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## Litigation Governance: A Gentle Critique of the Third Circuit Task Force Report

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# LITIGATION GOVERNANCE: A GENTLE CRITIQUE OF THE THIRD CIRCUIT TASK FORCE REPORT

*John C. Coffee, Jr.\**

The Third Circuit Task Force on the Selection of Class Counsel (the “Task Force”) has worked hard, considered everything, and exhaustively summarized the problems associated with class counsel auctions. Its views will undoubtedly resonate with most of the Bench and the vast majority of the Bar—neither of whom were enthusiastic about the prospect of auctions in the first place. Personally, I agree with the Task Force that auctions are not the most promising reform and that they may exacerbate, rather than correct, existing problems. Still, what is missing from the Task Force Report is the candid recognition that the agency problems associated with class litigation are serious and not adequately addressed by existing mechanisms. Instead, the Task Force has produced a relatively sanguine report that largely endorses the status quo and what it terms “traditional methods” of “private ordering.”<sup>1</sup> Precisely to this extent, the Task Force Report misses the forest for the trees.

Nowhere in the Task Force’s Report does one find any reference to the following critical facts about securities litigation:

1. Securities class actions produce relatively modest recoveries, ranging as low as 5% of the damage sought according to some surveys and under 15% according to most.<sup>2</sup> Critics can read this data to imply

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1. One of the Task Force Report’s principal conclusions is the following: “The traditional methods of selecting class counsel, with significant reliance on private ordering, are preferable to auctions in most class action cases.” See Third Circuit Task Force on the Selection of Class Counsel, Draft Report October 2001 (“Task Force Report”) at p. 18, *available at* <http://www.ca3.uscourts.gov>; 74 TEMP. L. REV. 689, 704 (2002) (“TEMPLE”). This conclusion goes beyond finding auctions unworkable or inconsistent with the purposes of the Private Securities Litigation Reform Act (“PSLRA”), or simply inferior to the “lead plaintiff” concept of the PSLRA, and appears to find that, across all contexts, “traditional methods” are superior to auctions. Here, I would disagree. Although I believe the lead plaintiff concept can produce superior results to an auction, I have little confidence in “private ordering” in a non-competitive world.

2. At the time of the PSLRA’s enactment, Congress was influenced by a comprehensive study by National Economic Research Associates, Inc. (“NERA”) finding that in 254 securities class actions between 1991 and 1993, for which investor losses could be calculated, the median recovery came to 5% of investor losses. See Frederick Dunbar & Vinita Juneja, “Recent Trends II: What Explains Settlements in Shareholder Actions?,” in “Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs,” 103rd Cong., 1st Session, (June 17 and July 21, 1993) at 739, 750 tbl. 3. For a review of this and other recent studies, see James Cox, *Making Securities Fraud Class Actions Virtuous*, 39 Ariz. L.

either that plaintiffs' attorney are not faithful to their clients or that these cases are disproportionately "strike suits" that settle cheap.

2. Attorney fee awards in securities class actions appear to average 33% of the recovery.<sup>3</sup> Yet, when lead plaintiffs negotiate compensation with class counsel or when auctions are used, the resulting fee levels agreements regularly drop by half or more.<sup>4</sup> The logical inference is then that the current systems permits attorneys to extract rents from the class.<sup>5</sup>

3. The plaintiff's bar in securities class actions is extremely concentrated and growing more so<sup>6</sup>—to the point that cartel-like behavior becomes predictable (particularly given the potential for the participating firms to reach trade offs and accommodations across cases). Even strong lead plaintiffs may be unable to negotiate effectively with counsel if the market for class counsel is non-competitive.

4. Institutional investors have little incentive to serve in the capacity of lead plaintiff, and few do.<sup>7</sup> As a result, if institutional investors

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Rev. 497, 501-07 (1997).

3. See Dunbar and Juneja; *supra* note 2, at 754 t.7 (finding average attorneys fees to equal 31.32% of the settlement). Later studies have found this percentage to have increased to the 33% to 34% range.

4. For example, in *In re Cendant Corp. Litig.*, 264 F.3d 201 (3d Cir. 2001), the three institutional lead plaintiffs negotiated an elaborate fee grid with class counsel that provided for a decreasing percentage of the recovery, which ranged as follows: (a) 5% of the first \$400 million and 3% of the recovery over \$400 million, if the case settled before the commencement of discovery, (b) 17.5% of the recovery of the first \$100 million, 10% of the range between \$100 and \$300 million, and 7.5% of the range between \$300 and \$500 million, if the case settled during discovery, and (c) 20% of the first \$150 million, 12.5% of the range between \$150 million and \$400 million, and 7.5% of the balance over \$400 million, if the case settled after the conclusion of discovery. *Id.* at 224 n. 4. The district court instead conducted an auction, which it determined was won by a bid that ultimately produced a fee equal to 8.275% of the total settlement. *Id.* at 228. Although the Third Circuit invalidated the auction and reinstated the retainer agreement, the relevant point here is that both measures produced far superior results for the class than the normal presumption of a 25% to 30% fee award. The author is also aware of several pending cases in which lead plaintiffs have negotiated fee formulas that will likely produce fee awards of under 20% (and even under 10%) of the recovery if the action is successful.

5. I do not mean to suggest that a 33% fee award is never justified, but only that it should be justified on a risk-related basis and not awarded presumptively. Unfortunately, in the current environment, the justification of the fee award is rarely done on an adversarial basis.

6. Prior to PSLRA, Milberg, Weiss, Bershad, Hynes and Lerach was the largest plaintiffs' firm in the United States. Since the PSLRA, its market share has grown even further, as smaller firms have simply withdrawn from securities litigation because they have been unable to afford the increased costs and additional delay until expected recovery.

7. Of all institutional investors, only public pension funds, and a limited number of union-related institutions, have been willing to serve as lead plaintiffs. The reluctance of both private pension funds and mutual funds to serve as lead plaintiffs suggests that the costs of this role exceed its benefits. Although little empirical work has been done on the participation of institutional investors in securities class actions, the Securities and Exchange Commission conducted a study of the first years's

volunteer to serve only in the minority of securities class actions, the role of lead plaintiff will be occupied by far weaker, less adequate representatives in the majority of such actions.

These four factors converge to suggest that the historic pattern of seemingly weak settlements and high fee awards in securities class actions may well continue in the future. That is, even if institutional investors can function as effective monitors in securities litigation (a premise that is reasonable but remains unproven), institutional investors are unlikely to appear in more than a minority of the cases (and that percentage may decline after an initial period of enthusiasm). In the remaining majority of the cases, weaker lead plaintiffs and a non-competitive market for legal services implies that high agency costs and weak settlements will persist.

Nonetheless, the Task Force strongly endorses the status quo:

The Task Force is of the opinion that class recovery generally can be maximized more effectively by using the traditional methods of appointing counsel: private ordering where that is possible, court selection on the basis of quality of counsel if private ordering is not workable, and court control over the fee award in all cases.<sup>8</sup>

This complacent refrain, which is repeated throughout the Task Force Report, goes beyond simply concluding that auctions are problematic or unworkable and concludes that all is well in the field of securities litigation and that the “traditional methods” of counsel selection produce the best outcomes. Neither the foregoing empirical data nor the Congressional views expressed in the legislative history to the Private Securities Litigation Reform Act (“PSLRA”) are consistent with such a Panglossian conclusion.<sup>9</sup> Those more cynical than I might suggest that such a self-satisfied self-assessment is just what might be expected from a professional group (whether lawyers or morticians). In common, professions tend to conclude that the governance of the profession by

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experience under the PSLRA and found that out of 105 class actions, institutional investors moved to become lead plaintiff in only eight cases. See U.S. Securities and Exchange Commission, April 1997, REPORT TO THE PRESIDENT AND CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (available at <http://www.asec.gov/news/studies/lreform.txt>). A later study covering the experience in 1997 found that institutional investors appeared as lead plaintiffs in only nine of 175 cases (or just over 5%). See Elayne Demby, “Ducking Lead Plaintiff Status,” (May 1999) (available at <http://www.assetpub.com/archive/ps/99-05psmay/may99PS58a.html>). While enthusiasts of the lead plaintiff concept rarely acknowledge this point, it suggests that institutional oversight may be limited to under ten percent of all securities class actions—at least on the available evidence to date.

8. Task Force Report at 61; TEMPLE at 740.

9. The legislative history of the PSLRA is replete with suggestions that securities litigation was a “lawyer-driven” phenomenon which needed to become more client-centered. See House Report 104-369 (“Securities Litigation Reform”), 104th Congress; 1st Session (November 28, 1995) (detailing “examples of abusive and manipulative securities litigation” involving “exorbitant” settlements and fee awards).

the profession and for the profession is just fine. Even if self-regulation can sometimes work (as I believe it can), more self-awareness is needed about the limits of private ordering than the Task Force's Report shows. Put simply, private ordering works least well when agency costs are high and competition is limited.

The Task Force's conviction that private ordering is working leads it to recommend judicial deference to the decisions of the lead plaintiff. Despite the fact that most lead plaintiffs are unlikely to be institutional investors, "[t]he Task Force concludes that once the court has identified the most adequate plaintiff under the terms of the Act, that party's choice of counsel should be viewed under the deference given to any other business decision"<sup>10</sup>—in short, the business judgment rule.<sup>11</sup> Thus, if no institution seeks to be named lead plaintiff and the largest financial stake is held by a loose aggregation of, say, twenty or more small shareholders, this group's choice of a law firm to serve as class counsel would seemingly be decisive, even if the law firm so chosen had never before litigated a securities class action as class counsel. Perhaps, the Task Force does not truly mean what it has said and would not endorse such a result. Yet, it is nonetheless open to criticism that its policy prescriptions assumes the "best case" scenario of a strong lead plaintiff when the opposite "worst case" scenario is more likely.

If auctions do not work and if strong lead plaintiffs are likely to be the exception, rather than the rule, what mechanism will work to effectively monitor class counsel? At various points, the Task Force Report comes perilously close to concluding that norms of professional responsibility and legal ethics adequately fill this void.<sup>12</sup> But, as a general rule, professional groups have little incentive to seek increased competition or lower fees, and professional ethical norms generally are enforced only against outliers and insurgents. To the extent that existing practices within the legal profession permit defendants to offer high fee awards in return for weak settlements, neither defense counsel nor plaintiff's counsel has much reason to upset this equilibrium, and hence professional norms represent a best at weak read on which to rely.

What then is the best, practical answer? The Seventh Circuit has taken a very different approach than the Third Circuit. While the Third Circuit has basically endorsed a percentage of the recovery approach to fee awards that must be assessed on an *ex post* basis,<sup>13</sup> the Seventh Circuit has long instructed the district court to "mimic the market" in setting fee awards.<sup>14</sup> Most recently, in

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10. Task Force Report at 87; TEMPLE at 763.

11. The term "business judgment rule" is actually used by the Task Force. Task Force Report at 88; TEMPLE at 763.

12. See, for example, the Task Force's conclusion that: "The Task Force concluded that procedures that enhanced client control and emphasized the experience, wisdom and judgment of the bench were superior to judicially-controlled auctions." Task Force Report at 29; TEMPLE at 713.

13. See *Court Awarded Attorney Fees, Report of the Third Circuit Task Force*, 108 F.R.D. 237 (E.D. Pa. 1985). In *re General Motors Corp. Pick Up Truck Fuel Tank Prods. Liab. Litig.*, 55 F.3d 768 (3rd Cir. 1995).

14. This attitude dates back at least to *In re Continental Illinois Securities Litig.*, 985 F.2d 867 (7th

*In re Synthroid Marketing Litig.*,<sup>15</sup> the Seventh Circuit has insisted that the district court should focus principally on the fee agreements that sophisticated class representatives enter into with their class counsel—and then generalize these results across other class contexts. In contrast to the Task Force Report, this approach is wholeheartedly *ex ante*, rather than *ex post*, in its methodology for fee awards. In addition, to the extent that it would apply the results of sophisticated negotiations to determine what the fee awards should be when less informed parties bargain, the Seventh Circuit's approach responds to the fact that "strong" lead plaintiffs will be the exception, not the rule. The Seventh Circuit's proposed answer thus seems superior to the Task Force's prescription of across-the-board deference to the lead plaintiff.

But there are problems with the Seventh Circuit's approach as well. First, even sophisticated lead plaintiffs disagree: some use the declining percentage of the recovery formula, which reduces the fee award as a percentage of the recovery as the recovery passes certain thresholds; others prefer an increasing percentage formula that is intended to incentivize counsel to maximize the recovery.<sup>16</sup> The average of these polarly divergent approaches would not be adopted by either group. Second, complete reliance on the fee agreements overlooks the increasing danger that counsel can bribe or induce even institutional investors to agree to an excessive fee award. To date, only public pension funds have volunteered in sizable numbers to serve as lead plaintiff, and public pension funds often are administered by elected political officials having sole discretionary authority over their decisions. These elected officials are necessarily eager to attract political contributions, and plaintiffs' law firms have responded quickly to this opportunity. As a result, "pay to play" practices have rapidly developed, and today it is not hard to find examples of plaintiffs' law firms exchanging large political contributions with elected officials in remote jurisdictions in return for the apparent right to use their pension fund as a lead plaintiff.<sup>17</sup> Although law firms may be agents to their clients in theory, the

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Cir. 1995) and *In re Continental Illinois Sec. Litig.*, 962 F.2d and 566 (7th Cir. 1992).

15. 264 F.3d 712 (7th Cir. 2001).

16. In *In re Alcatel Alsthom Securities Litigation*, MDL No. 1263, the lead plaintiffs negotiated a fee contract with class counsel under which class counsel would receive the greater of (i) 6% of the first \$300 million, 9% of the next \$300 million, and 12% of all recoveries above \$600 million or (ii) three times their lodestar. The premise of such an increasing formula is that the "first dollars come cheap" and progressively greater incentive is needed to obtain a larger recovery by accepting the risk of trial. A similar increasing percentage was also negotiated by the lead plaintiffs in *McNamara v. Bre-X Minerals, Ltd.*, 5:97-CV-159 (N.D. Tex. 2001), under which counsel will receive 17% of the first \$25 million and 22.5% of any recoveries above that level and 26% of the recovery if the action is resolved through a trial. The author has advised the lead plaintiffs in both these cases.

17. For a good survey of the level of campaign contributions now being made by traditional plaintiffs' firms to state and municipal comptrollers in distant jurisdictions where such officials have control over a pension fund, see Kevin McCoy, "Campaign Contributions or Conflicts fo Interest?," USA Today, September 11, 2001 at p.1B. The Third Circuit also noted this problem in its *Cendant* decision. See *In re Cendant Corp. Litig.*, 264 F.3d 201, 270 n. 49 (3rd Cir. 2001). See also Note, *The ABA Should Not Delay on Pay to Play: Regulating the Political Contributions of Lawyers to Government Officials Who Award Legal Contracts*, 49 Stan. L. Rev. 1523 (1997).

reality is that “pay-to-play practices” allow them to become *de facto* principals and to acquire control over a given jurisdiction’s pension fund.

The Task Force is sensitive to this problem, but its proposed remedy is inadequate. Its Report would only require disclosure to the court of contributions to an official having control or substantial influence over a pension fund.<sup>18</sup> Yet, even the ABA’s rules go further and forbid the use of political contributions to obtain legal business.<sup>19</sup> A stronger, more prophylactic rule should have been recommended that the pension fund’s choice of a class counsel should be disqualified when either the firm, or any of whose partners, had contributed to the campaign of any elected official administering or holding substantial influence over the fund.

### CONCLUSION

In fairness, it is best to conclude by re-emphasizing that the Task Force has done much that it is right. In incisive, readable language, it has explained the problem with auctions. Most systems have problems, however, and it is not an entirely fair comparison to contrast the deficiencies in auctions with an assumed perfect world that exists in their absence.<sup>20</sup> The “lead plaintiff” concept may well prove superior, but it too is subject to unique risks: political corruption and limited incentives to serve.

In the last analysis, litigation governance is inherently more complicated than corporate governance, because in the former context the agent does not bear most of the “agency costs” inherent in the relationship.<sup>21</sup> That is, an entrepreneur in the corporate world must convince shareholders that the entrepreneur is honest and will work diligently for the shareholders’ interests in order for the entrepreneur to be able to sell shares in his or her firm at a high price. Thus, the entrepreneur voluntarily installs monitoring and bonding controls in order to maximize share value and so bears most of the agency costs in the relationship. In contrast, the legal entrepreneur need not sell securities to its clients (although the plaintiff’s attorney is in reality a joint venturer with them

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18. See Task Force Report at 18, Recommendation No. 6 (“Court should require public institutional investors seeking appointment as lead plaintiffs to disclose whether chosen counsel has made contributions to the campaign of any public officials who have authority or substantial influence over the institutional decisionmaker.”); TEMPLE at 705.

19. See ABA Model Rules of Professional Conduct, Rule 7.6 (lawyer may not accept a “governmental legal engagement” if lawyer or firm has made or solicited political contributions for purposes of being considered for that appointment). Uncertainty exists, however, as to whether the appointment of class counsel constitutes a “governmental legal engagement.” See Task Force Report at 78; TEMPLE at 755. In any event, the ABA rule is only effective if adopted by individual states, and to date it has not been.

20. Law and economics scholars often refer to this error as the “nirvana fallacy.”

21. For the standard theory of agency costs, see M. Jensen and W. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976). This seminal article applies to all forms of agency relationship, but correctly notes that corporate managers have an incentive to control their own opportunism in order to maximize the price at which they can sell their firm’s securities to investors.

by virtue of the contingent fee), but must only convince the court that it has performed adequately to merit a fee award. In this latter endeavor, it is usually joined by the defendants who have every incentive to cooperate in order to convince the court that the settlement is fair and should be approved. Even the reviewing court is to a degree self-interested because rejecting a settlement implies that the court must keep a usually complex and time-consuming case on its docket. As a result, agency costs would appear to be higher in the litigation governance context than in that of corporate governance generally. Ultimately, the solution to this problem lies in structuring greater competition into the process.<sup>22</sup>

In this light, the Third Circuit Task Force Report should be read as a critique of one possible reform, but not as a reliable indicator that "all is well." It is not.

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22. For proposals toward this end, see John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice and Loyalty in Representative Litigation*, 108 Colum. L. Rev. 370 (2000). Auctions may prove to be an ineffective means to this end, but at least they had the correct goal (greater competition among agents) clearly in view. Their real weakness may be that they operate only *ex ante* and do not create *ex post* competition (as, for example, an effective right to opt out from the class does).