fees are today sometimes invalidated when discovered, they appear to be relatively common in class and derivative actions.[198] Tacky as such forwarding fee practices may appear, they may have considerable utility, because, absent such a compensation system, the local attorney would have little incentive to identify an attorney able to handle a complex securities or antitrust case and refer the client to him. Such fees in effect grease the rails of the underground railroad that directs eligible plaintiffs to specialized attorneys.

Given, on the one hand, that an ability to spread their risks would increase the plaintiffs' attorneys' fidelity to their clients' interests and, on the other, that a tradition of hostility to fee splitting is deeply ingrained in our legal culture and legal ethics, what compromise appears feasible? Realistically, the

196. Nonetheless, courts are increasingly recognizing that law is inevitably a business. *See* Judge Weinstein's comments, *supra* note 72.

197. Although Judge Weinstein's final opinion in the *Agent Orange* litigation accepted the agreement to treble the incoming attorneys' cash contributions out of the fee awards received by the other attorneys, *see supra* notes 169-88 and accompanying text, a strict interpretation of Disciplinary Rule 2-107 could lead to a contrary conclusion because the attorneys are not associated within a single firm in the usual sense, and their reallocation of fees is not proportional to the work actually performed.

198. *See* Kamens v. Horizon Corp., 1981 FED. SEC. L. REP. (CCH) ¶ 98,007 (S.D.N.Y. 1981); Lewis v. Teleprompter Corp., 88 F.R.D. 11, 17-19 (S.D.N.Y. 1980). Also apparently common are fee splitting agreements across different cases. This was the substance of much of the charges raised in the *Fine Paper* litigation, where it was alleged that firms engaged in reciprocal trading of work assignments across cases. *See In re* Fine Paper Antitrust Litig., 48 F.R.D. 48, 78-79, & n.15 (E.D. Pa. 1980) (noting "buddy system" among plaintiffs' attorneys).

prospect appears remote that true "fee swapping" agreements will be soon accepted or upheld under which participations were exchanged between two attorneys not involved in the same case. If the efficient answer is not within reach, however, a second best approximation appears achievable. Courts are accepting the idea of a master fee petition submitted by the plaintiffs' management or steering committee;[199] this approach obviates any need for the court to make a distribution of the aggregate fee among the individual attorneys. The allocation of the fees can then be specified by private contract (such as the one upheld in *Agent Orange*). The effect of this procedure should be to remove the court from a direct monitoring responsibility over fee sharing arrangements, and for the reasons already indicated a policy of benign neglect may be the best compromise.

Of course, disciplinary rules still remain an uncertain obstacle. The federal judge has more discretion than his state counterpart, however, because the validity of fee sharing agreements will be controlled by federal procedural law and state disciplinary rules can only indirectly influence his discretion.[200] Moreover, the ABA's Model Rules of Professional Conduct, adopted in 1983, have modified their prior requirement that any fees received be in proportion to the services performed by each attorney. Instead, Rule 1.5 now states alternative tests governing any "division of fees between lawyers who are not in the same firm"; under Rule 1.5(e), fee splitting is permitted either when the division is in proportion to the services performed by each lawyer or when "by written agreement with the client, each lawyer assumes joint responsibility for the representation."[201] Commentary to the rule adds that the disclosure to the client need not indicate the share each lawyer is to receive.[202] Arguably, this language (if adopted by individual states) could permit, for example, two attorneys to undertake joint

199. *See* comments of Professor Arthur Miller in Moore, *supra* note 169, at 7 (noting recent instances of use of master fee petitions).

200. *See* Dunn v. H.R. Porter Co., 602 F.2d 1805, at 1110 n.8; *Agent Orange I*, slip op. at 62 (federal law should govern court's analysis of internal redistribution agreements among plaintiffs' attorneys). Presumably, the source of federal law would be FED. R. CIV. P. 23(e) and the inherent supervisory power of federal courts. Courts have on occasion applied local bar association disciplinary rules to issues of fee disputes, *see* Prandini v. National Tea Co., 557 F.2d 1015, 1018 (3d Cir. 1977), but in such instances they have in effect assimilated those rules as a guide to the exercise of their general supervisory power.

201. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5(e) (1983). In relevant part, the Rule reads:

> (e) a division of fees between lawyers who are not in the same firm may be made only if:
>
> (1) the division is in proportion to the services performed by each lawyer or, by written agreement with the client, each lawyer assumes joint responsibility for the representation;
>
> (2) the client is advised of and does not object to the participation of all the lawyers involved; and
>
> (3) the total fee is reasonable.

Id.

202. Comment (4) to Rule 1.5 states that Paragraph (e) "does not require disclosure to the client of the share that each lawyer is to receive." It also states that a fee division "most often is used when the fee is contingent and the division is between a referring lawyer and a trial specialist." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5 comment (4). Although the commentary appears to cover forwarding or referral fees, it is obscure in its application to class actions.

representation in two actions; one attorney could remain relatively inactive in one case and the other relatively inactive in the other. The net effect would be reciprocal fee sharing across two cases, although each attorney would have to acknowledge that he had undertaken representation in each action. Substantial issues remain even under Rule 1.5(e) (particularly because it is not clear how the client can consent in a class action);[203] however, at least the prior roadblock in Disciplinary Rule 2-107 may soon be substantially lifted.

In the last analysis, toleration for fee sharing arrangements both benefits the clients and ends an arbitrary disparity between attorneys in large firms and those in small firms or solo practice. No rule is today offended when a tax partner in a large firm shares in the fee award obtained by his litigation partner. Yet, two full-time litigators who are not affiliated in a firm cannot in theory share fees across cases, unless the court blinks at the rule or the foregoing interpretation of Rule 1.5(e) is accepted. Nothing justifies this difference in treatment, although deference to the interests of large firms may explain it. Particularly if a percentage-of-the-recovery approach is utilized, fee sharing should not increase the aggregate fees charged against the settlement fund. To put it bluntly, hostility toward fee sharing is an anachronism that prejudices both plaintiffs' attorneys and their clients in order to maintain a polite image of the attorney as a faithful servent. The legitimate interests of society can be protected by narrower, more carefully focused rules.

V

TOWARD REFORM: A CHECKLIST OF NECESSARY STEPS

Proponents of corporate law reform regularly encounter the refrain, "If it ain't broke, don't fix it." Whatever the merits of this argument, it nowhere has less applicability than to the context of shareholder litigation. Viewed from any perspective, the derivative action is not performing as it should. Plaintiffs' attorneys complain that the advent of the special litigation committee has made derivative suits an endangered species. Defense counsel proclaim that strike suits filed only for their nuisance value abound. The contention of this article has been that both sides could be correct, in large measure because the two trends are logically linked.

In general, as changes in the law reduce the expected return from an action to the plaintiff's attorney, it is predictable that he will reduce his

203. The rule requires a "written agreement with the client" authorizing any fee division that is not in proportion to work actually performed. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5(e). It seems unlikely that a written agreement among the attorneys and the lead plaintiff, who is the nominal representative of the class, would suffice. Certainly, a lead plaintiff could not agree to pay a 50% percentage of the recovery on behalf of the other unrepresented class members, and his power appears similarly limited in this context. Judge Weinstein's final decision in the *Agent Orange* litigation surmounted this hurdle, however, by finding that the court's approval could substitute for that of the class. *See supra* note 180. Still, each attorney must accept joint responsibility for the action if he is to share in such a fee redistribution. Comment (4) to the Rule adds that acceptance of joint responsibility "entails the obligations stated in Rule 1.5 for purposes of the matter involved." This would appear to preclude inactive participation in the case.

investment in such actions. One logical adaptive response is the shotgun approach to litigation: file numerous actions, invest neither time nor money significantly in any single action, and pursue early settlements. Not all or even most plaintiffs' attorneys will necessarily operate in this fashion, but few can afford to litigate a case zealously when the prospects for a favorable payoff are poor and the alternative of a cheap settlement coupled with a generous fee award remains seductively attractive. Prior to the advent of the special litigation committee, the plaintiff's attorney could at least hope to enhance the expected return from a derivative action by screening potential cases and pursuing only those that appeared meritorious. But this distinction between "strong" cases and "weak" ones becomes less relevant once a litigation committee of the board is empowered to dismiss either. In consequence, the plaintiff's attorney can seek to outflank this doctrine either by suing only when there is a reasonable prospect that demand would be excused[204] or by underbidding the cost of the dismissal process by offering a cheap settlement. Thus, if one would prefer the plaintiff's attorney to focus on a few cases intensively, the most logical prescription is to reestablish the relevance of the litigation's merits by generalizing the power of the court to review the board's justification for dismissal. This prescription is, of course, precisely the recommendation of the proposals now pending before the American Law Institute.[205]

What else should be done? Earlier, this article stated a case for the following changes: (1) a return to a variable percentage-of-the-recovery formula for fee awards; (2) a stricter standard of judicial review with respect to nonpecuniary settlements (and as to the value of nonpecuniary relief in any settlement); (3) greater judicial tolerance for fee redistribution agreements among plaintiffs' attorneys; and (4) the use of a master fee petition filed by the plaintiffs' steering committee on behalf of all plaintiffs' attorneys in the action. This last step would achieve a variety of objectives by (1) economizing on the judicial time involved in reviewing individual fee petitions; (2) eliminating the need for judicial involvement in the distribution of the aggregate fee award, thereby facilitating private fee sharing agreements that help to finance the action and spread the risk; and (3) centralizing the control of the lead counsel over the action in order to reduce the "free rider" problem that arises when a horde of plaintiffs' attorneys become involved in the large case.

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204. Under Delaware law, on a motion to dismiss by a litigation committee, the court may review the substantive justifications for dismissal only when demand is excused. *See* Aronson v. Lewis, 475 A.3d 805 (Del. 1984). Nonetheless, some subsequent decisions in Delaware, most notably Kaplan v. Wyatt, 484 A.2d 501 (Del. Ch. 1984), still appear to require that the court determine in all circumstances that the justifications advanced for dismissal were reasonable.

205. *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.08 (Discussion Draft No. 1, June 3, 1985) [hereinafter cited as *Discussion Draft No. 1*]. In December of 1984, the Council of the American Law Institute approved *Discussion Draft No. 1* for publication. It should be emphasized (a) that the membership of the Institute has not yet reviewed these proposals of the American Law Institute, and (b) the author is serving as Reporter for this aspect of the American Law Institute's Project.

One additional step is also essential. If collusive settlements rob the derivative action of its deterrent threat, none of the foregoing steps alone precludes collusion. A prophylactic rule is therefore needed: adversaries should not be permitted to negotiate the fee award until after the settlement has been judicially approved.[206] A rule against contemporaneous negotiation of the fee award and the settlement shifts discretion from the parties to the court. Existing precedents in some jurisdictions support this rule,[207] as have commentators.[208] Moreover, the usual counterargument against it—namely, that it would deny the defendant the opportunity to know his total liability[209]—is simply inapplicable in the case of the derivative action. Because the corporation and not the defendant pays the fee award in derivative actions, it is irrelevant that the fee award will not be known by the defendant at the time he accepts the settlement.

In reality, opposition to such a rule is based largely upon a different consideration. Litigators for both plaintiffs and defendants recoil at any proposal that restricts their ability to settle a case. When the counterargument is advanced to them that such a rule would, over the long-run, discourage frivolous actions because the plaintiff's attorney could not expect to receive a substantial fee award from the court in return for a cheap settlement, their consistent response has been that they are not counsel to the long-run, but only the individual case involving their clients.[210] This response once again illustrates the centrality of the ex ante/ex post distinction. If one looks only ex post (that is, after the action is begun), the defendant's interest may seem to lie in obtaining the cheapest possible settlement. Examining the same issue ex ante (before an action is brought), the client's legitimate interest lies in reducing the incidence of frivolous actions. The prospect of collusive settlements maximizes the likelihood of nuisance actions, and a

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206. For a fuller statement of how this rule could be implemented, see PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 7.07(b) (Tent. Draft No. 1, 1982) [hereinafter *Tentative Draft No. 1*]. *See also Discussion Draft No. 1, supra* note 205, at 232-37.

207. *See* Prandini v. National Tea Co., 557 F.2d 1015, 1021 (3d Cir. 1977); Mendosa v. United States, 623 F.2d 1338, 1352-53 (9th Cir. 1980), *cert. denied,* 450 U.S. 912 (1981); Regalado v. Johnson, 79 F.R.D. 447, 451 (N.D. Ill. 1978); Lisa F. v. State of Arizona, 80 F.R.D. 665, 669 (D. Ariz. 1978); Munoz v. Arizona State Univ., 80 F.R.D. 670, 672 (D. Ariz. 1978).

208. *See* Wolfram, *The Second Set of Players: Lawyers, Fee Shifting, and the Limits of Professional Discipline,* LAW & CONTEMP. PROBS., Winter 1984, at 293, 314; Rhode, *Class Conflicts in Class Actions,* 34 STAN. L. REV. 1183 (1982). *See also* MANUAL FOR COMPLEX LITIGATION § 1.46 (1977) (noting inherent conflict of interest).

209. This argument was relied upon by the Supreme Court in White v. New Hampshire Dep't of Social Servs., 455 U.S. 445 (1982). Even there, the Court acknowledged that simultaneous negotiation "may raise difficult ethical issues." *Id.* at 454 n.19. In *White* and in most nonderivative actions, the fee recovery will deplete the settlement fund; this is not the case, however, in a derivative action where the corporation pays the fee award. *See supra* notes 41, 54-59, and accompanying text.

210. The substance of this argument has been repeatedly made to this author by attorneys opposed to any proposed prohibition on contemporaneous negotiation. Indeed, no other proposal made in the A.L.I. Project on Corporate Governance has yet encountered the same degree of opposition from litigators, many of whom are quite sympathetic to other provisions requiring judicial review of litigation committee justifications for dismissal.

prophylactic rule barring contemporaneous fee and settlement negotiations minimizes this likelihood.

Of course, one can debate whether such a reform is practical. To the extent that one doubts that it can be enforced, the case is strengthened for a return to a variable percentage-of-the-recovery fee formula, which, unlike the lodestar or any hybrid formula that gives substantial weight to a time component, cannot be easily manipulated by the parties.[211] Still, even an imperfectly implemented reform can yield significant marginal improvements. If such a prohibition were backstopped by a certification requirement under which counsel would be required to affirm to the court that they had not engaged in prohibited fee discussions, it seems likely that the exchange of generous fees for low settlements would be impeded.[212] In particular, because the corporation itself is a third player in the game, it is unrealistic to expect it to accept placidly a plaintiff's request for a generous fee that will disproportionately deplete the recovery it has received. So long as the corporation's discretion is preserved by a ban on contemporaneous fee and settlement negotiation, the plaintiff must fear that the corporation will oppose an excessive fee award. Although we cannot assume that the corporation will take a long-term perspective and resist the extortion implicit in nuisance actions (because it is not a repeat player), we can make its short-term perspective approach a similar result by severing the settlement and fee determination issues. The real obstacle in preventing collusion is the interests of the professionals—the attorneys on both sides—who have little interest in minimizing the incidence of litigation but considerable interest in avoiding the prospect of defeat inherent in a litigated outcome.

Ironically, any proposal that effectively precluded collusive settlements might well spell the end of the derivative action today. The advent of the special litigation committee and the judicial deference that has been given to its decision have chiefly served to erode the expected return on meritorious actions. Thus, if cosmetic settlements were chilled, the expected return on an action might justify its commencement only in the limited set of circumstances when demand was excused.[213] In this light, any proposal to restrict collusive settlements represents an unbalanced reform package, unless it is accompanied by standards that generalize the court's obligation to review the substantive justifications advanced for dismissal by the committee and thereby reject the "demand required/demand excused" distinction. This position is

211. Some manipulation is still possible to the extent that the adversaries could agree on the specific percentage of the recovery that the court should award. If, for example, the court typically awarded a percentage between 15% and 25% of the recovery in derivative actions, the plaintiff's attorney might be willing to discount the settlement in return for the defendant's agreement not to object to a 25% fee award.

212. I believe that it is unrealistic to think that counsel would normally be prepared to certify the nonexistence of discussions when they had in fact occurred. Not only would this represent perjury, but in multiparty actions involving numerous counsel there are simply too many persons involved for any secret to be safely kept. Counsel are also repeat players who will not rationally risk their professional reputations on success in one action. For a similar conclusion, see Wolfram, *supra* note 208, at 314.

213. *See supra* note 204.

in essence that taken in the various ALI drafts[214] and its defense is beyond the scope of this article.

Still, from an academic perspective, it is worth asking why the law should not simply disregard the special litigation committee and thereby treat the derivative action like any other civil suit. What justification exists for ever dismissing a legally sufficient action other than on the merits? One possible response is that the special litigation committee could be a preferable screening device to currently existing mechanisms, such as the security for expenses bond. If one starts with the assumption recognized at the outset of this article that the American rule on fee shifting encourages weak cases to be filed that the English rule would preclude,[215] then the traditional security for expenses bond becomes comprehensible as a partial substitute for the English rule requiring fee shifting. Because outside directors should be uniquely risk averse, given their nominal investment in the corporation, a bond requirement that discourages nonmeritorious actions can be more convincingly justified in this context than in that of civil litigation generally.[216] However, the security for expenses bond is an overbroad remedy that is in the process of being abandoned.[217] In terms of this article's analysis, its leading defect is that it can chill plaintiffs' attorneys who are undercapitalized or otherwise unwilling to accept the risk of loss inherent in fee shifting. It adds to the attorney's downside risk and thus compounds the problem of his likely risk aversion. In contrast, the special litigation committee device may reduce the settlement value of a case, but it does not add to the downside risk. Potentially, it could be structured to provide a superior screening mechanism by which to filter out weak cases, because it could have a lesser chilling effect on the plaintiff's attorney.

To be sure, the litigation committee will be an imperfect screening mechanism, however designed, and errors will occur. But the focus should be less on the possibility of error than on the relative error rate. From the latter perspective, the advantage of the special litigation committee procedure (in comparison with the security for expenses bond requirement) is that the filtering principle becomes not the attorney's ability to accept the contingency of a financial sanction (i.e., fee shifting), but rather the court's estimate of the action's probable merit.[218] In addition, an important timing difference

214. *See supra* note 205.

215. *See supra* notes 41-42.

216. *See supra,* text accompanying notes 43-46, regarding the argument that outside directors, typically having only a small stake in the corporation, should be more risk averse than other defendants.

217. Section 49 of the MODEL BUSINESS CORPORATION ACT was revised in 1982 to delete its former provision authorizing a security for expenses bond when the plaintiff's shareholdings in the corporation were small. Delaware law has never provided for a security for expenses bond, and commentators have generally found that its application could be evaded by a variety of stratagems. *See generally* Note, *supra* note 33. For a survey of state statutes finding that the majority of jurisdictions do not authorize a special security for expenses bond in the case of derivative actions, see *Discussion Draft No. 1, supra* note 205, at 71-74, 75-76.

218. Of course, the attorney's willingness to accept the risk of fee shifting against him will depend in substantial part on his evaluation of the action's merit. Thus, Professor Shavell argues

distinguishes the special litigation committee as a screening device. Because the critical threshold comes at a relatively early point in the litigation (i.e., when the litigation committee makes its motion), the plaintiff's attorney who survives this juncture thereafter has considerable incentive to invest in case preparation and pursue a litigated outcome. Conversely, the plaintiff's attorney who is required to post a security for expenses bond faces a downside risk of a financial loss (in addition to his own out-of-pocket costs) until the resolution of the case. Of these two alternatives, the security for expenses bond maintains the attorney in a state of continuing uncertainty, whereas the committee procedure could be structured so as to signal the court's determination that the action had potential merit. This signal, which would be implicit in the court's rejection of the committee's motion, could encourage investment in the action, while the bond requirement will always discourage investment.

At present, however, this asserted timing difference is more illusory than real. The introduction of the special litigation committee procedure has in fact enormously complicated derivative litigation and added a trial within a trial. Chancellor Brown's analysis in *Kaplan v. Wyatt*[219] of the current Delaware practice is in this regard devastating. As he points out, the special committee review process today "sidetracks derivative litigation as we have heretofore known it for approximately two years at a minimum . . . while the plaintiff passively awaits his chance . . . ."[220] Faced with a substantial delay before he can even obtain significant discovery, the plaintiff's attorney has an obvious incentive to settle early. The only answer to this problem is tighter judicial control over the period during which the committee conducts its inquiry. A two or three month delay for a study may be justifiable, but an average delay of two years means that justice has been both delayed and denied. That a sensible pretrial screening mechanism could be designed does not imply that any existing procedure today approximates this goal.[221]

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that fee shifting filters out less promising actions in terms of their likelihood of success. *See* Shavell, *supra* note 40. But, under a contingent fee system involving plaintiffs with a nominal investment in the corporation, the only person against whom fees can be shifted on the plaintiff's side (without discouraging all small shareholders from bringing suit) is the plaintiff's attorney. Because he receives only a percentage of the total recovery (typically around 20% historically), he should be more chilled than the defendant by a system of fee shifting, given his different risk/return ratio. Also, if the costs of the litigation are asymmetric, with the defendant incurring higher costs than the plaintiff, *see supra* text accompanying notes 43-44, fee shifting would have an unequal and prejudicial effect on the plaintiff's attorney, which the more limited security for expenses bond did not have because the typical bond (for, say, $20,000) limited the maximum exposure.

219. *See supra* note 62.

220. *Id.* (quoting opinion). Chancellor Brown reached this estimate after noting that there are today typically three contested hearings before the plaintiff can begin preparing his case for trial: First, the defendants move to stay discovery by the plaintiff pending the litigation committee's report; second, there is a motion made by plaintiff seeking limited discovery as to the report and the process of its preparation; finally, there is the motion to dismiss made by the defendants based on the report. Only if this motion is denied does the plaintiff then receive an opportunity after much delay to begin seeking discovery.

221. A variety of proposals have been recently made to establish a prescreening requirement with respect to class actions. *See, e.g.*, Berry, *Ending Substance's Indenture to Procedure: The Imperative for Comprehensive Revision of the Class Damage Action*, 80 COLUM. L. REV. 289, 314, 334-39 (1980);

VI

CONCLUSION

To some, the perspective that this article has taken will seem cynical. They will respond that attorneys are far from naked utility maximizers who seek only opportunities to subordinate the client's interests to their own. To be sure, any description that so characterizes them would be overdrawn and simplistic. Human motives in any actual case are always more complex and few attorneys are wholly insensitive to professional values. But any sensible attempt at reform should begin by identifying the self-interest of the actors in question and then assessing the marginal impact on them of alternative legal rules. In that light, this article has sought not to present a biography of the typical plaintiffs' attorney, but to model the marginal impact that altered legal rules would have. Because shareholder litigation presents the extreme case where the attorney is able to behave opportunistically, the potential of the private attorney general as a monitoring force is limited, unless and until the law faces more candidly and systematically the conflicts of interest that today pervade class and derivative litigation.

The problem is not simply that professional ethics has ignored these conflicts, but rather that its narrow focus on how a fiduciary should ideally behave tilts the balance of advantage in shareholder litigation against the plaintiff. An exclusively normative perspective blinds one to the obvious truths that (1) plaintiff's litigation, as with most other forms of extended profit-seeking endeavor, must be financed, and (2) the plaintiff's attorney has the same legitimate need to spread his risks as the defense counsel satisfies through his participation in a large firm. Thus, so long as codes of professional responsibility continue to insist that legal fees must be shared only on the basis of the work actually performed,[222] the plantiff's attorney will be disadvantaged. In effect, such a rule views the firm as consisting only of one factor of production: labor. Modern financial theory, however, views the firm as composed of multiple participants who supply the other necessary factors of production as well—in particular, credit and the ability to bear the residual risk.[223] Arguably, there may be reasons why the plaintiff's firm should not have the same internal arrangements allocating risk and control as

Committee on Class Actions of the ABA Section of Corporate, Banking and Business Law, *Recommendations Regarding Consumer Class Actions for Monetary Relief*, 29 BUS. LAW 957, 965-67 (1974). The feasibility of these proposals is not here assessed, but it is suggested that the litigation committee procedure should be viewed in similar terms as a prescreening mechanism whose purpose is to assist the court in filtering out weak cases at an early stage.

222. *See supra* notes 201-03 and accompanying text.

223. Those examining the firm from the perspective of classical economics see it as a "nexus of contracts" or "series of bargains" in which the various participants—i.e., the suppliers of capital, labor, management, and supplies—reach an equilibrium position. No one interest is seen as dominant, and the stockholder is simply viewed as the party willling to bear the "residual risk" of success or failure, rather than simply as the owner. For the major statements of this view, see Jensen & Mecklin, *supra* note 184; Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

the modern corporation. Some may believe that such a structure would only compound the "agency cost" problems that already complicate the relationship between attorney and client in class and derivative actions, or they may fear that the existence of shareholders would only intensify the pressure on the lead counsel to maximize profits over the short-run by accepting an inadequate settlement.[224] Even if these concerns are valid, however, an insistence that fee awards be apportioned exclusively in terms of work actually performed denies the ad hoc plaintiffs' firm of one hundred odd lawyers who assemble to litigate a large class action the ability to organize themselves in a manner that permits some of the participants to occupy the specialized roles of creditor and residual risk bearer. In contrast, the large law firm with its highly leveraged ratio of few partners to many associates comes closer to resembling an economic firm, because it has a class (the partners) who approximate the role of the residual risk bearer.[225] This more complex structure implies a greater ability to handle risk.

To sum up, although courts have a legitimate, if limited, role in overseeing the internal bargains struck within the plaintiffs' firm, courts misconceive that role when they become preoccupied with the "usurious" terms of credit; in so doing, they betray an attitude that seems more theological than economical. The proper focus should be on the interests of the client and the classic problems that arise when the client, as principal, cannot closely control the attorney, his agent. In fairness, both courts and the ABA's Model Rules have made considerable progress toward recognizing that the plaintiff's attorney is an entrepreneur.[226] Yet, although they have come to understand that the

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224. It is far from self-evident that the behavior of the plaintiff's attorney should change if he were permitted to sell participations in the action to stockholders or other quasi-creditors (whether composed of other attorneys or ordinary investors). To show that the presence of such investors would produce a greater conflict between the interests of attorney and client, one needs to demonstrate that these investors would have a different discount rate at which they discounted the value of a deferred and contingent recovery than the attorney's clients. Yet, it is equally possible that investor attitudes might more closely resemble those of the client than would the attorney's own preferences. Under the lodestar system, it is arguable that such investors might pressure the attorney to maximize the fee recovery through dilatory, fee-generating tactics, but the attorney's own incentives already point him in this direction. Thus, particularly if only other attorneys were eligible to be shareholders in an ad hoc firm, it is not clear why there would be any incremental pressure toward so maximizing the fee. Conversely, attorney/investors might prove to be better monitors than the client or the court, and they could remove incompetent or shirking counsel. In short, the trade-offs are indeterminate.

225. The partner is, of course, more than a passive residual risk bearer; unlike the stockholder, he is an entrepreneur, able to both manage and control. In this light, perhaps the strongest argument for prohibiting nonlawyer equity investments in litigation is shown by the evolution of the modern law firm. It suggests that the structure of owner-managers is highly efficient and courts should not deviate from it in regulating the ad hoc plaintiffs' firm that organizes to litigate a single case. Yet, if the modern firm is to be the model, it must be recognized that fee splitting occurs within that firm, as "rainmakers" receive a return that is not directly correlated to their "work" for any specific client. By analogy, recognition of the forwarding fee seems equally appropriate.

226. For example, Rule 1.5 of the *Model Rules* does permit a forwarding fee to be paid with the client's consent. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5 comment e (1983). Similarly, the *Model Rules* no longer require that the client be liable (at least in theory) for the expenses of the attorney who is to be compensated on a contingent fee basis when the action is unsuccessful. Previously, the client had to agree to repay these expenses in order to counter the impression that the attorney was impermissibly investing in the action (although instances of this rule's enforcement

plaintiff's attorney must be assured an adequate expected return if he is to perform effectively, they still lack an understanding of the relationship between risk and diversification.

The prescriptions offered by this article ultimately involve only marginal institutional adjustments: chiefly, a return to the former salvage value formula for fee awards and greater tolerance for private arrangements among plaintiff's counsel that spread risk or attract capital. The very modesty of these proposals, however, raises two basic questions: (1) Is there a more radical alternative suggested by economic theory that this article considered and rejected?; and (2) If the foregoing proposals were adopted, how significant a change in the performance of the attorney as monitor should we expect? The answer to the first of the these questions is "yes," while to the second, only a very qualified response can be given.

A. The Auction Alternative: The Road Not Taken

From the standpoint of economic theory, an obvious answer to many of the problems discussed in this article would be to auction off the right to bring the suit. The winner in such an auction would have an exclusive property right, would not be required to share the expected return with the horde of plaintiffs' attorneys who today often appear out of the woodwork once the initial action is filed, and would accordingly have a greater incentive to invest in case preparation. However, the drawbacks in any form of auction procedure are also considerable. If, for example, the simplest form of auction were used and the court awarded the case to the attorney who agreed to accept the lowest fee award (i.e., five percent of the recovery when everyone else demanded at least six percent), the perverse consequence of such an auction might be to award the action to the least competent counsel, who having the lowest opportunity cost, could afford to make the lowest bid.[227] Given that lawyers are not fungible, it is hardly a desirable characteristic of a market-driven selection process that it tilts the contest toward the counsel least able to command a high premium for his time. Moreover, such an action would also aggravate the earlier noted tendency toward premature or cheap settlements, because, other things being equal, the lowest bidder (in terms of

were conspiciously lacking). *See* Findlater, *The Proposed Revision of DR 5-103(B): Champerty and Class Actions*, 36 BUS. LAW. 1667, 1669-70 (1981).

According to Professor Leubsdorf, courts in applying the lodestar formula now reveal a "view of the lawyer as a calculating entrepreneur regulated by calculating judges." *See* Leubsdorf, *supra* note 93, at 481. Although it can be debated whether courts do act in quite this way when employing the lodestar formula, it represents some progress that they give any evidence of doing so. Finally, Judge Weinstein's explicit acceptance of the ad hoc law firm rationale for internal fee redistributions in the *Agent Orange* litigation is a major advance in this direction.

227. Other factors would also influence who could make the lowest bid. For example, because the fee is contingent, a party more confident of his ability to win the case could underbid another similarly situated bidder who was less confident. This might tilt the auction toward either the most capable attorney or the most egotistical. The relative confidence of the parties, however, may also relate to their relative willingness to enter into a "sweetheart settlement." Thus, the lowest bidder could be the "pilgrim" who intended an immediate settlement.

a percentage-of-the-recovery formula) would tend to maximize his recovery at the earliest point.[228]

Another more elegant alternative would be to auction off not the right to represent the clients, but instead the client's actual rights in the action. In this form of auction, the contestants would offer a cash price to the class in return for the rights held by the class in the action.[229] Unprecedented as this approach is, it would convert the lawyer and the client into a single economic entity, thus minimizing some of the prospects for collusion that depend upon conflicts of interest between the lawyer and client, while also tilting the contest in favor of those bidders who could pay the highest price, instead of those who could afford to accept the lowest return. Also, in terms of Exhibit A, this approach would in theory encourage the winning attorney to settle only at a later, more efficient point, because once having purchased the action, he thereafter would litigate until the marginal return on his efforts was equalled by his marginal costs.[230] A key problem still exists with this approach: if the auction is held only after the first action is filed, the result is to chill search activity. The attorney who discovers a legal violation that would support a lucrative action is in the same position as the prospector who cannot stake out his claim or the inventor who cannot obtain patent protection.[231] Ex ante, he has no incentive to search and, if the plaintiff's attorney is to perform a monitoring role, this approach eliminates the incentive society should precisely wish to maximize.

Conceivably, society could respond to this problem by auctioning off not the rights of the class in a specific action, but the franchise right to file any law suit asserting a particular cause of action; in effect, society would sell the right to monitor, discover, and enforce law violations of a specified type within a specified area for a specified period. This form of auction would have the advantage of not chilling search activity, but it would invite collusion and a

228. This point can be seen by referring to Exhibit A, *supra* p. 42. If the *o'* line is held constant as between different bidders, the winning bidder would have the smallest *f* curve, and this implies that Point *Y*, which is the point of maximum distance between the *f* curve and the *o'* line, would shift leftward toward the axis. The consequence is both a smaller recovery and less deterrence.

229. This approach has been suggested to the author by Professor Frank Easterbrook of the University of Chicago Law School.

230. Of course, the *o'* line on Exhibit A would shift upward under this approach because the attorney would invest a substantial amount at the outset in purchasing the rights held by the class and probably would incur significant interest expenses in so doing. Still, the attorney would rationally settle at the point where the vertical distance between this higher *o'* line and the *s'* curve was greater, and this distance will continue to be maximized at Point *Z* on Exhibit A.

231. Other problems also exist with this approach. Unless there was perfect competition among attorneys, the class might receive inadequate compensation for the rights they assigned, because (1) the ordinary class member could not evaluate the fair market value of the action; (2) some class members might rationally seek to opt out of the class and "free ride" on the winning bidder's efforts; and (3) there would be a significant danger that rival law firms would collude to reduce competitive bidding. Alternatively, rival firms might merge and form an ad hoc plaintiffs' law firm for purposes of the case in order to reduce competitive bidding. The irony is that society would have to enforce the antitrust laws against plaintiffs' attorneys on whom it, in turn, relied to enforce the antitrust laws through private actions. Regulatory oversight would therefore remain necessary.

variety of other hazards.[232] Above all, it abandons the compensatory goal of the law because it sells the potential recovery before the wrong even occurs or the victims are identified. Nor could one know the total number of victims entitled to compensation until the end of the franchise period. Although still further variations could be imagined,[233] the bottom line is that whatever technique of auction is employed—that is, whether society sells the right to represent the class, the right to the recovery belonging to the class, or the franchise right to enforce a particular law—a need for regulatory oversight will persist. Courts will and must remain in the business of regulating the private attorney general; the real issue is the appropriate scope of regulation.

B. The Plaintiff as Monitor: Some Realism about the Limits of Litigation

This article has focused essentially on the weaknesses in the contemporary system of private enforcement through shareholder litigation. There are also countervailing strengths. In particular, search costs are low for the plaintiff's attorney in shareholder litigation, because he is subsidized by the mandatory disclosure system created by the federal securities laws.[234] This subsidy partially compensates for the fact that the plaintiff's attorney receives only a small portion of the total recovery and thus in terms of the optimal level of social investment should underinvest in litigation expenditures.[235]

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232. Collusion could be avoided if the attorney also acquired the rights of the class in the action, because then he could not be bought off by a cheap settlement that exchanged high fees for a low recovery. But this solution does not leave anyone to whom to direct the proceeds of the auction at the time the franchise is sold because no one yet has been injured. Nor is it known how many will be injured over the franchise period that has been auctioned off until after this period has ended. In short, the goal of compensation to victims is abandoned by this approach. The idea of auctioning off a franchise to enforce the law thus seems particularly fanciful.

233. One could imagine a franchise contract for a limited period to monitor a particular type of violation (say, antitrust violations) with respect to a given number of companies or industries under which the plaintiff's attorney agreed to split the recovery on a percentage basis with the class. This approach could encourage search and specialization, but it reintroduces the problem of premature settlements because it is essentially a percentage-of-the-recovery fee formula. Also, because a franchise is by definition a monopoly, there is the problem that monopolists tend to restrict output and thus produce less total deterrence and compensation than under competitive conditions. Moreover, defendants would have an incentive to bribe such a monopolist. For a general economic critique of franchise bidding in another context as a substitute for regulation, see Williamson, *Franchise Bidding for Natural Monopolies—In General and with Respect to CATV*, 7 BELL J. ECON. 73 (1976).

234. One empirical study of class and derivative suits has noted their marked tendency to follow on the heels of "dramatic events," typically either SEC or bankruptcy proceedings. *See* Kennedy, *supra* note 19, at 809, 824 (finding that nearly 50% of the actions surveyed had piggybacked on prior SEC or bankruptcy proceedings). This statistic has a double-edge significance: it shows both that the private plaintiff in derivative actions is substantially subsidized by the SEC's enforcement efforts and that he is not totally dependent on them (as the private antitrust plaintiffs' bar seems to depend on the Antitrust Division of the Justice Department). For a discussion of this piggybacking phenomenon in securities and antitrust litigations, see Coffee, *supra* note 19, at 221-26, 248-52.

235. For example, assume that on average only 20% of the recovery in a class or derivative action is awarded as a fee to the plaintiff's attorney. This ceiling limits what he will spend on search activity, since he will obviously not invest 21% of the recovery to earn 20%. In contrast, if shareholders could coordinate their actions, the plaintiff class would invest much greater amounts on search and case preparation, because from their perspective it is rational to spend 99% of the recovery to earn the remaining 1%. Still, because the class members cannot coordinate their actions and free riding will occur, there should be inadequate investment in such litigation from a social perspective.

Nonetheless, even if the proposal recommended in this article were adopted, it remains difficult to assess the degree to which shareholder litigation can reduce the agency costs associated with the manager/shareholder relationship. Those economists who doubt that management's interests are closely aligned with those of the shareholders have advanced various behavioral models of the firm, under which management is typically seen as biased toward an inefficient growth-maximizing policy that expends corporate funds wastefully on expanded staff, acquisitions, and other perquisites.[236] Inefficient as such behavior may be, realism suggests that it is largely protected by the business judgment rule. The problem is not only that the substantive law of fiduciary duties cannot be stretched to recognize the implicit conflict of interest in these seemingly arm's length decisions, but also that inefficiency of this character does not necessarily take the form of highly visible transactions that the plaintiff can monitor at low cost. Accordingly, even if one adopts the premise that there are high "agency costs" associated with corporate governance,[237] one may still be skeptical about whether litigation remedies can offer more than a marginally effective solution, one capable at best of deterring significant, highly visible transactions, but not the more common departures from the goal of shareholder wealth maximization. This analysis then tends to support the conventional view that litigation is more effective at enforcing what lawyers term the duty of loyalty than the duty of due care.

This evaluation neither implies that shareholder litigation lacks utility nor that it is more imperfect than other modes of accountability. Other monitors—the independent director and the hostile bidder—can also be compromised in similar fashion.[238] The relevant issue should therefore become their comparative monitoring ability. A case can be made that shareholder litigation does have comparative advantages over the other

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236. Among the principal works in this "behavioral" theory of the firm are: W. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH MANAGERIAL CAPITALISM (1964); Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032 (1963); Leibenstein, *Allocative Efficiency v. "X-Efficiency,"* 56 AM. ECON. REV. 392 (1966).

Williamson introduced the concept of "expense preference"—the idea that management seeks to expend funds on staff and perquisites that it dare not distribute to itself in direct compensation. The theme that management will fail to cost minimize also underlies Leibenstein's "X-Efficiency" concept and is consistent with those theorists, such as Herbert Simon, who argue that managers in complex organizations only "profit satisfice," rather than "profit maximize."

237. Currently, the high premiums paid in leveraged buyouts by managements approximate the level of the premiums paid in hostile takeover contests. *See* DeAngelo, DeAngelo, & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J. LAW & ECON. 367 (1984). One inference that can be drawn from these high premiums is that the agency costs associated with corporate governance are high. Because relatively little increased efficiency seems likely to result from the elimination of public shareholders (and the dominant motive for the buyout is often fear of a hostile takeover), these premiums imply that management places a high value on their position in control of the corporation.

238. "Greenmail" is the obvious analogue of the collusive settlement of a derivative action. In greenmail, the bidder challenges management's control and is bought off by payment of a premium over the market price for his shares, thereby leaving shareholders typically worse off insofar as corporate funds have been wasted on the repurchase. Collusion then may frustrate corporate control contests as easily as it can undercut the end purposes of litigation.

monitoring forces over at least a significant range of potential violations,[239] but this comparison is a topic for a different article. All that can be sensibly concluded at this point is the following:

(1) Our contemporary system of private enforcement could easily be made more effective if there were a will to do so; and

(2) What is best for the litigators is not necessarily best for shareholders or society.

239. Professor Cox has argued in a recent article that litigation will be relatively more effective than market remedies in dealing with "one shot" transactions involving managerial conflicts of interest. *See* Cox, *Compensation, Deterrence, and the Market as Boundaries of Derivative Suit Proceedings*, 52 GEO. WASH. L. REV. 745, 753-54 (1984). His theory, which seems plausible, is that the market will react significantly only to transactions that seem likely to recur in the future. Also, to the extent management does not see itself as a "repeat player" (as it probably does not in the buyout context), reputational interests are a less effective deterrent.