Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging

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The politicians’ rhetoric seemed promising enough. With corporate scandals making front page headlines and defrauded investors facing hundreds of billions of dollars in losses, legislators vowed to “help defrauded investors to recoup their losses.”1 The Bush Administration similarly promised “to put the bad guys in prison and take away their money.”2 Seeking to calm the traumatized stock markets and anticipating voter outrage, the election-year Congress expedited, and President Bush signed into law, new antifraud legislation. This legislation, the Sarbanes-Oxley Act of 2002, attempts to strengthen the authority of the Securities and Exchange Commission (SEC) and to deter future wrongdoing by corporate executives and accountants through a variety of new regulations.3 However, in their lawmaking efforts, federal legislators largely ignored questions about whether and how injured investors would get any money back.

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1. See, e.g., Accountability Issues: Lessons Learned from Enron’s Fall: Hearing Before the S. Judiciary Comm., 107th Cong. (2002) (statement of Sen. Patrick J. Leahy) (“Congress can do more to make sure that our laws help deter corporate fraud and we should help defrauded investors to recoup their losses. In fact, by forcing through special exemptions for securities fraud, accountants and others made Congress a contributor to the Wild West mentality that came to be reflected in Enron’s hidden partnerships. The time has come for Congress to re-think and reform our laws in the other direction ...”), http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_senate_hearings&docid=f:84416.pdf.


Now, with fresh reforms in the statute books, public attention has turned from Capitol Hill to the courts, where federal judges face the largest number of investor class actions ever filed. The plaintiffs’ bar has invaded, seeking hundreds of billions of dollars on behalf of shareholders of some of this country’s largest publicly traded corporations—Enron, WorldCom, Tyco, Johnson & Johnson, Merck, Time Warner, Motorola, and HealthSouth. The list grew longer each month in 2002 and early 2003. Plaintiffs’ lawyers filed a record 261 class action fraud complaints last year, including claims against seven of the thirty companies comprising the Dow Jones Industrial Average and against one out of every eight corporate constituents of the Standard & Poor’s 500 index. With an unprecedented number of large-cap companies restating their financial results and spawning new investigations by the bigger-budget SEC, more “megasecurities litigation” has flooded the federal courts than ever before.


5. The recent proliferation of megacases is exemplified by the fact that the well-publicized Enron securities class action, a case involving $60 billion in losses, represented only the seventh largest securities fraud lawsuit filed in 2001. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS—2001: A YEAR IN REVIEW 6 (2002), http://securities.cornerstone.com/pdfs/yir_Filings.pdf (last visited Nov. 21, 2003). Cornerstone Research calculates “maximum dollar loss” as the dollar value decrease in the market capitalization of the defendant issuer from the trading day on which the issuer’s market capitalization reached its maximum during the class period to the trading day immediately following the end of the class period. Id. at 2. Another study completed by Woodruff-Sawyer in 2002 found that the number of securities fraud suits against companies with market capitalizations above $10 billion has more than tripled since 1995. WOODRUFF-SAWYER & CO., A STUDY OF SHAREHOLDER CLASS ACTION LITIGATION 13 (2002).


8. During the first nine months of fiscal year 2003, the SEC filed 443 enforcement actions, suspended 11 companies from trading, and froze the assets of 30 companies. SEC’s Donaldson
Decisions made by the judges overseeing this maelstrom of lawsuits not only will attract continued attention from the media, but these cases also likely will alter the jurisprudence of securities law enforcement for years to come, generating fodder for legal academics. As in the past, most scholars will focus their work on the deterrence impact of private litigation. At the end of the day, however, we also should inquire about the results actually achieved for the victims of the fraud. How much money will shareholders injured by deceptive accounting and management practices receive as compensation for their losses? Will these class actions merely transfer wealth from corporate wrongdoers and their insurers to opportunistic plaintiffs’ lawyers?

Certainly the lawsuits hold the promise of enormous potential profits for class counsel. As a general matter, the larger the company sued (as measured by market capitalization), the larger the losses suffered by the putative class, and the larger the potential settlement fund. In 2002, more than half of all securities class actions generated attorneys’ fees of 25% or more of the settlement funds amassed. Assuming that a megacase settles for $100 million, plaintiffs’ counsel could expect to receive $25 million for their litigation services. In fact, a number of the pending megacases likely will settle for well over $100 million. Eight megasecurities class actions recently settled for more than $200 million.


9. No single definition of “megacase” exists. However, as used in this Article, “megasettlements” refer to settlements of securities class actions in excess of $100 million.


11. One study of securities class action settlements determined that, generally, “the size of the average settlement grows with the size of the market cap.” Further, “[t]he settlement value of shareholder class actions is driven in large part by the loss in shareholder value (market capitalization). Since the passage of the Reform Act, there is a trend of increasing losses in shareholder values, which results in higher settlement values.” WOODRUFF-SAWYER & CO., supra note 5, at 14, 33; see also BUCKBERG ET AL., supra note 6, at 9 (“Investor losses, an estimate of what investors lost over a class period relative to an investment in the S&P, are the single most powerful determinant of settlements . . . .”).

From these settlement funds, plaintiffs’ counsel applied for awards of “mega attorneys’ fees,” receiving as much as 20% of the funds recovered through settlement. One insurance industry analyst recently estimated that thirty-six of the one thousand securities class actions currently on file in the federal courts will settle for more than $500 million each. If class counsel receives court-ordered fee awards of just 10% of such settlement funds, critics of private enforcement certainly will have new ammunition in their war against the plaintiffs’ securities bar.

The substantial financial incentive motivating plaintiffs’ lawyers to file investor lawsuits—and counsel’s actual behavior in response to those incentives—sparks the debate and ignites the rhetoric in discussions about the social benefits of securities class actions. Although private enforcement of the securities laws depends on critical investments by entrepreneurial attorneys, every dollar awarded by the courts to the attorneys as return on these investments is a dollar not available for

13. See Stanford Law School Securities Class Action Clearinghouse, at http://securities.stanford.edu (last modified Nov. 17, 2003). These settlements include: the Cendant litigation ($3.525 billion, including $3.185 billion in the common equity settlement and $340 million in the Prides settlement); the Lucent Technologies litigation ($563 million); the Bank of America securities litigation ($490 million); two separate private class actions settled by Waste Management ($457 million and $220 million); the Rite Aid litigation (settlements totaled more than $334 million); the Oxford Health Plans litigation ($300 million total from all defendants); and the 3Com litigation ($259 million).


15. Lewthwaite, supra note 6, ¶ 23.


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injured investors. The most persistent objection to securities class actions is that their prosecution does much for the lawyers but little for defrauded investors or the public interest. Class action lawyers stand accused of “abusing” the legal system for their personal gain at the expense of the investors they represent. Corporate defendants, reform-minded legislators, and the business press have vilified the securities class action bar as “greedy,” “extortionist” “bounty hunters.” By reporting on the multimillion-dollar fee awards obtained by some notorious members of the plaintiffs’ bar, the popular media have further inflamed the public’s offense. 

18. Of course, under the so-called “American rule,” parties in civil litigation must pay their own legal fees unless otherwise provided by statute. Alyeska Pipeline Serv. Co. v. Wilderness Soc’y, 421 U.S. 240, 247–50 (1975); see also infra note 54.


20. Congress has also expressed concern that plaintiffs’ attorneys pursue claims with little or no merit, or without regard for their merit, leading to overdeterrence and less disclosure of forward-looking information to investors. See H.R. CONF. REP. NO. 104-369, at 31–32 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 730–31 [hereinafter CONFERENCE REPORT]. The impact of abusive securities litigation on defendants’ disclosure of material information to investors is beyond the scope of this Article.

21. E.g., 141 CONG. REC. S9173 (daily ed. June 27, 1995); see also, e.g., 141 CONG. REC. S17,957 (daily ed. Dec. 5, 1995) (statement of Sen. Christopher Dodd) (“Taken together, Mr. President, [the PSLRA] should ensure that defrauded investors are not cheated a second time by a few unscrupulous lawyers who skim their exorbitant fees right off the top of any settlement.”); 141 CONG. REC. S8894 (daily ed. June 22, 1995) (statement of Sen. Christopher Dodd) (“[S]ettlement sounds good for entrepreneurial attorneys, but it does little to benefit companies, investors or even the plaintiffs on whose behalf the suit was brought.”).


There often is substantial publicity of successful class actions, and the focus of the publicity will naturally be on the amount of the recovery if it is large. Large recoveries get public attention, and large recoveries often result in substantial attorneys’ fees that also attract attention. When class actions are dismissed, the publicity is often sparse or nonexistent, and the fact that class lawyers are uncompensated is often not understood. Motions to dismiss on the pleadings are not big news, although they are common in a number of class action scenarios. 

Id. Examples of news stories reporting on fees awarded to lawyers in securities class actions include: Kurt Eichenwald, Millions for Us, Pennies for You, N.Y. TIMES, Dec. 19, 1993, § 3, at 1; Peter Elkind, The King of Pain Is Hurting, FORTUNE, Sept. 4, 2000, at 190; Peter Thal Larsen, New Life for the US Lawyers Who Help Shareholders Sue: Corporate Scandal and Falling Stock Markets Have Boosted Class Action Litigation, FIN. TIMES (LONDON), Mar. 28, 2002, at 26. See also Dominic Rushe, America’s $20bn Pied Piper of Class Actions, SUNDAY TIMES (LONDON), May 5, 2002, Business, at 10 (“There’s a whole industry out there saying securities litigation is all
significant part of the nonlawyer population and even among lawyers and judges that the risk premium is too high in class action cases and that class action plaintiffs’ lawyers are overcompensated for the work that they do.\(^{23}\)

In 1995, seemingly persuaded that class counsel enrich themselves at the expense of injured investors,\(^{24}\) Congress passed the Private Securities Litigation Reform Act (PSLRA).\(^{25}\) Among other objectives, federal legislators sought to protect absent class members from “manipulation by class action lawyers” and “lawyer-driven lawsuits” by “giving control of the litigation to lead plaintiffs with substantial holdings of the securities of the issuer.”\(^{26}\) The PSLRA empowered lead plaintiffs to select and retain counsel for the class, subject to court approval. Congress apparently assumed that the lead plaintiffs’ relatively larger economic interest in the outcome of the lawsuit and, presumably, greater sophistication would forestall awards of windfall fees to class counsel and increase the compensation received by the class. To help ensure this result, Congress prohibited judges from awarding to lead counsel total fees and expenses exceeding “a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class.”\(^{27}\)

However, even after nearly eight years of practice under the PSLRA, it is not clear that the fee regulations have impacted the economic incentives motivating private enforcers. A number of presiding judges have reduced requested fee awards, but such decisions are unpredictable,

\(^{23}\) Task Force 2001 Report, supra note 22, at 692.

\(^{24}\) Congressional hearings preceding enactment of the Private Securities Litigation Reform Act of 1995 included testimony recounting various examples of alleged self-dealing and other abusive practices by the plaintiffs’ bar. See infra Part I.A.


\(^{26}\) CONFERENCE REPORT, supra note 20, at 31–32. Congress also sought to reform the law to thwart three other abusive practices by plaintiffs’ lawyers: (1) “the routine filing of [meritless] lawsuits against issuers of securities and others whenever there is a significant change in an issuer’s stock price”; (2) “the targeting of deep pocket defendants . . . without regard to their actual culpability”; and (3) using discovery “to impose costs so burdensome” that defendants choose to settle. Id. at 31. However, these three abuses primarily harm defendants. This Article instead focuses on reforms targeted to benefit absent class members.

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and no published empirical studies have compared the attorneys’ fees awarded by courts prior to reform with fees awarded by courts after reform. In the meantime, some commentators have advocated for more active intervention by the courts. With the number and size of securities fraud lawsuits ballooning, commentators are appealing to the courts to protect absent class members.28 Noting that presiding judges are the self-proclaimed “fiduciaries,” “agents,” or “guardians” of absent class members, scholars have proposed various mechanisms by which district judges may fulfill their duties to scrutinize (and cut) the lawyers’ fee requests. Appellate courts, too, have begun to admonish the lower courts that they themselves must intervene more actively in class actions to protect absent class members, especially in compensating class counsel.29

These entreaties to presiding judges raise important and previously unexamined questions about the proper exercise of judicial authority under the PSLRA’s statutory regime. Can judges make securities class actions more “virtuous”30 by assuming for themselves fiduciary obligations to absent class members? This Article argues that they cannot. Judges cannot perform fiduciary duties on behalf of absent class members and still fulfill their responsibilities as impartial arbiters of the parties’ disputes. Furthermore, Congress recognized that the judiciary cannot efficiently and effectively police opportunistic behavior by the plaintiffs’ bar. The PSLRA assigns that monitoring responsibility to the lead plaintiffs for the class, persons whose interests are more closely aligned with the interests of absent class members.

As the new wave of megacases moves through the judicial system, it is timely to probe the judiciary’s role in reforming securities class actions. Part I of this Article summarizes the perceived attorney

28. See, e.g., CLASS ACTION DILEMMAS, supra note 19, at 485–86 (“[I]t is judges who hold the key to improving the balance of good and ill consequences of damage class actions.”); James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 Ariz. L. Rev. 497, 524 (1997) (advocating for judges to “become more active in their reviews” of settlement proposals and fee applications); Judith Resnik, Money Matters: Judicial Market Interventions Creating Subsidies and Awarding Fees and Costs in Individual and Aggregate Litigation, 148 U. Pa. L. Rev. 2119, 2175–77, 2190–95 (2000) (urging increased judicial regulation of class counsel by, among other things, requiring counsel to disclose fee information and agreements and by employing public attorneys to assist judges in evaluating the fairness of proposed settlements); see also William C. Rand, The Role of the Judge as Protector in Class Action Settlements, N.Y. L.J., Sept. 24, 2002, at 4 (arguing that when a class action settles, the judge becomes a fiduciary for absent class members).

29. See infra Part III.B.

30. Cox, supra note 28, at 523 (referring to the judiciary as “[v]irtue’s [s]lumbering [g]uardian”).
opportunism that has inspired judges to appoint themselves as fiduciaries for injured investors. This section describes the need for private enforcement of the securities laws, the economics of the traditional private attorney general model, and the potential for abuse by the plaintiffs’ bar. Part I also reviews the agency cost theory that explains counsel’s incentives to act against the interests of the putative class in prosecuting shareholder lawsuits. Part II discusses the courts’ authority to award attorneys’ fees under Rule 23 of the Federal Rules of Civil Procedure and the traditional methods and heuristics used by judges to determine reasonable fees at the conclusion of the litigation. After examining the vexing obstacles that have long plagued effective ex post judicial regulation of attorneys’ compensation, Part III considers Congress’s efforts to reform securities class actions. The PSLRA’s empowered lead plaintiff model specifies duties for judges presiding in these cases. Part III describes the responsibilities of the bench as articulated in the statute before analyzing how the courts have reacted to congressional reforms. Specifically, this section reviews post-PSLRA cases in which courts have reduced class counsel’s requested fees at the conclusion of the litigation, selected and retained lead counsel themselves, or appointed the lead plaintiff based upon the fee negotiated with counsel. These decisions illustrate that confusion persists. Courts cannot seem to agree on the proper approach to calculate reasonable fees, much less how to apply a particular methodology when they decide how much to pay the lawyers at the conclusion of the case. The lack of predictability associated with ex post judicial regulation of attorney compensation skews the incentives of the private attorney general and undermines the effectiveness of the private enforcement regime. Yet, judges who have attempted to avoid these inefficiencies by intervening on behalf of the putative class at the inception of the litigation have infringed on the lead plaintiffs’ rights, as granted by Congress, to select and retain lead counsel.

Part IV evaluates the extra-statutory justification for greater judicial activism in this area—the widely accepted but uncritical claim that judges must represent the interests of absent class members as fiduciaries. For both normative and pragmatic reasons, I contend that the courts cannot become default fiduciaries for absent class members. The notion that judges owe fiduciary duties to absent class members conflicts with the classical model of the judicial role, violates the current statutory scheme, and causes injury to prudential values. Rather than assuming fiduciary obligations themselves (performing as fiduciary judges), the
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courts instead should focus their efforts on judging fiduciaries (lead plaintiffs and lead counsel) more effectively. In Part V, I explain that presiding judges can reduce agency costs in securities class actions most efficiently and effectively by allowing—in fact, by ordering—lead plaintiffs to negotiate fee agreements with lead counsel at the inception of the case and approving the negotiated fee arrangements as reasonable, absent extraordinary circumstances.

I. EVALUATING THE TRADITIONAL PRIVATE ATTORNEY GENERAL MODEL

A. The “Need” for Private Enforcement of the Securities Laws

The argument supporting private enforcement of the securities laws is well recognized, though not unassailable. It begins with the assertion—recently publicized in connection with the uncovering of major corporate misdeeds at Enron, WorldCom, and elsewhere—that the government lacks sufficient resources to prosecute many violations of the antifraud provisions of the relevant federal statutes. The SEC, as the federal agency principally charged with responsibility for securities law enforcement, has suffered from persistent underfunding for many years. In fact, more than a decade ago, then—SEC Chairman Richard Breeden told federal lawmakers that budgetary limitations meant that private class actions must "perform a critical role in preserving the

31. See, e.g., Mike France, Don’t Kill All the Trial Lawyers, Bus. Wk., Aug. 26, 2002, at 156 ("At a time when regulators are a step behind public anger and self-policing is a joke, the attorneys who make a living suing Corporate America have become one of the most powerful forces compelling executives to behave."); Pitt Says SEC Needs More Bodies to Fight Fraud, Wall St. J., Apr. 18, 2002, at C3.

32. See, e.g., Noelle Knox and Matt Krantz, SEC Funding a Drop in the Bucket, USA Today, July 18, 2002, at 2B (reporting that David Ruder, former SEC chairman, has determined that the agency has been underfunded since at least 1980); Stephen Labaton, SEC Is Suffering Nonbenign Neglect, N.Y. Times, July 20, 2002, at B1 ("Although both Republican and Democratic chairmen forged a series of policy initiatives on behalf of investors, the agency’s vital infrastructure has been sorely neglected, starved of adequate money and manpower by politicians. That hobbled its ability to keep up with the markets at the worst possible moment—just as ordinary Americans plowed huge amounts of their savings into the markets."); see also U.S. Gen. Accounting Office, SEC Operations: Increased Workload Creates Challenges, GAO-02-302, at 11–14 (Mar. 5, 2002) [hereinafter SEC Operations] (documenting restrictions on SEC staff resources and explaining the resulting constraints on SEC enforcement actions), available at http://www.gao.gov/new.items/d02302.pdf.
integrity of our securities markets. After a few years later, Breeden’s success, Arthur Levitt, declared that private lawsuits, rather than government actions, had become “the primary vehicle for compensating defrauded investors.” Unless law enforcement efforts are privatized, victims of fraud will go uncompensated for their injuries, wrongdoers will go unpunished and undeterred (or at least underpunished and underdeterred), and, consequently, the U.S. economy will suffer as investors lose confidence in the integrity of the capital markets. When it enacted the PSLRA, Congress lauded private securities litigation as “an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action.” The Supreme Court, too, has recognized that private enforcement of the securities laws must supplement government regulatory efforts for the benefit of defrauded investors and the capital markets generally. The benefits of private enforcement—the private attorney general model—derive from the reality that the government simply cannot pursue many persons who violate federal antifraud proscriptions. “The SEC is overwhelmed” and


34. Common Sense Legal Reform Act: Hearing Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce, 104th Cong. 1 (1995) (prepared statement of then–SEC Chairman Arthur Levitt) (“[P]rivate actions . . . provide a ‘necessary supplement’ to the Commission’s own enforcement activities by serving to deter securities law violations. Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.” (footnote omitted)), available at http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt (last visited Nov. 21, 2003).

35. HERBERT B. NEWBERG & ALBA CONTE, NEWBERG ON CLASS ACTIONS § 22-6 (3d ed. 1992) (“Private enforcement is necessary to afford relief to those investors injured by violations of the securities laws. The SEC and the judiciary have recognized that the class action may be the only meaningful and viable method by which securities investors may remedy their claims.” (footnote omitted)).

36. CONFERENCE REPORT, supra note 20, at 31.


38. See SEC Operations, supra note 32, at 11 (reporting that the agency’s “ability to fulfill its mission has become increasingly strained” due to, among other things, “imbalances between [the SEC’s workload . . . and [its] staff resources”).

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“nothing would be done except for class-action lawyers.”39 Furthermore, the government faces numerous legal and practical obstacles in compensating injured investors itself.40

In truth, we simply cannot know whether the compensation and deterrence benefits of securities class actions justify the costs of such litigation because the benefits and costs are difficult to measure.41 According to Congress, however, the social benefits of private securities litigation do outweigh the costs. Lawmakers concluded in 1995 that class actions are socially beneficial, both for compensating victims of securities fraud and for deterring future wrongdoing by corporate actors, thereby promoting confidence in the nation’s securities markets.42 Private securities litigation “promote[s] public and global confidence in our capital markets and help[s] to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers, and others properly perform their jobs.”43 Congress has affirmed that enforcement of the securities antifraud laws should not be left exclusively to government prosecutors.

B. The Economics of Private Enforcement

Although Congress sanctioned enforcement of the securities laws by victims of fraud, many diversified investors who lose money in the securities markets do not have enough damages at stake to seek out

41. Deborah R. Hensler, Revisiting the Monster: New Myths and Realities of Class Action and Other Large Scale Litigation, 11 DUKE J. COMP. & INT’L L. 179, 205 (2001) (reporting results of ten case studies of resolved consumer and mass tort class actions and concluding that “[d]etermining whether the benefits of Rule 23 damage class actions outweigh their costs—even in only ten lawsuits—turned out to be enormously difficult”). Indeed, for any particular lawsuit, it is difficult to determine whether class counsel have achieved the optimal outcome for the class members. Information concerning the merits of the allegations, likelihood of success on the claims, and amount of damages is not readily available for analysis, and the actual cost of prosecuting the lawsuit is information well guarded by plaintiffs’ counsel.
42. CONFERENCE REPORT, supra note 20, at 31–32.
43. Id. at 31.
counsel to investigate potential fraud claims against the company and its officers, directors, and advisors. The class action, as a procedural device, enables the economic prosecution of private securities fraud claims by aggregating the losses of thousands of similarly situated investors, thereby conserving litigation costs and attracting the interest of plaintiffs’ counsel willing to represent a large number of injured investors on a contingent fee basis. The attorney for the plaintiff class serves as a “private attorney general,” an enforcer of legal claims otherwise unprosecuted by the government.

Drawn to such cases by the large aggregate value of securities fraud claims against public companies and the prospect of collecting huge damages, lawyers for the proposed class must invest significant time and assets at the beginning of the case. Plaintiffs’ counsel must recognize the claims, investigate their merits, decide whom to sue and where, and file the complaint as a putative class action after selecting one or more injured investors who will sue and serve as putative lead plaintiff(s) and class representative(s). Plaintiffs’ counsel—and not the named plaintiffs or absent class members—then assumes the true risk that the court will

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44. The prototypical class action complaint alleges that the defendant issuer, through its senior management and/or advisors, misrepresented or fraudulently failed to disclose material information about the company to the market in order to inflate the price of the company’s securities artificially. When truthful information about the company is revealed to the market, the price of the securities corrects to its “proper” level, damaging investors who traded in the interim.

45. Scholars have challenged this presumption in recent years. See infra Part III.

46. Janet Cooper Alexander, Contingent Fees and Class Actions, 47 DEPAUL L. REV. 347, 347–48 (1998) (“Contingent fees are the nearly universal form of compensation for class counsel. Indeed, in most class action litigation no other form of compensation would be practical.” (footnote omitted)).

47. The phrase “private attorney general” denotes “someone who is understood to be suing on behalf of the public, but doing so on his own initiative, with no accountability to the government or the electorate.” Jeremy A. Rabkin, The Secret Life of the Private Attorney General, LAW & CONTEMP. PROBS., Winter 1998, at 179, (tracing the history of the private attorney general model).

48. Defendants’ potential liability runs to all persons who traded at a price affected by the alleged fraud, and these investors may receive in damages the difference between the purchase or sale price, as appropriate, and the mean trading price of the security during a 90-day period beginning on the date on which the market received the corrected information. See Securities Exchange Act of 1934, § 21D(c)(1)–(3); 15 U.S.C. § 78u-4 (2000). Since thousands of investors and millions of shares typically are at issue, the dollar amounts in dispute may total hundreds of millions if not billions of dollars. Thus, the average damages award in securities class actions greatly exceeds the average damages award in other federal class action litigation. Thomas E. Willging et al., An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges, 71 N.Y.U. L. REV. 74, 90 (1996).
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dismiss the claims or refuse to certify the class.\textsuperscript{49} Absent class members effectively relinquish authority over their claims to plaintiffs’ counsel.\textsuperscript{50} Insofar as the attorneys command “nearly plenary control over all important decisions in the lawsuit,”\textsuperscript{51} the potential for self-dealing by the lawyers at the expense of the class is evident.

Further, because plaintiffs’ counsel is paid a contingent fee, the return to absent class members is reduced by the amount of the fee awarded from the common fund. Hence, there is a conflict of interest endemic to class action litigation, indeed, to all contingent fee litigation. In contrast to other contingent fee lawyers, however, class attorneys typically do not contract ex ante for compensation.\textsuperscript{52} Rather, they prosecute the lawsuit with the expectation that they will recover their fees and costs at the conclusion of the litigation if they achieve a successful outcome.\textsuperscript{53} Assuming the attorney creates a fund benefiting the investor class, either through settlement or judgment on the merits, she may recover her fees and expenses from that pool of money under the equitable “common fund” doctrine.\textsuperscript{54} Courts determine the amount of any award to class counsel ex post.

\textsuperscript{49} Patricia M. Hynes, \textit{Plaintiffs’ Class Action Attorneys Earn What They Get}, 2 J. INST. FOR STUDY LEGAL ETHICS 243, 244–46 (1999). Class counsel stands to lose its entire investment of time as well as its investment of money for out-of-pocket expenses if the court dismisses the lawsuit on the pleadings, refuses to certify the case as a class action, or enters summary judgment in favor of the defendants. Assuming the lawsuit survives these challenges, it is likely that the case will settle and counsel will receive an award of fees and expenses. See infra notes 58 and 74. That award likely includes a risk premium on counsel’s investment of time and reimbursement of most, if not all, out-of-pocket costs advanced by the law firm.

\textsuperscript{50} In this regard, the representation model in class actions flies in the face of “[a] fundamental premise of American adjudicative structures . . . that clients, not their counsel, define litigation objectives.” Deborah L. Rhode, \textit{Class Conflicts in Class Actions}, 34 STAN. L. REV. 1183, 1183 (1982). Judge Richard Posner has described class action litigation as a “fundamental departure from the traditional pattern in Anglo-American litigation” insofar as “lawyers for the class, rather than the clients, have all the initiative and are close to being the real parties in interest.” Mars Steel Corp. v. Con’t Ill. Nat’l Bank & Trust Co., 834 F.2d 677, 678 (7th Cir. 1987).

\textsuperscript{51} Macey & Miller, supra note 17, at 3.

\textsuperscript{52} The Model Rules of Professional Responsibility require that attorneys agree to contingent fees in writing prior to inception of the case. \textit{MODEL RULES OF PROF’L CONDUCT R. 1.5(c) (1983).} The PSLRA has encouraged some ex ante contracting, subject to judicial review at the end of the case, as discussed in Part III.

\textsuperscript{53} Alexander, supra note 46, at 348.

\textsuperscript{54} The common-fund doctrine is a recognized exception to the “American rule” under which both parties bear their own legal fees and expenses regardless of the outcome of the litigation. See Boeing Co. v. Van Gemert, 444 U.S. 472, 478–81 (1980); see also \textit{Court Awarded Attorney Fees: Report of the Third Circuit Task Force}, 108 F.R.D. 237, 241 (1985) [hereinafter \textit{Task Force 1985 Report}]. Derived from the doctrine of unjust enrichment, the common-fund doctrine provides that a plaintiff who sues as a representative of other persons and recovers a fund for the benefit of others
C. Overpaying Class Counsel: The Indictment

Class action critics have long claimed that too much of the money recovered on behalf of investors goes to the lawyers, and that class counsel most certainly receive excessive awards of attorneys’ fees from the courts. Despite the pervasive notion that attorneys receive windfalls from securities class actions, empirical evidence that lawyers serve their own interests at the expense of absent class members is difficult to develop. The evidence of self-dealing by class counsel is largely anecdotal and circumstantial. For example, critics typically compare the amount of fees awarded by the courts to the lawyers for the class with the amount of money or other consideration received by each class member. During the previous decade, plaintiffs’ lawyers in securities class actions typically received 30% of multimillion-dollar compensation funds. The average award to class counsel in securities fraud cases was

55. For an interesting analysis of how the public perceives plaintiffs’ lawyers who represent clients on a contingent fee basis, see Marc Galanter, Anyone Can Fall Down a Manhole: The Contingency Fee and Its Discontents, 47 DEPAUL L. REV. 457 (1998).

56. As Arthur Miller, a proponent of class actions, opined,

It seems to me that facile invocations of a cliché or epithet like “windfall” are becoming a substitute for (or reflect an unwillingness to come to grips with) responding to more challenging questions. “Windfall” to whom? By what standards is that to be judged? Aren’t there countervailing values and policies? In a subjective, human process aren’t some outlier cases (including cases in which class counsel are significantly undercompensated) inevitable?


57. Hensler, supra note 41, at 203 (“Critics often use [another] benchmark to assess plaintiff class action attorney fees: the amount the attorneys are awarded, compared to the amount class members receive. Because class counsel are paid for what they accomplish for the class as a whole, their fee awards will almost certainly be greater than any individual class member’s award . . . .”).

58. Between January 1991 and May 1999, some 733 federal securities class actions settled for total payments of $6.1 billion. Of that amount, $1.837 billion, approximately 30%, went to lawyers for the plaintiff classes. See TODD S. FOSTER ET AL., NATIONAL ECONOMIC RESEARCH ASSOCIATES, RECENT TRENDS VI: TRENDS IN SECURITIES LITIGATION AND THE IMPACTS OF PSLRA 7 (1999) [hereinafter TRENDS VI]. Other prereform studies of settled shareholder class actions found that attorneys received average fee awards of approximately 28% and 29% of funds recovered. See PRIVATE LITIGATION UNDER THE FEDERAL SECURITIES LAWS: HEARING BEFORE THE SUBCOMM. ON SEC. OF THE S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, 103d Cong. 740 (1993) (average attorneys’ fees in federal securities class actions between July 1991 and June 1992 were 28% of settlements, and were 29% of funds recovered in securities class actions settled between July 1992 and June 1993).
$2.5 million compared to an average gross settlement of $8.3 million.\textsuperscript{59} Class members recover, on average, just a fraction of the total damages claimed in these lawsuits.\textsuperscript{60} During the congressional hearings that preceded passage of the PSLRA in 1995, lawmakers heard testimony that shareholders in class actions received just 14 cents for every dollar lost, while the lawyers received, on average, a third of the amount recovered. Because judges seldom deviated from benchmark awards of 25% to 33% of the common fund\textsuperscript{61}—much less refused counsel’s fee requests—legislators might well have agreed that the courts awarded excessive fees in securities class actions before reform.\textsuperscript{62}

Investors apparently have not fared better since enactment of the PSLRA. One recent study indicates that class members recover, on average, just 5.1% of their estimated damages.\textsuperscript{63} Other researchers have reported that the average securities class action settlement recovered 3% to 7% of potential investment losses (measured by market drop) between 1988 and 1999.\textsuperscript{64} Statistics like these support the impression that lawyers are the only big winners in securities class actions; the lawyers make

\textsuperscript{59} TRENDS VI, supra note 58, at 7.

\textsuperscript{60} Keith L. Johnson, Deterrence of Corporate Fraud Through Securities Litigation: The Role of Institutional Investors, LAW & CONTEMP. PROBS., Autumn 1997, at 155, 157 (citing a 1996 study by National Economic Research Associates reporting that the ratio of settlement funds to plaintiffs’ claimed damages did not exceed 14% on average). The charge that class actions benefit lawyers for the class rather than class members themselves is not unique to securities class actions and, in fact, has generated debate since the early 1970s. For a historical perspective of the controversy, see CLASS ACTION DILEMMAS, supra note 19, at 15–47. See also Herbert M. Kritzer, Seven Dogged Myths Concerning Contingency Fees, 80 WASH. U. L.Q. 739 (2002).

\textsuperscript{61} Joseph A. Grundfest, Attorneys Fees in Class Action Securities Fraud Litigation: A Proposal for Addressing a Problem That Has No Perfect Solution 6 (June 1, 2001) [hereinafter Grundfest Proposal] (testimony presented before the Third Circuit Task Force on Selection of Class Counsel), at http://www.ca3.uscourts.gov/classcounsel/Witness%20Statements/grundfest2.pdf; see also, e.g., In re Pac. Enters. Sec. Litig., 47 F.3d 373, 379 (9th Cir. 1995) (benchmark attorneys’ fee award of 25% of recovery is reasonable, with adjustments of up to 33% depending on the complexity of the case, risk involved, and nonmonetary benefits achieved).

\textsuperscript{62} See, e.g., Jill E. Fisch, Aggregation, Auctions and Other Developments in the Selection of Lead Counsel Under the PSLRA, LAW & CONTEMP. PROBS., Spring/Summer 2001, at 53, 94.

\textsuperscript{63} Steve Seidenberg, Little Guys Look at Very Long Odds, NAT’L L.J., Nov. 4, 2002, at A1 (citing study conducted by Cornerstone Research in 2002 covering all 303 securities class action settlements filed after enactment of the PSLRA through December 2001, defining damages as the decrease in share value that occurred after the fraud was discovered, adjusted by changes in a general market index over that period).

\textsuperscript{64} Id. (citing report by the Law and Economic Consulting Group Inc., for the year 2000 that analyzed 1,203 federal and 92 state case filings from 1988 to 1999).
millions of dollars while the individual class members each receive only negligible monetary recoveries.65

The charge that class actions benefit lawyers for the class rather than class members themselves is not unique to securities class actions and, in fact, has generated debate since the early 1970s. Not only do fee-heavy class action settlements harm the interests of particular shareholder classes, but, to the extent courts compensate class attorneys in greater amounts than fully informed clients would have agreed to pay counsel prior to authorizing the filing of the complaint, judges also inadvertently distort the incentives for private attorneys general to prosecute only meritorious cases.66

These criticisms of private enforcement have not gone unnoticed by members of the High Court. Justice O’Connor has commented publicly that class actions “have made more overnight millionaires [of lawyers] than almost any other businesses”; and, noting “the perverse incentives and the untoward consequences” created by class actions, Justice O’Connor criticized the plaintiffs’ bar for becoming “business partners of plaintiffs in seeking large-dollar recoveries rather than act[ing] as objective servants of the law.”67 Justice O’Connor’s remarks reflect the concern that fees awarded to class counsel not only constitute a windfall but actually encourage the prosecution of groundless securities fraud complaints that never should have been filed.68

Of course, champions of the private enforcement model—particularly the small number of firms that dominate the plaintiffs’ bar69—dispute these charges. They contend that advocates of reform have created a false impression that courts overcompensate

65. See, e.g., Elkind, supra note 22, at 190. Elkind quotes Joseph Grundfest, describing class actions as a means to transfer wealth: “The plaintiffs [sic] lawyers are getting a cut of the money that flows from our left pocket [current shareholders] to our right pocket [former shareholders] . . . .” Id.


68. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975) (“[A] plaintiff [initiating a class action under Rule 10b-5] with a largely groundless claim [may] simply take up the time of a number of other people, with the right to do so representing an in terrorem increment of the settlement value . . . .”).

69. For a discussion of some of the most active firms, see Laural L. Hooper & Marie Leary, Auctioning the Role of Class Counsel in Class Action Cases: A Descriptive Study, 209 F.R.D. 519, 593 (2001).
plaintiffs’ counsel and that the lawyers are the only persons who actually benefit from private litigation. They justify class counsel’s objectively large tax on investors’ litigation proceeds by pointing not only to the aggregate value of the benefits pocketed by investors who otherwise would receive no compensation for their injuries, but also to the high level of risk undertaken by lawyers prosecuting such suits and the incalculable benefits obtained for the economy as a whole. “[M]any large fee awards that critics pejoratively characterize as ‘windfalls’ are . . . appropriate compensation for counsel whose skill, hard work, creativity, and willingness to expend resources and take significant risks (generally without any guarantee of a return on their investment) have resulted in a significant benefit for the class.” Unless the plaintiffs’ bar receives adequate financial returns, lawyers will not undertake the risks of representing defrauded investors. Shareholders will receive less compensation for their injuries, and fraud will become more rampant because fewer lawyers will participate in private securities enforcement.

70. “Defendants attempt to quietly settle class actions that pose the most risk, then attack less clear-cut cases in the media.” Amy J. Longo, Class Action: A Blessing or a Blight on Civil Justice, ABA LITIG. NEWS, May 2001, at 3 (quoting plaintiffs’ lawyer Alan Schulman); see also David J. Bershad et al., A Dissenting Introduction to SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES 20–26 (Edward J. Yodowitz et al. eds., 1994); William S. Lerach, ‘The Chickens Have Come Home to Roost’: How Wall Street, the Big Accounting Firms and Corporate Interests Chloroformed Congress and Cost America’s Investors Trillions 3 (2002) (“Demand for passage of the PSLRA was greased by millions of dollars of lobbying fees and political contributions from corporate and financial interests. This tsunami of special-interest money was flavored by anecdotal tales of woe by high-tech corporate executives who were paraded by the handlers before Congressional committees to whine about how frivolous class action suits by avaricious lawyers resulted in ‘blackmail’ settlements . . . .”), at http://www.enronfraud.com/pdf/chickens.pdf (last visited Nov. 20, 2003).

71. “[M]ost nonlawyers are unaware of many of the risks faced by lawyers who take on and assume responsibility for class actions.” Task Force 2001 Report, supra note 22, at 693 n.13; see also Longo, supra note 70, at 4 (“The public focuses on the great successes and assumes all class actions are like that, but the vast majority of the cases are much closer to the margin. . . . What is important is the ratio of attorneys’ fees to the recovery. Courts routinely supervise these cases to ensure that they are proportional.” (quoting plaintiffs’ lawyer Elizabeth Cabraser)); Hynes, supra note 49, at 244–46 (arguing that class actions impose greater risks on plaintiffs’ counsel due to the need for attorneys to devote a substantial fraction of their firms’ resources to a single case for an extended period of time and the inability to diversify to reduce this risk).

72. Fisch, supra note 62, at 56 (“Lawyer-driven litigation is not inherently undesirable. The willingness of plaintiffs’ lawyers to investigate potential causes of action, mobilize the plaintiff class, and bear the costs and risks associated with the suit leads to an increase in enforcement and provides a valuable contribution to the deterrence of corporate misconduct.”); see also Longo, supra note 70, at 4 (“Class actions make for a better society because they ensure that people deal fairly and honestly with each other in the marketplace.” (quoting plaintiffs’ lawyer Michael B. Hyman)).

73. Miller Statement, supra note 56, at 18 n.12.
In response to these arguments, private enforcement detractors counter that plaintiffs’ lawyers actually do not face an appreciable risk of nonrecovery in securities class actions because “virtually all cases are settled.” More accurately, unless dismissed by the court on the pleadings, most class action securities claims settle prior to trial. Recent empirical work indicates that 83% of all resolved securities fraud cases have settled. The larger the potential damages are, the larger the settlement is, irrespective of the merits of plaintiffs’ claims or the efforts of plaintiffs’ counsel. Between 1990 and 2001, megasettlements on pre-Reform Act cases represented 21% of the total dollars paid out. Excluding the resolution of one “off-the-chart” case, the share of post-reform megasettlements—those between $100 million and $500 million—rose to 43% of the total. Critics of class actions cite these studies to support their contention that plaintiffs’ counsel will receive fees in many of the cases they choose to file (sometimes significant fees) and do not bear substantial risk in prosecuting securities claims.

Whether anyone other than the lawyers benefits from private class action litigation, and indeed, whether the private enforcement regime actually serves as an efficient and effective adjunct to regulatory enforcement of the securities laws, are questions that have confounded policymakers and academics alike. The answers depend, in part, on


75. Weiss & Beckerman, supra note 74, at 2064.

76. WOODRUFF-SAWYER & CO., A STUDY OF SHAREHOLDER CLASS ACTION LITIGATION 25 (2002); see also Alexander, supra note 74, at 497 (studying a sample of settlements in class actions filed against technology companies following initial public offerings and determining that most cases settled for 25% of potential damages).


79. As Senator Christopher Dodd expressed, [A]fter a long hearing . . . we found no agreement on whether there is in fact a problem, the extent of the problem, or the solution to the problem. In my experience with this [Senate Subcommittee on Securities], I’ve never encountered an issue where there is such disagreement over the basic facts.
one's evaluation of the social benefits of private securities enforcement.81 Maximizing the loss returns to individual defrauded investors is one objective of securities class actions but not the only objective. Other goals recognized by Congress include deterrence of future wrongdoing and confidence in the capital markets.82 To be sure, the objectives of individual class members should not conflict with these broader social objectives, but thoughtful commentators recognize that “[t]here is often a tension between these two masters. Approaches that provide the most effective deterrence of future fraud may not necessarily provide the largest loss recovery.”83 Even if the litigation outcome does not maximize class members’ individual returns, the private attorney general model would sanction the result if the outcome maximizes welfare to society.

Nonetheless, the social benefits of private enforcement cannot justify receipt by plaintiffs’ counsel of excess attorneys’ fees. If plaintiffs’ counsel can extract excessive attorneys’ fee awards from the gross settlement proceeds of shareholder suits, the compensation benefits of private enforcement cannot be realized.84 In addition, the ability to recover windfall attorneys’ fees compromises the deterrence benefits of securities class actions. Motivated by the potential receipt of excess returns on their investments, the plaintiffs’ bar may file questionable fraud claims against corporations, their management, and their

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81. Developments in the Law: The Paths of Civil Litigation, 113 HARV. L. REV. 1752, 1831 (2000). In awarding fees, courts also should optimize social benefits of class action litigation, including deterrence and tort insurance. Id. The private attorney general model presupposes that potential defendants will abstain from securities fraud in order to avoid the costs (both monetary and reputational) of defending a class action lawsuit for large damages; presumably, they would not fear individual or group litigation with much smaller exposure for damages. Deterring fraud is efficient and increases social welfare if potential defendants are not overdeterred and if the rules of law are themselves efficient. The efficiency of the federal antifraud rules and the efficiency of private class action litigation as a tool for enforcing compliance with those laws are important subjects for inquiry beyond the scope of this Article.

82. CONFERENCE REPORT, supra note 20, at 31.

83. Johnson, supra note 60, at 155 (providing examples of settlement structures that pay less to investors but arguably have greater deterrence value).

84. See CONFERENCE REPORT, supra note 20, at 31–32 (Congress heard some evidence that securities class actions settle without regards to the merits of the claims asserted in the lawsuit.).
professional advisors. Overcompensation of class counsel encourages the filing of more lawsuits, even if the evidence of fraud is weak. The filing of numerous lawsuits of questionable merit leads to management overdeterrence; that is, management becomes so concerned with avoiding liability for fraud that corporations fail to disclose information wanted by investors, resulting in social welfare losses. That is why reconciling the tension between the system-wide objectives of the private enforcement regime and the self-interested objectives of the private enforcers requires careful attention to the lawyers’ economic incentives. Agency theory describes those economic incentives, explains the potential for counsel to profit at the expense of absent class members, and provides the explanation for legal rules designed to safeguard against opportunism by entrepreneurial plaintiffs’ lawyers.

D. Agency Theory and Securities Class Actions

Agency theory posits that the nature of the private enforcement model itself, coupled with counsel’s sizable financial incentives, tempts plaintiffs’ lawyers to engage in opportunistic behavior. Such temptations are so powerful that class counsel cannot be deterred by fiduciary obligations or ethical proscriptions from acting in their own economic self-interest. Because, in general, neither individual investors nor their court-appointed representatives have the economic incentive, much less the ability, to monitor counsel effectively, and because attorney-initiated bonding and ex ante compensation contracts will not reduce substantially the costs of opportunism, legal rules—including regulations providing


86. This is not to say that private attorneys general never seek to advance ideological or professional objectives by prosecuting securities class action lawsuits. However, these lawyers are economic actors who, assuming they are rational, will not risk their time and capital on such litigation unless they believe they will achieve a reasonable profit from their investments. Further, although legal rules impose fiduciary responsibilities on attorneys, agency theory supposes that class counsel will make litigation investments to maximize their own economic return, even if the economic return to the class is not maximized thereby. As John Coffee, author of the largest body of work describing the motivations and behavior of economically self-interested plaintiffs’ lawyers, has argued, “Convenient and comforting as it is to view the attorney only through the nostalgic lens of fiduciary analysis, a fixation on this mode of analysis is likely to blind us to the real issues relating to the incentives and misincentives that the law today creates for the plaintiff’s attorney.” Understanding the Plaintiff’s Att’y, supra note 10, at 726–27.
for judicial oversight of class counsel’s compensation—have evolved to protect absent class members.

1. The principal-agent dilemma

In general concept, agency theory examines relationships in which one party, the principal, delegates work to another party, the agent. Whether the parties are owner and manager, trustor and trustee, employer and employee, or client and attorney, the theory recognizes that the interests or objectives of the principal may conflict with those of the agent and that it is difficult or costly for the principal to verify the agent’s activities.87 Among other possibilities, the self-interested agent may not have performed the work as agreed (the moral hazard / hidden action problem), or may have misrepresented the work or her skills or abilities to perform the work (the adverse selection / hidden information problem), or both. The agent’s opportunistic behavior—that is, conduct providing value to the agent at the expense of the principal—harms the principal. However, the principal cannot determine readily what the agent actually did and cannot judge accurately whether the agent’s failure to achieve the principal’s preferred outcome has occurred as a result of some deviant behavior on the part of the agent, such as shirking or setting excessive compensation. In order to reduce the costs of the agent’s opportunism, the principal may employ various monitoring devices, bonding mechanisms (such as agents guaranteeing fidelity to the principal), and ex ante incentive compensation structures. However, these tools may not reduce significantly the agency costs endemic to securities class actions.

2. Agency costs in class action litigation

A generation of academics has written on the high agency costs endemic to small-claim, large-scale class action litigation.88 Importantly, this literature derives from the application of agency theory to the classical attorney-client relationship a model in which the individual

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87. Michael C. Jensen & William J. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J. FIN. ECON., October, 1976, at 305, 308 (defining agency relationship as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent”).

88. One of the most often-cited articles is Understanding the Plaintiff’s Att’y, supra note 10, at 714–20.
client acts as the primary decision-maker.89 Recognizing the potential for conflict between the self-interested lawyer and her client, the classical form is premised on two normative canons: (1) the client controls the attorney, and (2) the attorney has a duty to advance the client’s interests to the maximum extent permitted by law and the rules of ethics governing the attorney as a professional. Implicit in the assertion that class actions are characterized by high agency costs is the assumption that such lawsuits primarily serve as a means for claimants to achieve individual ends; that is, a mechanism to increase the welfare of individual class members. Viewed through this normative lens, class counsel should conduct the litigation in the interest of the class members, which is to maximize their return. Maximizing returns to class members is a unifying objective and provides a simple and direct rule—a value-maximizing decision rule—under which class counsel should make decisions.

Agency theory posits that class counsel may disregard the value-maximizing decision rule in order to advance their own economic self-interests.90 Attorneys may attempt to maximize their fees at the expense of injured investors, acquiring assets that otherwise would have gone to class members. Hypothetically, counsel could maximize her fee by engaging in any of a number of opportunistic behaviors. For example, counsel might shirk, failing to expend the effort that she would have exerted if the absent class members were monitoring her actively. Counsel also might exchange a high fee award for a low class recovery in settlement negotiations; defendants will agree to such a settlement if their expected liability at trial exceeds their total payments to settle the

89. See Model Rules of Prof’l Conduct R. 1.2(a) (1983) ("A lawyer shall abide by a client’s decisions concerning the objectives of representation" subject to narrow exceptions in Rule 1.2(c), (d), and (e). For example, “a lawyer shall abide by a client’s decision whether to accept an offer of settlement of a matter.”).

90. Accepting this theory, the Third Circuit recently explained, [A] rational, self-interested client seeks to maximize net recovery; he or she wants the representation to terminate when his or her gross recovery minus his or her counsel’s fee is largest. In contrast, at least in theory and often in practice, a rational, self-interested lawyer looks to maximize his or her net fee, and thus wants the representation to end at the moment where the difference between his or her fees and costs . . . is greatest. These two points rarely converge. As a result, there is often a conflict between the economic interests of clients and their lawyers, and this fact creates reason to fear that class counsel will be highly imperfect agents for the class.

claims. Counsel might overstate the value of the settlement relative to the value of the class members’ claims, including overstating the value of nonpecuniary relief or understating the probability of success at trial or both. Or counsel might exaggerate her prosecution efforts, creatively accounting for her time or engaging in unnecessary activities in order to inflate her fee.

a. Class members are unlikely to monitor. Even if nonparticipating investors are aware of their claims, the vast majority of absent class members have little economic incentive to participate actively in the case or monitor counsel’s conduct. They are a large and diffuse group, usually dispersed geographically. Because they own a comparatively small claim in relation to the total potential gains of the lawsuit (and, perhaps, a diversified portfolio of other securities), absent class members are rationally apathetic. They will not monitor the litigation or the representatives prosecuting it because their individual gains from effective monitoring are too small relative to the policing costs. Further, monitoring is prohibitively expensive because nonparticipating class members have no routine interactions with the attorneys managing the lawsuit and cannot directly observe, except at a high cost, the activities of counsel. “[T]he client, as principal, is neither well-situated nor adequately motivated to closely monitor and control the attorney, his agent. Shareholders with well-diversified portfolios or small holdings lack the incentive and information to police settlements—the costs of policing typically outweigh any pro rata benefits to the shareholder.”

91. In practice, most negotiated resolutions of securities class actions follow a similar pattern. The settling defendants, while denying all wrongdoing, agree to pay to the class some amount of money and/or securities, often funded with the proceeds of directors’ and officers’ liability insurance, into a fund from which class members may make claims and class counsel will receive compensation and reimbursement of costs. The settling defendants also agree to fund the costs of notifying the class and administering the settlement fund. In exchange, the class representatives, on behalf of the class, release the settling defendants from any and all liability relating to the claims made in the complaint, and the parties stipulate to a court order dismissing plaintiffs’ complaint with prejudice. Following negotiation and documentation of the terms of their agreement, class counsel joins with the defendants to present to the court for approval a proposed settlement that includes a suggested fee award to class counsel. One commentator has described securities class action settlements as “large-scale business transactions that commodify res judicata” insofar as defendants agree to purchase the class members’ legal right to sue through plaintiffs’ attorneys who engage in “primarily business-oriented” rather than “legal activities.” William B. Rubenstein, A Transactional Model of Adjudication, 89 Geo. L.J. 371, 372, 375 (2001).

92. Bell Atl. Corp. v. Bolger, 2 F.3d 1304, 1309 (3d Cir. 1993); see also In re Oracle Sec. Litig., 136 F.R.D. 639, 645 (N.D. Cal. 1991) (“The central and long recognized problem in class litigation arises from the inability of the persons whose rights are at stake to monitor the faithfulness
Collective action and free-rider problems render unlikely the possibility of sharing these high monitoring costs among an organization of class members.

Even if absent class members had the economic incentive to monitor the litigation, they lack the necessary information to do so. Nonparticipating class members may have no awareness of their claims, much less knowledge that counsel filed suit on their behalf, until they receive individual notice that the litigants have agreed to settle. The attorney-client relationship generally is created by legal rules rather than actual contracts. Class counsel usually does not know the absent class members and does not regard them as individual clients. Indeed, it is not clear, as a matter of doctrine or theory, who the plaintiffs’ lawyer actually represents in class action litigation. What is clear is that, in traditional class action practice, the attorney is the real party in interest in the lawsuit and controls the complex litigation deciding whether to

93. The counselor-client relationship, like other professional relationships, is characterized by informational asymmetry. Legal services are “credence goods”—goods or services provided by experts who strongly influence (if not decide) the buyers’ needs for the goods or services. Many buyers of legal services cannot efficiently evaluate the quantity of the service they should purchase, much less whether the seller actually supplied the service promised or the quality of the service provided. Economists thus theorize that sellers of credence goods may defraud buyers by charging for services that the buyer does not need, by charging for services that the seller did not perform, or by providing inferior quality services. See Winand Emons, Credence Goods and Fraudulent Experts, 28 RAND J. ECON. 107, 111 (1997). The credence goods problem is amplified when clients purchase litigation services and is amplified even further in class action litigation.

94. The PSLRA attempted to address this problem by providing for early notice of the lawsuit. See infra note 135. However, this notice is by publication only.

95. This mentality became public in 1993 when Forbes magazine quoted William Lerach, perhaps the most prominent member of the plaintiffs’ securities bar, as saying, “I have the greatest practice of law in the world. . . . I have no clients.” William P. Barrett, I Have No Clients, FORBES, Oct. 11, 1993, at 52.

96. Some scholars have argued that class counsel represents individual class members, while others theorize that the class, as an entity, is the client. Compare John C. Coffee, Jr., Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation, 100 COLUM. L. REV. 370, 380–85 (2000) [hereinafter Class Action Accountability], with David L. Shapiro, Class Actions: The Class as Party and Client, 73 NOTRE DAME L. REV. 913, 938–40 (1998). Class action jurisprudence could support either conclusion. Id.


98. See Class Action Accountability, supra note 96, at 418 (“[T]he attorney is not simply an agent of the client. Rather, the attorney is also the creditor and joint venturer who is effectively
settle the case and for how much and for what fee, without consulting the class in advance of these decisions. For this reason, Rule 23(e) requires that courts approve the parties’ settlement agreement, thereby providing, in theory, “a substitute for individual assent [by absent class members] to the contract’s terms.” In fact, scrutinizing class counsel’s determination to settle makes little economic sense for the investor unless such monitoring could lead that investor to uncover information affecting her decision to opt out of the class and proceed against the defendants in a separate lawsuit. If class members would and could opt out of any settlement that gave them a net recovery that was materially less than the value of their claims, attorneys for the class would be motivated to maximize the class members’ net recovery. However, even members of investor classes who suspect attorney opportunism do not necessarily opt out of poor settlements. Assuming a suspicious class member would have declined to bring the claims in the first place (due to the relatively greater cost of prosecuting a lawsuit compared to the prospects of limited individual recovery), opting out of the class is irrational; any recovery through the class action is better than no recovery at all. Further, if the court has certified the class before settlement, class members cannot opt out of an insufficient settlement. Although amendments to Rule 23 are forthcoming, the current law does not provide an additional opt-out right for class members who deem the negotiated settlement inadequate. Objection is the only avenue of financing their common undertaking and has much more at stake than any individual class member.”)

99. FED. R. CIV. P. 23(e) (“A class action shall not be dismissed or compromised without the approval of the court . . . .”).

100. Susan P. Koniak, The Lawlessness in Our Courts, 28 STETSON L. REV. 283, 294 (1998). Judges rarely reject a settlement negotiated by class counsel and the defendants, even where the court receives objections from absent class members. In most cases, the courts make no inquiries into the details of the settlement negotiations. Nor do courts typically require that the parties file a final report documenting the total amount of money paid out from the settlement fund to class members, class counsel, and others involved in the administration of the settlement. When confronted with objections, courts sometimes recite the unobjectionable tenet that class counsel “possess, in a very real sense, fiduciary obligations to those [absent class members] not before the court.” Greenfield v. Villager Indus., Inc., 483 F.2d 824, 832 (3d Cir. 1973); see also Pettway v. Am. Cast Iron Pipe Co., 576 F.2d 1157, 1176 (5th Cir. 1978) (noting that class counsel have the duty to report conflicts of interest between the named plaintiffs and the rest of the class so that the court may consider intervention on behalf of absent class members).

101. Proposed Rule 23(e)(3), approved by the Supreme Court in March 2003, would permit district judges to order a second opt-out opportunity for members of the certified class at the time of
dissent. In other words, absent members of a certified class cannot vote with their feet. If they do not agree with the recommended settlement or fee application, they only can voice their objections to the court.

Class members also have little incentive to exercise their right to object. They face small stakes along with information and free-rider problems. Courts often reject motions by objectors’ counsel to recover their attorneys’ fees and costs. In addition, courts have imposed various legal barriers to objectors’ challenges. Thus, even those investors who suspect that counsel has breached the value-maximizing decision rule may, rationally, do nothing.

b. Named plaintiffs may choose not to monitor. Rather than absent class members monitoring, the named plaintiffs may monitor counsel to reduce agency costs in securities class actions. Named plaintiffs who serve as class representatives act as fiduciaries for absent class members. However, at least prior to the PSLRA, the named plaintiffs

settlement if the opt-out period expired before public announcement of the settlement. Assuming no intervention by Congress, this proposed rule and other amendments to Rule 23 will become effective on December 1, 2003. See Supreme Court Approves Class Action Rule Changes, ANDREWS CLASS ACTION LITIG. REPORTER, Apr. 2003, at 24.

102. Class members often must opt out at the end of the notice period, and they must make objections at that time. Some commentators have argued that this timing is unfair because “the opt-out decision comes prior to the point where class members have a fair opportunity to evaluate the arguments on both sides of the settlement.” Brian Wolman & Alan B. Morrison, Representing the Unrepresented in Class Actions Seeking Monetary Relief, 71 N.Y.U. L. REV. 439, 490 n.109 (1996).


104. Among these legal barriers, district courts may (1) require objectors to submit their objections in writing before the moving parties file their briefs supporting the fairness of the proposed settlement, (2) deny the objectors the opportunity to add new objections after reviewing the proponents’ submissions, (3) deny the objectors any discovery, or (4) prohibit the objectors from discovering the substance of the settlement negotiations. Koniak & Cohen, supra note 92, at 1109–10.

105. The Federal Judicial Center’s 1994–1995 study of class actions in four federal district courts found that “[t]he percentage of cases in which there was no objection [to the proposed settlement] ranged from 42% to 64% in the four districts,” and “[c]lass members, or other interested parties, did not object to fees very often.” Willging, supra note 48, at 140, 164.

106. See Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 549 (1949) (describing the class representative as a volunteer who assumes a position of fiduciary nature); see also In re Oxford Health Plans, Inc., Sec. Litig., 182 F.R.D. 42, 46 (S.D.N.Y. 1998) (“A class representative, once designated by court, is a fiduciary for the absent class members.”); Kline v. Wolf, 88 F.R.D. 696, 700 (S.D.N.Y. 1981) (noting that a class representative serves as fiduciary to advance and protect interests of those whom he purports to represent), aff’d, 702 F.2d 400 (2d Cir. 1983). For further discussion, see Geoffrey C. Hazard, Jr., The Settlement Black Box, 75 B.U. L. REV. 1257, 1270
selected by class counsel to serve as class representatives often lacked both the motivation and the ability to fulfill their fiduciary duties to monitor the lawyers. As courts have long recognized, "the named plaintiff is largely a figurehead who plays little or no part in the initiation and prosecution of the class claim." Before Congress enacted the PSLRA, district courts routinely certified classes represented by persons with nominal investments, and defendants seldom challenged the adequacy of such representatives based upon potential intraclass conflicts.

Further, although prereform class action jurisprudence pays lip service to "the duty of the class representative to ensure that absent members' interests are adequately protected," district courts certified the named plaintiffs as adequate class representatives even when they demonstrated lack of understanding of their claims and lack of ability or interest in overseeing the prosecution of those claims. Presiding judges rarely imposed on named plaintiffs any specific responsibilities or duties to participate actively; the courts apparently recognized that, with much smaller stakes in the litigation than plaintiffs' lawyers (and with the prospect of receiving repeated bonus payments from those
lawyers prereform), class representatives were unlikely to monitor class counsel or even consult with the lawyers. “[C]lass representatives often are recruited by class counsel, play no client role whatsoever, and—when deposed . . . —commonly show no understanding of their litigation.” Simply put, class representatives appointed prior to securities litigation reform seldom reviewed class counsel’s time records, expenses, or work product, much less objected to class counsel’s fee application at the conclusion of the litigation. In any event, courts generally balked when appointed class representatives attempted to exercise meaningful control over key litigation decisions, such as the decision to settle class claims.

c. Bonding mechanisms fail to reduce opportunism. Bonding, another theoretical mechanism for reducing agency costs, is not effective in securities class actions. Bonding describes methods by which agents provide assurances that they will act faithfully even in the absence of monitoring by their principals. In the classical model of attorney-client relations, lawyers, like other professionals, invest in their reputation as a bonding mechanism in order to reduce, although not eliminate, agency costs. The threat of losing future business deters opportunistic behavior, and the possibility of attracting future business encourages behavior that promotes the client’s interests. However, bonding is problematic for

113. Making monitoring even more unlikely, some plaintiffs’ lawyers prior to 1996 used “professional plaintiffs”—persons who purchased a small number of shares in many public companies—to file multiple lawsuits in exchange for bonus payments. See Conference Report, supra note 20, at 32–33 (“[M]any of the ‘world’s unluckiest investors’ repeatedly appear as lead plaintiffs in securities class action lawsuits.”). With passage of the PSLRA, Congress constrained the use of professional plaintiffs by limiting persons (other than institutional investors) from serving as lead plaintiff more than five times in three years. See 15 U.S.C. §§ 77z-1(a)(3)(B)(vi), 78u-4(a)(3)(B)(vi) (2000). The statute also barred bonus payments to named plaintiffs. See id. §§ 77z-1(a)(4), 78u-4(a)(4) (2000). However, investors still may receive reimbursement of the reasonable costs and expenses they incur as a direct result of serving as lead plaintiff. Id.

114. See Macey & Miller, supra note 17, at 20 (“No rational plaintiff would take on the role of litigation monitor because she would incur all the costs of doing so but would realize only her pro rata share of the benefits.”).

115. Cooper, supra note 111, at 927.

116. See, e.g., Maywalt v. Parker & Parsley Petroleum Co., 67 F.3d 1072 (2d Cir. 1995) (affirming district court’s denial of motion to remove class counsel and district court’s approval of settlement negotiated by counsel over objections by four of five named class representatives); Laskey v. Int’l Union, 638 F.2d 954 (6th Cir. 1981) (upholding settlement over named plaintiffs’ objections); Kincade v. Gen. Tire & Rubber Co., 635 F.2d 501 (5th Cir. 1981) (upholding settlement despite plaintiffs’ objections); see also Class Action Accountability, supra note 96, at 406–09 (describing the Third Circuit’s decision to approve settlement over objections by three of four named class representatives in Lazy Oil Co. v. Witco Corp., 166 F.3d 581 (3d Cir. 1999)).
litigators because litigation outcomes are not easily correlated to the quality of the lawyers’ efforts. Furthermore, in the context of most class actions involving small claims but large stakes, reputational bonding is even more unlikely to affect agency costs for two primary reasons. First, class members do not select counsel; rather, counsel initiates the litigation after finding one or more class members to represent the class. Counsel, then, typically has no need to develop or maintain her reputation in order to attract business from absent class members. Second, the potential for a multimillion-dollar fee award may cause class counsel to risk (or “cash in”) her reputation in exchange for profits now. The larger the potential fee, the greater the risk of this “last period problem.” Megacases would pose the greatest temptation for plaintiffs’ lawyers.

\[d.\text{ Contracting with class counsel may reduce agency costs.}\]

(1) Benefits and limitations of contingent fee compensation. Although agency theory suggests that class members and class representatives will not monitor class counsel effectively and cannot reduce agency costs through bonding by class counsel, the theory also posits that certain compensation structures may deter the lawyers from behaving opportunistically. Contingent fees represent one such compensation structure with the potential to reduce agency costs.\footnote{The economics of contingency fees has spawned a large literature and continuing empirical study. See, e.g., Herbert M. Kritzer, The Wages of Risk: The Returns of Contingency Fee Legal Practice, 47 DEPAUL L. REV. 267 (1997). For a general discussion of how the parties in ordinary litigation may design contingent fee agreements to reduce agency costs, see Bruce L. Hay, Contingent Fees and Agency Costs, 25 J. LEGAL STUD. 503 (1996).} By

\footnote{117. Macey & Miller, supra note 17, at 20–22.}
\footnote{118. John C. Coffee Jr., Rethinking the Class Action: A Policy Primer on Reform, 62 IND. L.J. 625, 629 (1987) (noting that class counsel needs to impress the court, not the absent class members).}
\footnote{119. The last period problem describes why agents facing the last period of their employment may behave more opportunistically, assuming greater risks that the principal will learn of the wrongful behavior in exchange for greater rewards in the short term.}
\footnote{120. On the other hand, if the fee award is extraordinarily high, counsel’s concern for her reputation may motivate her to reduce her percentage share of the recovery. See Daniel J. Capra et al., The Tobacco Litigation and Attorneys’ Fees, 67 FORDHAM L. REV. 2827, 2845 (1999) (recounting decision of plaintiffs’ firm to forgo its contractual right to receive $1.5 billion fee award in the tobacco litigation).}
\footnote{121. The economics of contingency fees has spawned a large literature and continuing empirical study. See, e.g., Herbert M. Kritzer, The Wages of Risk: The Returns of Contingency Fee Legal Practice, 47 DEPAUL L. REV. 267 (1997). For a general discussion of how the parties in ordinary litigation may design contingent fee agreements to reduce agency costs, see Bruce L. Hay, Contingent Fees and Agency Costs, 25 J. LEGAL STUD. 503 (1996).}
deferring compensation to counsel until the class realizes a positive gain at the conclusion of the case, contingency fees give class counsel a direct interest in the outcome of the litigation, thus aligning counsel’s interests with the interests of the class.\textsuperscript{122} Of course, a contingent fee lawyer anticipates that she will receive a compensation premium for assuming the risk that her clients will lose and, as a result, that she will be paid nothing for her services.\textsuperscript{123} As Justice Blackmun once explained, “[L]awyers charge a premium when their entire fee is contingent on winning. . . . The premium added for contingency compensates for the risk of nonpayment if the suit does not succeed . . . .”\textsuperscript{124} Although contingent fee structures require payment of premium fees for successful outcomes, to the extent that contingency fee arrangements effectively link counsel’s compensation to the fate of the class’s claims, the principal may reduce his monitoring costs.

Some of the problems associated with contingent fees are unique to class actions, but others are not. Whether a contingent fee is reasonable or excessive in any context depends largely on the risk of nonrecovery borne by counsel. However, lawyers often possess superior information about the likelihood of successful prosecution. Unsophisticated clients may not know enough about the risks associated with the litigation to make informed decisions about the terms of representation. Furthermore, counsel must make upfront investments of both time and capital (for litigation expenses) in order to prosecute the claims. These investments made by counsel—in prefiling investigations, drafting the complaint, responding to motions filed by defendants, engaging in discovery, and the like—affect the return to the client and, presumably, would increase client welfare. Nonetheless, insofar as counsel owns only a portion of the return from the litigation, she does not obtain the full benefit from investments she makes in the litigation. For this reason, contingent fees

\textsuperscript{122} According to Judge Frank Easterbrook,
The contingent fee uses private incentives rather than careful monitoring to align the interests of lawyer and client. The lawyer gains only to the extent his client gains. This interest-alignment device is not perfect. . . . But [an] imperfect alignment of interest is better than a conflict of interests, which hourly fees may create.
Kirchoff v. Flynn, 786 F.2d 320, 325 (7th Cir. 1986).

\textsuperscript{123} See RICHARD POSNER, ECONOMIC ANALYSIS OF LAW § 21.9, at 567–68 (4th ed. 1992) (noting the established practice in private legal markets of rewarding attorneys for taking the risk of nonpayment by paying premiums over normal hourly rates for successful outcomes in contingency cases).

create incentives for lawyers to prefer settlements to trials. A settlement ensures that the lawyer will receive at least some attorneys’ fees; if counsel tries the case and loses, she will forfeit both the opportunity cost of her time (and her colleagues’ time) spent on the case as well as the amount of out-of-pocket expenses she has advanced to her client.

Plaintiffs’ counsel may face even greater incentives to settle class action litigation. As the Supreme Court has recognized, “[W]ith an already enormous fee within counsel’s grasp, zeal for the client may relax sooner [in negotiating a class action settlement] than it would in a case brought on behalf of one claimant.”125 Class actions typically are more factually and legally complex than bipolar cases, and prosecution of such claims requires greater investments of time and greater outlays for pretrial expenses. Presumably, class counsel will take on the increased exposure in exchange for the correspondingly greater potential returns from such an action. In theory, however, class counsel is also more risk averse than the typical class member who owns a diversified portfolio of securities.126 The more time and money invested by counsel, the more risk averse counsel will become, resulting in a greater likelihood that counsel’s comparative risk aversion will harm the interests of the class. The extent of the conflict—counsel’s incentive to settle the class claims in violation of the value-maximizing decision rule in order to recover counsel’s fees and costs—also will depend on the size of the potential fee and the fee award methodology employed by courts in the jurisdiction where the lawsuit is pending.127

This conflict of interest between counsel and class becomes most troubling when, as almost always occurs, defendants offer to settle the lawsuit for some fraction of the total potential recovery. Because the time and effort necessary to obtain a greater return for the class generally may yield a reduced (hourly) return to class counsel, counsel may recommend the “cheap settlement” in contravention of the value-maximizing decision rule.128 “Even if a substantially higher recovery might be obtained through litigation, the return on counsel’s investment might be

126. Class Action Accountability, supra note 96, at 390–92 (explaining why plaintiffs’ attorneys, being comparatively more risk averse than class members, will accept settlement offers that informed class members would reject).
127. Courts determine attorneys’ fees in class actions using a lodestar (hourly) approach or a percentage-of-recovery approach. For further discussion, see infra Part II and accompanying notes.
lower than that provided by the settlement, especially if lost opportunity costs are taken into account.” Insofar as class counsel’s risk preference deviates from the risk preference of the class, and insofar as class members do not monitor class counsel, the attorneys will not invest in the litigation in a way or to the extent that is most beneficial to class members. In the most extreme case, there is danger that lawyers for the class will collude with defendants and agree to accept an early and cheap (so-called “sweetheart” or “sell out”) settlement in exchange for a larger award of attorneys’ fees.

To be sure, agency costs also infect settlements of bipolar litigation negotiated by plaintiffs’ lawyers under the classical representation model. Clients often cannot evaluate the legitimacy of their lawyers’ assessment of litigation risk or second-guess their lawyers’ settlement recommendations. Nor can clients costlessly determine whether their counsel has adopted an effective negotiation strategy and is bargaining zealously on their behalf. Yet, the danger of lawyer opportunism is more compelling in class action litigation because plaintiffs’ counsel typically does not confer with any of her “clients” during the course of the settlement negotiations. Rather, counsel makes the decision to compromise the claims and negotiates the settlement price with the defendants in “a black box,” providing little or no opportunity for client participation or monitoring. Left unmonitored by clients, counsel may bargain harder for its own compensation than for money for the class.

Ironically, the PSLRA may have exacerbated the temptation for plaintiffs’ counsel to settle too cheaply because the risks confronted by plaintiffs’ lawyers specializing in securities litigation may have increased as a result of congressional reform. Attorneys prosecuting securities class

131. See Entrepreneurial Litigation, supra note 17, at 883 (defining sweetheart settlements as agreements “in which the plaintiff’s attorney trades a high fee award for a low recovery”). The risk that class counsel will recommend an inadequate settlement in violation of the value-maximizing decision rule exists regardless of whether the court adopts a lodestar or percentage-of-recovery approach, as described at length by Professor John C. Coffee, Jr., in The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation, LAW & CONTEMP. PROBS., Summer 1985, at 5, 35–48 [hereinafter Unfaithful Champion]. However, as described in Part II, infra, most scholars agree that the contingent percentage-of-recovery method is more efficient than the lodestar method in reducing agency costs.
132. S. REP. NO. 104-98, at 6 (1995) (“The lawyers can decide when to sue and when to settle, based largely on their own financial interests, not the interests of their purported clients.”).
133. See Hazard, supra note 106, at 1272 (arguing that settlement decisions of “ineffectual or self-interested” class attorneys do not receive sufficient scrutiny).
Reforming Securities Class Actions

actions post-PSLRA must invest more time and capital to investigate claims, draft complaints, and provide early notice of the lawsuits, but they face greater uncertainty regarding whether their pleadings will survive defendants’ inevitable motions to dismiss, and the lawsuits have become more protracted. Moreover, the lawyers have no assurance that they will receive the appointment as lead counsel even if they invest substantial resources prefiling and draft a well-pleaded complaint.

How might members of the plaintiffs’ bar react to the increased risk in securities class actions post-PSLRA? They may decide to select their cases more carefully, limiting their risk exposure by pursuing only cases with a high probability of recovery, such as lawsuits against solvent

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134. The PSLRA established new, more stringent standards for pleading scienter and strengthened the requirement that plaintiffs plead the circumstances of fraud with particularity. See 15 U.S.C. § 78u-4(b) (2000).

This means that firms need to invest substantially more resources and manpower in investigating each case thus raising the cost of filing a case. From an economic perspective, this change leads to higher sunk costs because of the need to investigate the case and spend money on accountants and investigative agents. Randall S. Thomas et al., MegaFirms, 80 N.C. L. REV. 115, 192 (2001).

In addition, the statute requires that plaintiffs publish in a widely circulated business publication a notice to members of the putative class within twenty days of filing the complaint. See 15 U.S.C. §§ 77z-1(a)(3)(A), 78u-4(a)(3)(A) (2000). This early notice must identify the claims alleged in the lawsuit and the purported class period and must inform putative class members that they may move to serve as lead plaintiff. Id. §§ 77z-1(a)(3)(A), 78u-4(a)(3)(A).

135. Because the PSLRA also provides for a stay of discovery until after resolution of defendants’ motions to dismiss, 15 U.S.C. § 77z-1(b) (2000), plaintiffs’ counsel faces an increased likelihood that its complaint will fail to meet the statute’s enhanced pleading requirements. Thomas, supra note 135, at 192. According to one study, judges dismissed 24.3% of securities class actions on motions by defendants in 2001. Bruce Rubenstein, Congressman Fights to Amend 1995 Reform Act: Enron-Andersen Debacle Spurs an Uprising on the Hill, CORP. LEGAL TIMES, May 2002, at 16 (citing study by Woodruff-Sawyer & Co. comparing 2001 dismissal rate of 24.3% to 1994 pre-PSLRA dismissal rate of 8.8%). A 1999 study found that dismissals as a percentage of dispositions more than doubled after enactment of the PSLRA, from 12% to 25%. TRENDS VI, supra note 58, at 6 (attributing the increase to the PSLRA’s heightened pleading standards).

136. Research trends show that the rate of disposition of federal court cases appears to have slowed somewhat in the post-PSLRA period. We hypothesize that this downward trend is the result of the PSLRA provision that stays discovery while a motion to dismiss is pending, which has, in turn, slowed the rate of settlements. TRENDS VI, supra note 58, at 6.

137. Thomas, supra note 135, at 191. The selection of lead counsel under the PSLRA is discussed infra Part III.

138. CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 528 n.19 (1986) ("[E]xperienced lawyers can make a prediction about the success of a representation and can refuse to accept cases..."
defendants involved in well-publicized and government-investigated corporate frauds. They may struggle with a greater temptation to settle at least some cases in violation of the value-maximizing decision rule, thus jeopardizing the return to class members.\(^{139}\) Perhaps they will attempt to diversify their risk by filing a larger number of lawsuits.\(^ {140}\) Rather than spending substantial time and resources on any one case to the benefit of class members, counsel instead may choose to prosecute an expanded portfolio of actions, making more minimal investments in many more actions (recognizing the potential for sanctions\(^ {141}\)), with the expectation that a small number will become “winners” and result in large fee awards. This rational strategy reduces the risks for class counsel\(^ {142}\) but does not maximize the returns for defrauded investors.

(2) Difficulties in negotiating compensation ex ante. By negotiating contingent fee agreements up front, informed clients may direct the performance of counsel and provide incentives designed to reduce agency costs. The success of such ex ante compensation contracts in reducing agency costs generally hinges on three factors: (1) the principal’s ability to assess accurately the risk of opportunism, which is a function of the principal’s experience, sophistication, and access to information about the agent’s behavior in prior comparable transactions; (2) the principal’s capacity to diversify to reduce the risk of agent opportunism; and (3) the competitiveness of the market for the agent’s

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139. However, recent studies indicate that the median settlement value in securities class actions has increased as well. Cornerstone Research, Federal Securities Class Action Cases Filed and Defendant Market Cap Losses Surge in 2001, at 2 (2002) (reporting $5.5 million median settlement value for cases settled from 1996 through 2001, as compared to $4.0 million for sample cases pre-PSLRA), available at http://securities.stanford.edu/scac_press/20020315_CR_SCAC.pdf (last visited Nov. 20, 2003).

140. Thomas, supra note 135, at 193 (“The Reform Act may . . . make it more important [for plaintiffs’ counsel] to have a diversified portfolio in order to spread the [increased litigation] risks.”). Professor Coffee discussed risk-spreading by plaintiffs’ counsel as an explanation for “strike suits” in Unfaithful Champion, supra note 132, at 20–23.


142. See Skelton v. Gen. Motors Corp., 860 F.2d 250, 254 (7th Cir. 1988) (“In the common fund context, attorneys whose compensation depends on their winning the case, must make up in compensation in the cases they win for the lack of compensation in the cases they lose.”).
Contingency fee agreements can be difficult to tailor because of the difficulty in predicting outcomes and in tying outcomes to attorney effort. This problem becomes more pronounced in litigation involving unique issues of great legal and/or factual complexity.

Class actions pose special challenges for reducing agency costs through ex ante compensation agreements insofar as putative class counsel cannot bargain with absent class members ex ante. Indeed, compensation agreements between counsel and the class could be deemed unenforceable for two reasons. First, the “class” cannot contract with counsel before counsel files the complaint. The class does not exist as a legal entity until the court certifies it, and absent class members are not bound in the litigation until they receive notice and have the opportunity to opt out of the class. Second, the court ultimately must approve the fees and expenses awarded to class counsel, a determination made at the conclusion of the case. For these reasons, before securities reform empowered lead plaintiffs to select and retain counsel, many agreements between putative class counsel and putative class representatives simply provided that the court would set the fees for services rendered.

Having examined the agency theory underlying the need to regulate the private attorney general in securities class action litigation—and comprehending the limitations of principal monitoring, agent bonding, and ex ante contracting for reducing opportunistic behavior by plaintiffs’ bar—the next Part describes how the courts traditionally exercised oversight by deciding the fees awarded to class counsel. After reviewing the classical model and the substantial obstacles to effective judicial regulation of plaintiffs’ lawyers, we can understand better Congress’s 1995 efforts to reform securities class actions by empowering lead plaintiffs.

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144. See Bruce L. Hay, Optimal Contingent Fees in a World of Settlement, 26 J. LEGAL STUD. 259 (1997).
145. See discussion infra Part II.
146. See discussion infra Part III.
II. REDUCING AGENCY COSTS THROUGH JUDICIAL CONTROL OF ATTORNEYS’ FEES

In its current form, Rule 23 itself does not mandate that the courts decide class counsel’s compensation. Federal courts instead award attorneys’ fees and costs to class counsel under a still-developing line of precedent.\textsuperscript{148} Prior to securities litigation reform, judges were guided by the deceptively simple principle that they should award “reasonable attorneys’ fees” to class counsel who create common funds benefiting investors. However, almost since the enactment of Rule 23 in 1966, judges and academics have debated the meaning of “reasonable.” Reasonable in relation to what the lawyers could obtain in a functioning market? Reasonable to compensate counsel for work actually performed or work forgone? Reasonable in relation to the benefit achieved for the class? Reasonable in relation to the risk assumed by counsel in prosecuting the case? Reasonable to provide counsel with a return on investment such that other private attorneys general are encouraged to represent defrauded investors?

Furthermore, no consensus exists for how judges should determine reasonable fees. The only noncontroversial norms established in the common-fund jurisprudence are (1) judges should not allow their review of fee applications to create “a second major litigation,” and (2) judges must set forth clearly the reasons for their awards.\textsuperscript{149} Although appellate panels review fee decisions for abuse of discretion,\textsuperscript{150} the courts of appeals recently have reversed a number of district court awards, apparently recognizing the “special responsibility upon appellate courts to hear challenges to fee awards by class members whose claims may have been reduced or in some way negatively affected in exchange for large fee awards.”\textsuperscript{151} From the inception of the modern class action, trial courts have used one of two methods (or both) to calculate reasonable attorneys’ fees. The judiciary has despaired of both approaches.

\textsuperscript{148} Although not pertaining to class actions specifically, courts have awarded attorneys’ fees under the common-fund doctrine by invoking FED. R. CIV. P. 54(d)(2).


\textsuperscript{150} Gunter v. Ridgewood Energy Corp., 223 F.3d 190, 195 (3d Cir. 2000) (noting that appellate courts give a “great deal of deference to a district court’s decision to set fees”).

\textsuperscript{151} In re Cendant Corp. PRIDES Litig., 243 F.3d 722, 728 (3d Cir. 2001) (reversing district court); see also In re Cendant Corp. Litig., 264 F.3d 201, 280–86 (3d Cir. 2001); Rosenbaum v. MacAllister, 64 F.3d 1439 (10th Cir. 1995); Gunter, 223 F.3d at 190. In nonsecurities class actions, too, the courts of appeal recently have reversed lower courts’ fee awards. See, e.g., In re Synthroid Mktg. Litig., 264 F.3d 712 (7th Cir. 2001) (antitrust class action).
A. Competing Methods for Calculating Reasonable Fees Ex Post

In the years immediately following the adoption of Rule 23, courts awarded attorneys’ fees based on a fixed percentage of the total recovery obtained for the class. Few reported decisions initially questioned the wisdom of such an approach; courts seem to have analogized to familiar contingency fee contracts because the percentage-of-recovery method compensates lawyers by awarding them some percentage of the amount recovered from defendants through settlement or trial. However, as the class action device became used with greater frequency, judges increasingly became uncomfortable with the large fee awards generated under the percentage-of-recovery approach, and some jurists voiced concern about the impact of such awards on the public’s perception of the bar. Thus, beginning in the early 1970s, and for the next two decades, most judges refocused their fee analyses on the time and effort expended by counsel rather than simply the results obtained for the class. Courts accomplished this shift by awarding fees using the lodestar method, abandoning (for a time) the percentage-of-recovery method. Under the lodestar approach, judges first calculate a “lodestar fee” by fixing a reasonable hourly rate for class counsel and multiplying that rate by the amount of hours spent (or reasonably spent) by counsel. In determining the reasonable hourly rate, courts typically review the rates charged by attorneys of like experience and skill in the community. Judges may then adjust the lodestar fee up or down using a “multiplier” in consideration of, among other factors, the risk undertaken by counsel in litigating the case on a contingency fee basis.

In 1985, the Third Circuit convened a blue ribbon panel to consider the comparative advantages and disadvantages of the two alternative approaches for calculating fee awards in common-fund class actions. The Task Force criticized the lodestar methodology for creating conflicts of interest between counsel and the class by motivating counsel to prolong

152. Bennett A. McConaughy, Back to the Future: Use of Percentage Fee Arrangements in Common Fund Litigation, 12 U. PUGET SOUND L. REV. 43, 44–46 (1988) (asserting that percentage fees were typical in class actions prior to adoption of the lodestar but created windfalls for class counsel relative to the time and effort expended).

153. As the Third Circuit explained, “unless time spent and skill displayed are used as a constant check on applications for fees there is a grave danger that the bar and bench will be brought into disrepute.” Lindy Bros. Builders, Inc. v. Am. Radiator & Standard Sanitary Corp., 487 F.2d 161, 168 (3d Cir. 1973) (quoting Cherner v. Transition Elec. Corp., 221 F. Supp. 55, 61 (D. Mass. 1963)).

154. Id. (initiating use of lodestar method).
the litigation, engage in unproductive and unnecessary tasks, staff litigation activities redundantly, exaggerate the number of hours actually worked, and inflate their billing rates. For these reasons, among others, the final report sanctioned the percentage-of-recovery approach in order to compensate attorneys according to the size of the recovery obtained for the class rather than the hours expended by the lawyers. The panel also recognized that awarding fees at the conclusion of the litigation would require courts to evaluate class counsel’s efforts in hindsight and would eliminate the ability to align the incentives of counsel with the interests of the class. Thus, the Task Force further recommended that presiding judges establish “at the earliest practicable moment” a “percentage fee arrangement agreeable to the Bench and to plaintiff’s counsel.”

B. Using Benchmarks to Simplify Ex Post Decision-making

Following publication of the Third Circuit Task Force’s advisory (but influential) final report in 1985, district courts throughout the country increasingly utilized the percentage-of-recovery approach to award attorneys’ fees in securities class actions, and the federal courts of appeals sanctioned, if not mandated, use of that methodology. Yet,


156. Among the problems noted in the Report, the Task Force found that the lodestar method caused great expenditures of scarce judicial resources and produced inconsistent and unpredictable results. Id. at 246–49.

157. Id. at 255. The Task Force assumed that the “earliest practicable moment” would occur “immediately after the pleadings are closed and before discovery is fully underway.” Id. at 255 n.62. Academics endorsed the percentage-of-recovery approach for reducing agency costs by linking counsel’s rewards to the results counsel achieved for the class. See Understanding the Plaintiff’s Att’y, supra note 10, at 724; Macey & Miller, supra note 17, at 59.

158. Alexander, supra note 46, at 349 (“Recently, there has been a trend in common fund cases away from the lodestar and toward a return to the percentage-of-the-recovery method of calculating fees.”); Willging, supra note 48, at 156; see also MANUAL FOR COMPLEX LITIGATION (THIRD) § 24.122 (1995).

159. See, e.g., Gottlieb v. Barry, 43 F.3d 474, 487 (10th Cir. 1994) (finding the district court abused its discretion by using lodestar/multiplier method rather than percentage-of-recovery); In re Wash. Pub. Power Supply Sys. Sec. Litig., 19 F.3d 1291, 1296 (9th Cir. 1994); In re Cont’l Ill. Sec. Litig., 962 F.2d 566, 572–73 (7th Cir. 1992) (explaining that district courts may use either method to calculate fees, but percentage method is preferred, and courts should simulate “what the market in fact pays not for the individual hours but for the ensemble of services rendered in a case of this character”).

Courts of appeals also endorsed the percentage-of-recovery approach in nonsecurities, common-fund class actions. See, e.g., In re Thirteen Appeals Arising Out of San Juan Dupont Plaza Hotel Fire Litig., 56 F.3d 295, 307 (1st Cir. 1995); In re Gen. Motors Corp. Pick-Up Fuel Tank Prods. Liab. Litig., 55 F.3d 768, 821 (3d Cir. 1995); Swedish Hosp. Corp. v. Shalala, 1 F.3d 1261, 1276
with few exceptions, courts failed to adopt the report’s recommendation that judges (or their agents) negotiate and establish the percentage fee early in the case. Presiding judges seemed to take care to avoid the subject of class counsel’s incentives and compensation until the conclusion of the litigation, at which time judges could consider various factors in setting the percentage, including the risk associated with litigating the case, the efforts of counsel, and the result obtained for the class. However, to avoid speculating ex post about class counsel’s real risks of nonrecovery or engaging in time-consuming ex post investigations of counsel’s productivity or attempting to determine the impact of a proposed fee award on the incentives for the plaintiffs’ bar going forward, courts employed a simple heuristic. Specifically, courts facing the complexity and uncertainty associated with post hoc review of fee applications simplified their decision-making by adopting benchmarks to assess the reasonableness of the percentage of the fund requested by class counsel. In securities class actions, courts came to rely on a presumption that class counsel are entitled to an award of between 25% and 33% of the amount recovered from the defendants through settlement. “[D]istrict courts across the nation . . . apparently eased into a practice of ‘systematically’ awarding fees in the 25% range, ‘regardless of type of case, benefits to the class, numbers of hours billed, size of fund, size of plaintiff class, or any other relevant factor.’”

1271 (D.C. Cir. 1993) (“Percentage-of-the-fund is the appropriate mechanism in awarding fees in common fund [class actions].”); Camden I Condo. Ass’n v. Dunkel, 946 F.2d 768, 774 (11th Cir. 1991) (mandating that “[h]enceforth in this circuit, attorneys’ fees awarded from a common fund shall be based upon a reasonable percentage of the fund established for the benefit of the class”).


for its decision, further motivating judicial adherence to the benchmark.

A review of numerous reported decisions fails to reveal the basis for the notion that the benchmark fee is reasonable. To be sure, fee awards have become more predictable under the benchmark percentage approach, and the use of benchmarks conserves judicial resources otherwise spent reviewing voluminous fee petitions. However, courts adopting this heuristic appear simply to “rubber-stamp” class counsel’s applications for attorneys’ fees (at least those applications submitted in conjunction with motions for approval of settlement) without regard to the quality of the representation, the work performed, or the risk assumed by the lawyers. In awarding fees using a simple benchmark standard, judges seldom refer to the market for class counsel’s services and make no attempt to test the “reasonableness” of the benchmark against a fee recoverable in the market. Rather, courts simply look to the percentage fee applied by other courts that previously engaged in the same endeavor.

Application of the percentage-of-recovery approach with the use of standard benchmarks has produced the most controversial fee awards in cases generating megasettlements and in cases settling at an early stage of the litigation. When the settlement creates a megafund or when counsel negotiates a speedy conclusion to the lawsuit, percentage fee awards appear to be grossly excessive. Judicial application of a 25% to 33% benchmark to a common fund of $100 million or more produces an

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164. See, e.g., Graulty, 886 F.2d at 273 (explaining that a departure from the benchmark upward or downward must be accompanied by “a reasonable explanation of why the benchmark is unreasonable under the circumstances”).


166. Macey & Miller, supra note 17, at 48 (“Judges rarely reject fee petitions presented as part of a settlement.”).

167. Fisch, supra note 62, at 60.

168. Prior to the PSLRA, the Seventh Circuit did mandate that district courts use a market-based approach to setting the percentage fee. In re Cont’l Ill. Sec. Litig., 962 F.2d 566, 568 (7th Cir. 1992) (Posner, J.) (noting that in awarding fees, presiding judges should “determine what the lawyer would receive if he were selling his services in the market rather than being paid by court order”).

169. But see Hensley v. Eckerhart, 461 U.S. 424, 447 (1983) (Brennan, J., concurring in part and dissenting in part) (“Judges awarding fees must make certain that attorneys are paid the full value that their efforts would receive on the open market . . . .”).

170. See In re Coordinated Pretrial Proceedings in Petroleum Prods. Antitrust Litig., 109 F.3d 602, 607 (9th Cir. 1997) (noting that a 25% benchmark might be “arbitrary” if the common fund was extremely large).
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eight-figure fee likely to engender criticism. Yet, even if the case settles for a more modest amount soon after the filing of the complaint, the question may be raised: what could the lawyers possibly do to earn their 25–33% fee? Compared to the actual hours expended using a dollars-per-hour-worked calculation, the fees associated with large settlement funds and early resolutions seem disproportionate to the value obtained for the class through counsel’s efforts and skills. In these circumstances, courts adhering to the benchmark percentage appear to overcompensate counsel by awarding a large monetary fee for little work rendered, for counsel assuming little risk, or for both. Intuitively, “it is not ten times as difficult to prepare, and try or settle a ten million dollar case as it is to try a one million dollar case.” However, when courts do balk at awarding the benchmark and instead award a reduced percentage fee, those judges also may receive criticism for acting arbitrarily.

C. Criticisms of Ex Post Judicial Regulation Generally

Regardless of the methodology adopted, courts and commentators alike have recognized that ex post judicial regulation of class counsel’s compensation is both costly and likely ineffective in reducing agency costs. Commentators have pointed out that judges lack both the necessary resources and the expertise to review fee petitions. In

171. The fees awarded to counsel retained by the states to prosecute claims against tobacco companies incited a similar uproar. See, e.g., Robert A. Levy, The Great Tobacco Robbery, LEGAL TIMES, Feb. 1, 1999, at 27.

172. Courts have recognized that the size of the fund may impact their ability to properly assess class counsel’s fee request. See, e.g., In re Wash. Pub. Power Supply Sys. Sec. Litig., 19 F.3d 1291, 1297 (9th Cir. 1994) (reviewing fees awarded from $687 million settlement fund) (“[I]n determining fee awards in class actions, it is especially important that judges not be unduly influenced by the monetary size of the settlement. A sizable settlement can reflect a number of factors in addition to the prestige, skill and vigor of Class counsel.” (citation omitted)). However, some commentators have argued that the percentage applied by the courts should not decrease simply because counsel has obtained a larger fund. See, e.g., Reagan W. Silber & Frank E. Goodrich, Common Funds and Common Problems: Fee Objections and Class Counsel’s Response, 17 REV. LITIG. 525 (1998).


174. See Martha Pacold, Attorneys’ Fees in Class Actions Governed by Fee-Shifting Statutes, 68 U. CHI. L. REV. 1007, 1021 (2001) (“In the 1970s, many courts began to view the percentage method as problematic because it generated windfalls for attorneys in cases with exceptionally large funds. Some courts avoided this problem by reducing the percentage awarded. However, this exposed the method to criticism as unprincipled.”).

order to make optimal decisions about reasonable attorney compensation, courts must acquire accurate information about projected litigation outcomes, the lawyers’ investments, their settlement evaluations, the history of the negotiations, and the other factors necessary either to value the lawyers’ services under the lodestar approach or to set a contingent fee under the percentage-of-recovery approach. In addition, some important information is within the exclusive province of the lawyers themselves. “The critical factors in evaluating a settlement are the timing of settlement opportunities and amounts left ‘on the table.’ A court will almost never have reliable information on these factors.”

Class counsel certainly will not volunteer to share such closely guarded information with the judge.

Furthermore, particularly when judges evaluate fee applications at the conclusion of the litigation, they cannot rely on the parties themselves to provide required information. Defendants often have agreed to keep silent concerning the pending fee application, having consented to a “clear sailing” provision in the settlement documents. Disaffected absent class members lack information and incentives to

resource is simply time. “[T]he average class action demands considerably more judge time than the average civil case.” Willging, supra note 48, at 96 (reporting the results of a sample of cases from a then-recent District Court Time Study conducted by the Federal Judicial Center).

According to one recent paper examining judicial opinions in securities fraud litigation, most federal judges have little experience in securities law prior to taking the bench and little interest or incentive in developing substantial expertise in the area after confirmation. Stephen M. Bainbridge & G. Mitu Gulati, How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions, 51 EMORY L.J. 83, 103 (2002). Judges also lack recent experience in the market necessary to evaluate fee applications. See In re Oracle Sec. Litig., 131 F.R.D. 688, 696 (N.D. Cal. 1990) (“To the extent that a judge ever possessed such first-hand knowledge [necessary to evaluate fee applications], it rapidly becomes out of date. Judges who believe that they have any special expertise on this subject are simply fooling themselves (but probably no one else).”).

Professor Coffee explained how clear sailing provisions—agreements to remain silent—disable the reviewing courts:

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 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.

Unfaithful Champion, supra note 131, at 35.
challenge the fee application, and they also have insufficient stakes in obtaining a reduction of the requested fee to organize or retain separate representation. They are rationally apathetic. Thus, when reviewing class counsel’s fee petition at the end of the case, “the court is abandoned by the adversary system . . . . Rarely do the settling defendants . . . offer any counterpoint; rarely do members of the class come forward with any response or opposition to the fees sought. There are no amici curiae who volunteer their advice.”179 Particularly if no class members have objected to the fee petition, “[a]ll the dynamics conduce to judicial approval,”180 and the judge likely will accept the settlement package presented by former adversaries.181

In addition to lacking the information necessary to award reasonable compensation to counsel, judges reviewing fee applications at the conclusion of the litigation likely suffer from hindsight bias.182 Because judges, like other human beings, have difficulty assessing the ex ante predictability of outcomes after the fact,183 they cannot evaluate impartially the reasonableness of class counsel’s fee requests ex post. When the judge learns the outcome of the class action (typically, the amount of the settlement negotiated by the parties), that knowledge will alter her perception of what risks preceded the settlement, particularly the risks faced by class counsel at the inception of the case. For example,

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180. Alleghany Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting), aff’d en banc by equally divided court, 340 F.2d 311 (2d Cir. 1965).
181. Koniak & Cohen, supra note 103, at 152–53 & nn.142–45 (reviewing empirical evidence supporting the contention that courts are “extremely reluctant to reject proposed class action settlements” and usually award “the full fee requested”); Rhode, supra note 50, at 1218–19 (“Effectively monitoring class counsel’s representation could require more personal innuendo and factual investigation than many trial judges are disposed to supply.”).
182. Hindsight bias describes the tendency for people to overestimate the predictability of past events. Psychologists have determined that when we learn outcomes, we update our beliefs, relying on the new beliefs to generate conclusions about what was predictable, without recognizing that learning the outcome changed the beliefs. See Baruch Fischhoff, For Those Condemned to Study the Past: Heuristics and Biases in Hindsight, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIAS 335, 341 (Daniel Kahneman et al. eds., 1982) (“In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also to view it as having appeared ‘relatively inevitable’ before it happened. People believe that others should have been able to anticipate events much better than was actually the case.”).
if the lawyers negotiate a settlement before the court decides defendants’ motion to dismiss, the judge may perceive that counsel should receive a fee lower than counsel has requested, even if the early settlement produced a large common fund. In hindsight, it would appear to the court that counsel in that case did not face a serious risk of nonrecovery. On the other hand, a judge may lean toward awarding higher fees in a case where counsel settled only after surviving the defendants’ impassioned entreaties for the court to dismiss the complaint and their vigorous oppositions to class certification, even if the settlement negotiated represents a relatively small recovery of the losses suffered by the class. In hindsight, it would appear to the court that counsel exerted great effort to obtain the result achieved. Counsel in the second case may receive a larger fee as both a percentage of the fund and even in actual numbers, yet the outcome secured by the lawyers in the first case clearly benefited the class more. For judges reviewing fee applications at the conclusion of the litigation, “hindsight alters the perception of the suit’s riskiness, and sunk costs make it impossible for the lawyers to walk away if the fee is too low.”

Absent mechanisms to avoid or reduce its influence, hindsight bias poses a troublesome problem for judges evaluating fee requests ex post, resulting in judicial awards that may diverge significantly from the compensation arrangement that the class could have negotiated with counsel at the outset of the litigation. In any given case, the court may overcompensate counsel, thereby harming absent class members, or undercompensate counsel, thereby injuring the petitioning lawyers as well as diminishing the incentives for attorneys to represent investor classes in the future. With regard to the latter possibility, Justice Scalia recently observed,

It is . . . something quite irrational—to look at the consequences of a

185. The Seventh Circuit has analogized ex post judicial regulation of attorneys’ fees with “a public utilities commission, regulating the fees of counsel after the services have been performed, thereby combining the difficulties of rate regulation with the inequities of retrospective rate-setting.” Kirchoff v. Flynn, 786 F.2d 320, 325 (7th Cir. 1986).
186. In re Wash. Pub. Power Supply Sys. Sec. Litig., 19 F.3d 1291, 1300 (9th Cir. 1994) (“A large segment of the public might be denied a remedy for violations of the securities laws if contingent fees awarded by the courts did not fairly compensate counsel for the services provided and the risks undertaken.” (citation omitted)); see also In re Oracle Sec. Litig., 131 F.R.D. 688, 693 n.11 (N.D. Cal. 1990) (“[U]ncertainty about compensation affects not only the litigation at hand, but also ‘incentives in future roughly comparable cases.’” (citation omitted)).
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contingent-fee agreement after the contingencies have been resolved, and proclaim those consequences unreasonable because the attorney has received too much money for too little work. That is rather like declaring the purchase of the winning lottery ticket void because of the gross disparity between the $2 ticket price and the million-dollar payout.187

Other scholars—some adopting the “view of the lawyer as a calculating entrepreneur regulated by calculating judges,”188—have questioned the courts’ motivation to scrutinize fee applications carefully.189 Although judges have voiced concerns from time to time about how the public perceives their fee awards in securities class actions,190 some critics have questioned the courts’ sensitivity to public concerns about the entrepreneurial plaintiffs’ bar.191 Institutional pressures to clear the courts’ dockets also may motivate some jurists to approve summarily counsel’s fee request. Judges typically receive fee petitions in conjunction with the parties’ motions for settlement approval. If the court rejects the class action settlement, a complex and time-consuming case remains on the judge’s docket. Faced with congested dockets, district courts “frequently see little incentive to delve deeply into an uncontested matter that is being resolved on terms similar to [those] approved in other cases by well-respected jurists.”192 Finally, as some judges have admitted candidly, the courts simply do not relish the task of deciding attorneys’ compensation.193 No doubt Justice William

189. See, e.g., Konik & Cohen, supra note 92, at 1122–30 (asserting that judges serve their own self-interests by approving settlements in order to clear their dockets); Charles W. Wolfram, Mass Torts—Messy Ethics, 80 CORNELL L. REV. 1228, 1233 (1995) (noting judicial incentives toward settlement); Rhode, supra note 50, at 1219 (“Where the pressures to clear dockets are substantial, the costs of smoking out conflict may seem prohibitive.”).
190. See, e.g., Rothfarb v. Hambrecht, 641 F. Supp. 71, 74 (N.D. Cal. 1986) (“This Court is keenly aware of its duty to protect the absent plaintiff class members, and determined to avoid . . . even the appearance of having awarded windfall fees . . . .” (citations omitted)); In re Capital Underwriters, Inc. Sec. Litig., 519 F. Supp. 92, 98 (N.D. Cal. 1981) (“Excessive fees have a broader detrimental effect as well on the continued usefulness of the class action mechanism since such awards provoke criticism of the legal profession and class representation in particular.”), aff’d in part, vacated in part, 705 F.2d 466 (9th Cir. 1983).
191. See Matt Smith, Soft Firm, S.F. WEEKLY, May 29, 2002, at 13 (“[J]udges, attorneys all, don’t necessarily share the layman’s view that lawyer profiteering is a form of social malaise.”).
193. Charles Kocoras points out, The idea of getting enmeshed in determining how much a client should pay his lawyer is
III. REDUCING AGENCY COSTS BY EMPOWERING LEAD PLAINTIFFS

Whether empirically valid or not, the popular and theoretically supported perception that class counsel receive windfall fees from private securities lawsuits enabled proponents of litigation reform to garner bipartisan support for legislative action in 1995.195 Both the statutory language and the legislative history of the PSLRA make manifest Congress’s concern that securities class counsel, if left unmonitored, will behave in ways that harm both absent class members and the private enforcement system generally.196 Most federal lawmakers agreed that the mechanisms and procedures for controlling class counsel, including through ex post judicial regulation of attorneys’ compensation, had failed to reduce opportunistic behavior by the plaintiffs’ securities bar.197 Having determined that abusive securities litigation was “lawyer-driven,” Congress attempted to transfer control of the lawsuits from the plaintiffs’ bar to the investors whom the bar purports to represent. In so doing, lawmakers altered the responsibilities of federal benches presiding over securities class actions.

195. “Congress passed the Private Securities Litigation Reform Act seven years ago out of a sense that a few select firms were minting money by shaking down innocent companies on behalf of imaginary clients.” Greg Mitchell, Let a Thousand Lerachs Bloom, RECORDER, July 19, 2002, at 2.
197. Fisch, supra note 62, at 94 (“It is also fair to read the adoption of the PSLRA as reflecting some degree of congressional skepticism about the ability of the courts effectively to supervise the process of selecting class counsel… . [J]udicial control over plaintiff’s attorneys’ fees, coupled with the courts’ reluctance to refuse fee requests or to deviate from traditional benchmarks, has led to excessive fee awards.”).
A. Congress Adopts the Empowered Lead Plaintiff Model

The PSLRA includes new class action procedures designed to “increase the likelihood that parties with significant holdings in issuers, whose interests are more strongly aligned with the class of shareholders, will participate in the litigation and exercise control over the selection and actions of plaintiff’s counsel.” These innovative rules changed the way courts appoint class representatives in securities cases. The PSLRA’s appointment scheme favors investors with the largest financial losses—presumably institutional investors—based upon the assumption that these investors’ substantial stakes provide them with the economic incentive to represent the class voluntarily and diligently. As the appointed representatives of the class, large investors would be in a position to monitor class counsel and, in the words of Weiss and Beckerman, “assess whether plaintiffs’ attorneys are acting as faithful champions for the plaintiff class.”

The PSLRA thus mandates that presiding judges appoint as “lead plaintiff” the “most adequate plaintiff.” The most adequate plaintiff is the person or group of persons whom “the court determines to be most capable of adequately representing the interests of class members.” Presumptively, the most adequate plaintiff is the investor seeking to be appointed (via motion) who has “the largest financial interest in the relief sought by the class [who] . . . otherwise satisfies the requirements of Rule 23.” By adopting this rule and thus embracing the so-called “empowered lead plaintiff model” of class representation, Congress intended to “encourage institutional investors to take a more active role in securities class action lawsuits” in order to “ultimately benefit shareholders and assist courts by improving the quality of . . .

198. CONFERENCE REPORT, supra note 20, at 32.
199. The genesis of these provisions is the influential work of Professors Weiss and Beckerman, whose article is cited in the legislative history. See Weiss & Beckerman, supra note 74, at 2053.
200. Weiss and Beckerman asserted that most putative classes in securities cases included shareholders whose interests were large enough to create a strong proprietary interest in the litigation, and their model assumes that shareholders with more significant interests in the litigation could more effectively represent the interests of absent class members because they would have the economic incentive to control the lawyers for the class. Id. at 2088–2104.
201. Id. at 2095.
representation” of absent class members. While the statute does not give express preference to institutions, the legislative history reflects the lawmakers’ prediction that “courts [would be more confident [that] settlements negotiated under the supervision of institutional plaintiffs were ‘fair and reasonable’ than is the case with settlements negotiated by unsupervised plaintiffs’ attorneys.” The statute provides that the presumption in favor of the person(s) with the largest financial stake may be rebutted only “upon proof that . . . the presumptively most adequate plaintiff . . . will not fairly and adequately protect the interests of the class[,]” or . . . is subject to unique defenses.

The PSLRA also mandates that the lead plaintiff will “select and retain counsel to represent the class,” subject to court approval. Weiss and Beckerman had argued that the courts should defer to the lead plaintiff’s discretion in negotiating and setting attorneys’ fees, and they believed that institutions seeking to represent the class would be in a position to negotiate fee arrangements with proposed counsel for the class prior to the filing of the complaint. However, the statute is silent as to the criteria or method that the lead plaintiff should employ in selecting and retaining counsel. Nor does the law dictate that the lead plaintiff must monitor counsel’s efforts and participate in settlement decisions. Nonetheless, a handful of district courts have opined on the importance of the lead plaintiff negotiating a reasonable fee agreement with putative lead counsel. The legislative history also indicates that

204. CONFERENCE REPORT, supra note 20, at 34. “The Conference Committee seeks to increase the likelihood that institutional investors will serve as lead plaintiffs by requiring courts to presume that the member of the purported class with the largest financial stake in the relief sought is the ‘most adequate plaintiff.’” Id.

205. Id. at 35 (quoting Weiss & Beckerman, supra note 74, at 2105); see also Gluck v. CellStar Corp., 976 F. Supp. 542, 548 (N.D. Tex. 1997) (“The legislative history of the Reform Act is replete with statements of Congress’s desire to put control of [securities] litigation in the hands of large, institutional investors.”).


207. Once appointed as lead plaintiff, the most adequate plaintiff “shall, subject to the approval of the court, select and retain counsel to represent the class.” 15 U.S.C. § 78u-4(a)(3)(B)(v).

208. Weiss & Beckerman, supra note 74, at 2105.

209. Id. at 2107. The authors also predicted that these fee arrangements might differ substantially from the fee structures courts had approved in securities class actions. Id. at 2122–23.

210. See In re Party City Sec. Litig., 189 F.R.D. 91, 116 (D.N.J. 1999) (noting the fee should be “the result of hard bargaining”); In re Network Assocs., Inc. Sec. Litig., 76 F. Supp. 2d 1017, 1033 (N.D. Cal. 1999) (“The lead plaintiff owes a fiduciary duty to obtain the highest quality representation at the lowest price.”).
Congress empowered the lead plaintiff to select class counsel in order to foster competitive bidding among law firms for class representation or, at the very least, to generate actual fee negotiations between prospective class counsel and the lead plaintiff, acting for the benefit of the class.\textsuperscript{211}

The statute does not set forth the standard for judicial review of the lead plaintiff’s performance of its duties, whatever those duties might be.\textsuperscript{212} The legislative history notes that lawmakers “expect[ed] that the plaintiff will choose counsel rather than, as [wa]s true [previously], counsel choosing the plaintiff.”\textsuperscript{213} Yet the same legislative history also advises that Congress intended to preserve “the court’s discretion under existing law to approve or disapprove the lead plaintiff’s choice of counsel when necessary to protect the interests of the plaintiff class.”\textsuperscript{214} And, although lawmakers seem to have intended that the appointed lead plaintiff would monitor class counsel, the PSLRA did not disturb the several legal rules mandating judicial oversight of securities class actions as well. Not only must presiding judges approve the lead plaintiff’s selection and retention of lead counsel under the PSLRA, but, per Rule 23 of the Federal Rules of Civil Procedure,\textsuperscript{215} district courts still must certify the putative class, requiring a determination of, among other things, representational adequacy.\textsuperscript{216} Further, courts still must approve

\begin{itemize}
\item \textsuperscript{211} Cox, supra note 28, at 516.
\item \textsuperscript{212} Weiss and Beckerman recognized that institutions might decline to participate as lead plaintiffs. Weiss & Beckerman, supra note 74, at 2005. However, Congress attempted to reassure potential lead plaintiffs that they would not face undue liability as a result of their participation by including in the legislative history a statement that “the most adequate plaintiff provision does not confer any new fiduciary duty on institutional investors—and the courts should not impose such a duty . . . .” CONFERENCE REPORT, supra note 20, at 34.
\item \textsuperscript{213} Id.
\item \textsuperscript{214} Id.
\item \textsuperscript{215} The proposed revisions to Rule 23 also are designed to “assur[e] appropriate judicial oversight of class action litigation from stem to stern, from certification, to class counsel appointment, to settlement approval, and finally to attorney fee awards.” Memorandum from David F. Levi, Chair of the Advisory Committee on the Federal Rules of Civil Procedure, to Hon. Anthony J. Scirica, Chair of the Standing Committee on Rules of Practice and Procedure 5 (July 31, 2001), available at http://www.uscourts.gov/rules/comment 2002/8-01CV.pdf.
\item \textsuperscript{216} In order to certify a class, the district court must find that the putative class meets four threshold requirements found in Rule 23(a)—numerosity, commonality, typicality, and adequacy of representation. In addition, pursuant to Rule 23(b)(3), the court must find that common questions “predominate over any questions affecting only individual members” of the class and that resolution of the claims on a classwide basis be “superior to other available methods for the fair and efficient adjudication of the controversy.” Fed. R. Civ. P. 23(b)(3). With regard to representational adequacy (Fed. R. Civ. P. 23(a)(4)), many federal courts have interpreted this requirement to apply not just to the named plaintiffs but also to their attorneys. See, e.g., Crawford v. Honig, 37 F.3d 485, 487 (9th Cir. 1994). Further, the court may reevaluate the adequacy of the named plaintiffs or class counsel to
\end{itemize}
any settlement of the class’s claims, although, in practice, judges rarely determine that class counsel agreed to settle a case for less than its fair value. Finally, district courts retain their authority to award reasonable attorneys’ fees and costs to plaintiffs’ counsel and to make appropriate orders “for the protection of the members of the class.”

With this understanding of the reform model adopted by Congress, the next section explores the courts’ post-reform regulation of class counsel’s compensation.

B. Awarding Fees Under the Empowered Lead Plaintiff Regime

Although no comprehensive study has compared fee awards before and after the enactment of the PSLRA, it does seem that district courts increasingly have recognized the PSLRA’s “mandate . . . for greater judicial management” of securities class actions targeted at protecting absent class members from perceived abuses by the plaintiffs’ bar. Judge Jed Rakoff from the Southern District of New York, a frequent venue for securities class actions, documented this recognition when he wrote,

represent the class at the time of settlement if the court previously certified the class. If necessary, the court may decertify the class or replace the representatives. MANUAL FOR COMPLEX LITIGATION (THIRD) § 30.16 (1995).

217. FED. R. CIV. P. 23(e). Although Rule 23(e) itself does not describe the procedure, much less the criteria, that judges should employ in deciding whether to approve a proposed settlement, courts often hold a hearing to consider whether the settlement proposed by class counsel and the defendants is fair, adequate, and reasonable. See, e.g., Weinberger v. Kendrick, 698 F.2d 61, 73 (2d Cir. 1982) (“The central question raised by the proposed settlement of a class action is whether the compromise is fair, reasonable and adequate.”); 4 ALBA CONTE & HERBERT NEWBERG, NEWBERG ON CLASS ACTIONS § 11.43 (4th ed. 2002) (listing criteria used in determining whether a judgment is “fair, reasonable, and adequate”). Courts tend to assess the substantive fairness of the proposed settlement by comparing the amount of the proposed settlement with the estimated amount of the aggregate loss incurred by the class, discounted by the likelihood that the plaintiff class would prevail at a trial of the merits, and reduced by the costs of litigating the case through trial. Mars Steel Corp. v. Nat’l Bank & Trust Co., 834 F.2d 677, 682–83 (7th Cir. 1987) (describing how to calculate settlement value and explaining that “[a] settlement is fair to the plaintiffs in a substantive sense . . . if it gives them the expected value of their claim if it went to trial, net of the costs of trial”).

218. A study of class action settlements in four federal districts found that “[a]pproximately 90% or more of the proposed settlements were approved without changes.” Willging, supra note 48, at 141. Thus, some scholars have argued that judicial oversight of settlements is ineffective in reducing agency costs. See, e.g., Class Action Accountability, supra note 96, at 438 (“Although many reforms are possible and could succeed, only one is sure to fail: reliance on trial court scrutiny of the settlement.”).

219. FED. R. CIV. P. 23(d).

“[S]ecurities class action litigation continues to be lawyer-driven in material respects and the reforms Congress contemplated in the Reform Act can be achieved, if at all, only with some help from the courts.”

Beyond simply expressing an understanding of Congress’s objectives, some presiding judges have attempted to reduce agency costs themselves by scrutinizing counsel’s fees ex post with a view toward maximizing recovery for the class. A few other courts have attempted to maximize class recovery (or at least reduce attorneys’ fees) by selecting lead counsel through the use of judicially supervised competitive bidding, and at least one judge has selected the lead plaintiff expressly based upon the fees negotiated with the putative lead counsel. These judicial efforts at reducing agency costs call into question the role of judge as independent arbiter, as discussed further in Part IV.

I. Scrutinizing requested attorneys’ fees ex post

Although the legislative history of the PSLRA documents Congress’s concern that lawyers “often receive a disproportionate share of settlement awards,” Congress gave little guidance to district courts in determining class counsel’s compensation. Rather than fixing the percentage of fees and costs that courts could award to class counsel or providing per se quantitative prohibitions, the PSLRA mandates only that total attorneys’ fees and expenses awarded to lead counsel “shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class.” This “reasonable percentage” provision evidences Congress’s intent that district courts would determine reasonableness of fees in each case based on the amount of money actually recovered by class members.

222. See infra Part III.B.2–3.
223. Indeed, the presiding judges refer to themselves as the “fiduciaries” or “agents” or “guardians” of the absent class members in a number of opinions. See infra notes 367–68 and accompanying text.
224. CONFERENCE REPORT, supra note 20, at 36.
226. Id.; see also CONFERENCE REPORT, supra note 20, at 36 (“The Conference Committee limits the award of attorney[s’] fees and costs to counsel for a class . . . to a reasonable percentage of the amount of recovery awarded to the class. By not fixing the percentage of fees and costs counsel may receive, the Conference Committee intends to give the court flexibility in determining what is reasonable on a case-by-case basis.”); 141 CONG. REC. S1085 (daily ed. Jan. 18, 1995) (“The bill requires that courts tie awards of lawyers’ fees directly to how much is recovered by investors, rather than simply how many hours the lawyers billed or how many pages of briefs they filed.”) (statement
To date, two federal appellate courts, the Second Circuit and the Third Circuit, have reviewed lower courts’ awards of fees and costs under the PSLRA. Both circuits expressly rejected the use of benchmarks in securities class actions and endorsed the application of flexible criteria for determining the reasonableness of attorneys’ fees. In Goldberger v. Integrated Resources, Inc., a case arising from the Michael Milken junk bond scandal of the 1980s, the Second Circuit found that the district court did not abuse its discretion in awarding fees amounting to 4% of the common fund rather than the 25% requested by class counsel. In its opinion affirming the trial court’s award—an award calculated under the lodestar method—the court listed a series of factors for trial courts to consider when reviewing the reasonableness of fee requests in securities class actions, “including: (1) the time and labor expended by counsel; (2) the magnitude and complexities of the litigation; (3) the risk of the litigation; (4) the quality of representation; (5) the requested fee in relation to the settlement; and (6) public policy considerations.” The Second Circuit cautioned lower courts that in “scrutinizing . . . the unique circumstances of each case,” presiding judges must “approach fee awards ‘with an eye to moderation’” and give “‘jealous regard to the rights of those who are interested in the fund,’” that is, the absent class members. Further, the court allowed for the use of either the lodestar or percentage approaches, but it denounced the broad use of customary benchmark percentages of recovery in securities class actions, describing the use of such benchmarks as “routine largess” and criticizing the use of benchmarks as “an all too tempting substitute for the searching assessment that should properly be performed in each case.”

In Gunter v. Ridgewood Energy Corp., the Third Circuit mandated the use of a similar set of criteria to that listed in Goldberger, except that Gunter also instructed district courts in the Third Circuit (where percentage fees are mandated) to review the range of awards in similar

of Sen. Peter Domenici). Lawmakers also sought to provide more information to absent class members about counsel’s potential fee by including in the PSLRA new notice procedures. 141 CONG. REC. S9212 (daily ed. June 28, 1995) (noting that the bill “contains better disclosure of how much a shareholder might get under a settlement and how much the lawyers will get so that shareholders can challenge excessive lawyers’ fees”) (statement of Sen. Peter Domenici).

227. 209 F.3d 43, 44–45 (2d Cir. 2000).

228. Id. at 50 (quoting In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig., 724 F. Supp. 160, 163 (S.D.N.Y. 1989) (internal quotation marks and ellipsis omitted)).

229. Id. at 53 (quoting City of Detroit v. Grinnell Corp., 995 F.2d 448, 469–70 (2d Cir. 1974)) (citations omitted).

230. Id. at 51–52.
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cases. Following Gunter, the court of appeals further instructed lower courts against the use of benchmarks in In re Cendant Corp. PRIDES Litigation. That decision made clear that presiding judges “may not rely on a formulaic application of the appropriate range in awarding fees but must consider the relevant circumstances of the particular case.” The appellate court vacated the district court’s fee award, criticizing the lower court for failing to specify the method used to set the fees and failing to apply the seven factors adopted by the circuit in Gunter for awarding fees on a percentage-of-recovery basis in common-fund class actions.

While both the Second Circuit and the Third Circuit have denounced the use of benchmarks, neither court announced a rule of decision to govern the application of the fee award factors they cited—factors that, upon closer inspection, appear somewhat redundant and potentially contradict one another. The appellate courts also failed to provide meaningful guidance to district judges about the relative importance of the factors. In fact, review of more than two dozen decisions reducing fees after enactment of the PSLRA reveals that, in various ways, presiding judges again are attempting to value the legal services provided by counsel to the plaintiff class. And although the courts may scrutinize fee applications less deferentially after reform, facially applying the same

231. 223 F.3d 190, 195 n.1 (3d Cir. 2000).
232. 243 F.3d 722 (3d Cir. 2001).
233. Id. at 736.
234. Id. at 743. Although lead counsel applied for a fee representing 10% of the stated value of the total amount of rights available for distribution to class members (approximately $34 million), plus reimbursement of reasonable expenses, the district court instead approved an award of 5.7% of the amount of net value of the settlement rights (after deducting for expenses), or $19.3 million. Id. at 725–27.
235. Id. at 733–44. The appellate court admonished the district court for failing to consider that the case had settled at an early stage of the litigation, that little or no discovery had occurred, and that defendants had admitted liability, reducing the complexity and risk involved. Further, the district court erred by not considering fee awards in other cases in which the common fund exceeded $100 million. Finally, the court of appeals held that the lower court abused its discretion in failing to cross-check the reasonableness of the percentage-of-recovery fee against a lodestar calculation with a justifiable multiplier. The court of appeals suggested that, on remand, “a lodestar multiplier of is the appropriate ceiling for a fee award, although a lower multiplier may be applied in the District Court’s discretion.” Id. at 742.
236. The Third Circuit did opine that in securities class actions, factors relating to the skill and efficiency of the attorneys and fee awards in similar cases are of limited use. In re Cendant Corp. Litig., 264 F.3d 201, 284 (3d Cir. 2001). The court also noted that those two factors “should receive less weight” in a megafund case. Id. (citing In re Prudential Ins. Co. of Am. Sales Practices Litig., 148 F.3d 283, 339 (3d Cir. 1998)) (commenting that the size of the fund created and the number of persons benefited is less important in a megacase).
methodologies\textsuperscript{237} and even many of the same award considerations, the results are hardly predictable. Courts reducing fees emphasize different factors influencing their awards.\textsuperscript{238} Further, many judges discount the risk of nonrecovery with the benefit of hindsight attendant to ex post review. Informational deficiencies continue to plague the courts in reviewing fee applications, leading to judicial conjectures about counsel’s performance, the reasonableness of the hours expended, and the value of attorneys’ time. Some judges have developed their own extrastatutory public policy rationales for cutting fees, and the courts’ opinions provide little assurance that their decisions reflect compensation arrangements that injured investors would have negotiated directly with class counsel.\textsuperscript{239} At best, courts review the “market” for class counsel compensation by reviewing some sampling of awards made by other courts faced with the same task. Of course, precedents “cannot establish a valid market rate.”\textsuperscript{240}

In sum, fee awards in securities class actions are, if anything, more subjective and less predictable after the PSLRA and the abolishment of benchmarks in two circuits. A review of the case law confirms the judiciary’s wide discretion to determine reasonable fees, but no guiding rules of decision emerge. Judges anchor their decisions with a myriad of partially duplicative and conflicting factors utilized to value lawyers’ efforts and productivity. These trends increase the risk for private attorneys general, who will look to prior fee awards in assessing the expected return from future litigation. “[S]hrewd plaintiffs’ lawyers are able to weigh the risks and rewards of litigation, but they are much less able to gauge in advance the reaction of an individual judge to a fee application that is to be given discretionary review in accordance with a standard of review that is anything but standardized.”\textsuperscript{241}


\textsuperscript{238} Of the twenty-seven cases reviewed for this Article, only one failed to provide detailed reasons for its decision to reduce the requested attorneys’ fees. In \textit{Gunter v. Ridgewood Energy Corp.}, the district court merely stated that the “nature of the litigation,” its resolution “without the necessity of trial,” and its value dictated that 18%, rather than the 33% requested, was a reasonable award. No. Civ. 95-438, 1999 WL 33266979, at *1 (D.N.J. Nov. 16, 1999). The Third Circuit vacated the decision and remanded the case to the district court for a more thorough analysis. 223 F.3d 190, 201 (3d Cir. 2000).

\textsuperscript{239} As Seventh Circuit Judge Frank Easterbrook observed recently in his opinion reversing a lower court’s fee award in an antitrust case, “The [S]econd [C]ircuit’s consider-everything approach [adopted in \textit{Goldberger}] . . . lacks a benchmark; a list of factors without a rule of decision is just a chopped salad.” \textit{In re Synthroid Mktg. Litig.}, 264 F.3d 712, 719 (7th Cir. 2001).

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with . . . essentially meaningless factors . . . ." 241 These are not the only unknowns, however, that plaintiffs’ counsel must face. In addition to lawyers facing greater uncertainty about their compensation in securities class actions, the following developments in the post-reform fee jurisprudence also should concern the plaintiffs’ bar. 242

a. Discounting the risk of nonrecovery. In awarding fees to class counsel under the common-fund doctrine, courts historically have considered risk to be the most important factor in determining whether the plaintiffs’ counsel deserved an enhancement above the lodestar amount243 or above the benchmark for percentage fees. Recently, however, many judges awarding reduced fees have determined that the risk borne by the plaintiffs’ lawyers did not justify the amount of compensation requested. In fact, in more than half of the cases reviewed, the courts found that the risk of nonrecovery was small.

Courts analyzing the risk of nonpayment have looked to a variety of factors to support their conclusions. Judges in five cases stated that the high rate of settlement in securities class action litigation generally has eliminated much of the risk for plaintiffs’ lawyers. The court in In re Quantum Health Resources Inc. Securities Litigation made this point most broadly, stating, “[T]here is no inherent risk of attorneys [sic] fee non-recovery in securities class action suits.” 244 Similarly, in Goldberger, the Second Circuit cited a combination of anecdotal evidence and a law review article245 for the proposition that there is “no appreciable risk of non-recovery in securities class actions.” 246 Subsequent district court opinions within the Second Circuit have followed Goldberger in emphasizing this point. 247 These courts did not

242. This is not to say that judges have reduced fees in most or even a majority of securities class actions. In the Rite Aid megasettlement litigation, for example, the plaintiffs’ counsel received 25% of the $334 million settlement fund, a paycheck of nearly $83 million. See Shannon P. Duffy, Rite Aid Suit Yields $83 Mil. in Fees, LEGAL INTELLIGENCER, June 4, 2003, at 1. In smaller securities class actions, judges even have awarded class counsel one-third of the settlement funds. See, e.g., Maley v. Del Global Techs. Corp., 186 F. Supp. 2d 358 (S.D.N.Y. 2002); In re Safety Components Int’l, Inc. Sec. Litig., 166 F. Supp. 2d 72 (D.N.J. 2001).
245. Alexander, supra note 74, at 578.
246. Goldberger, 209 F.3d at 52 (quoting Alexander, supra note 74, at 578) (court’s emphasis omitted).
consider the possibility that the PSLRA increased the risk faced by plaintiffs’ counsel. They failed to cite more recent studies available suggesting that the plaintiffs’ securities bar faces a greater likelihood of dismissal and protracted litigation. Nor did these courts consider that the lawyers made their prefiling investments without any assurance that they would receive the appointment as lead counsel.

In addition to the generalized notion that there is little risk in prosecuting securities class actions, many courts have listed case-specific factors that, according to the courts’ determination, have reduced class counsel’s risk of nonrecovery. Often, these factors include some sort of perceived “piggybacking”—that is, class counsel’s reliance upon the efforts of a third party that made the defendant’s liability more evident. In several cases, the courts reduced fees based on their perception that enforcement actions by the SEC assisted plaintiffs’ counsel or reduced the risk of loss. The court in In re PaineWebber Ltd. Partnerships Litigation, for example, found that “piggybacking” justified a

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248. See, e.g., In re Arakis Energy Corp. Sec. Litig., No. 95 CV 3431 (ARR), 2001 WL 1590512, at *12 (E.D.N.Y. Oct. 31, 2001); In re Dreyfus Aggressive Growth Mut. Fund Litig., 2001 WL 709262, at *4–5 (S.D.N.Y. June 22, 2001) (cutting class counsel’s request for 30% of recovery in half, finding that “the merits of this case were promising from the outset” and noting that all but a small percentage of securities class actions settle, “guaranteeing counsel payment of fees and minimizing the risks associated with contingency fee litigations”); In re Fine Host Corp. Sec. Litig., No. MDL 1241, 3:97-CV-2619JCH, 2000 WL 33116538, at *5 (D. Conn. Nov. 8, 2000).

249. See supra notes 135–38 and accompanying text.

250. In one unique case, Walco Investments, Inc. v. Thenen, the court had established at the outset that plaintiffs’ attorneys “would receive interim payments at a substantially reduced hourly rate with a final enhancement or reduction of fees based on the amount recovered.” 975 F. Supp. 1468, 1470 (S.D. Fla. 1997). At the conclusion of the litigation, the court cut counsel’s fee request, reasoning that because “the attorneys were not paid on a pure contingency fee basis, the incentives . . . that justify a percentage fee award were not fully in place.” Id. at 1472.

251. Recent empirical studies probably would not change these courts’ perceptions. James Cox and Randall Thomas reviewed 248 securities fraud class actions settled between 1990 and 2001 and found that private suits with parallel SEC actions settle for significantly more than private suits without such proceedings, and private cases with parallel SEC actions take substantially less time to settle than other private cases. James Cox & Randall Thomas, SEC Enforcement Actions for Financial Fraud and Private Litigation: An Empirical Inquiry (May 2003) (unpublished manuscript, on file with author). Another study determined that private class action settlements are significantly larger and constitute a higher percentage of estimated damages when “accompanied by” a corresponding SEC litigation release or administrative action. Laura E. Simmons & Ellen M. Ryan, Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2002, at 8 (2003), at http://securities.cornerstone.com/pdfs/LES%20Through%201202.pdf (last visited Oct. 31, 2003).

reduction in fees requested. The case concerned PaineWebber’s marketing of certain limited partnerships and investment trusts.\textsuperscript{253} While class counsel conducted discovery and began settlement negotiations, the SEC also investigated PaineWebber’s limited partnership sales and eventually issued an order “finding extensive federal securities law violations and imposing sanctions.”\textsuperscript{254} The court found that the class counsel’s risk in litigating the claims “was substantially reduced by pressure placed on PaineWebber in the SEC Order.”\textsuperscript{255}

Even concurrent SEC fraud investigations have influenced the courts to cut fees to class counsel in both \textit{In re Sunbeam Securities Litigation}\textsuperscript{256} and \textit{In re Bausch & Lomb, Inc. Securities Litigation}.\textsuperscript{257} In the Sunbeam litigation, shareholders sued the corporation and its accountant over allegedly inflated financial statements.\textsuperscript{258} The defendant accounting firm, Arthur Andersen, agreed to pay $110 million, and class counsel requested fees totaling 30% of this fund.\textsuperscript{259} The court rejected counsel’s request that it depart upward from the Eleventh Circuit’s benchmark award of 25%, citing, among other reasons, the SEC’s concurrent investigation and civil penalties action against the individual defendants.\textsuperscript{260} Similarly, in \textit{Bausch & Lomb}, the SEC conducted an investigation while the private class action litigation was ongoing.\textsuperscript{261} Bausch & Lomb agreed to settle the class action at the same time the SEC ordered the company to cease committing violations of federal securities law. The court awarded a multiplier of 2 rather than the 5.7 multiplier requested, reasoning that the SEC’s investigation and subsequent order substantially reduced the risk of the litigation for class counsel.\textsuperscript{262}

Courts offered similar justifications for their decisions to cut fees in \textit{Goldberger} and \textit{Quantum}. In affirming the district court’s decision in \textit{Goldberger}, the Second Circuit noted that “the scope of defendant’s misconduct was unprecedented” and that “a good portion of counsel’s

\begin{itemize}
\item \textsuperscript{253} Id. at 721.
\item \textsuperscript{254} Id. at 722.
\item \textsuperscript{255} Id. at 725.
\item \textsuperscript{256} 176 F. Supp. 2d 1323 (S.D. Fla. 2001).
\item \textsuperscript{257} 183 F.R.D. 78 (W.D.N.Y. 1998).
\item \textsuperscript{258} 176 F. Supp. 2d at 1327.
\item \textsuperscript{259} Id. at 1328–29, 1332.
\item \textsuperscript{260} Id. at 1336.
\item \textsuperscript{261} 183 F.R.D. at 87.
\item \textsuperscript{262} Id. at 87–88.
\end{itemize}
lodestar was based on hours spent scouring the records developed during
the parallel criminal proceedings [against Milken and Drexel].”263 In
Quantum, a case alleging accounting fraud, Judge Taylor, in the Central
District of California, rejected class counsel’s request for 30% of the $10
million settlement fund.264 The court found that the case was not
complex, that the violations of the securities laws were apparent, and that
the risks in prosecuting the case were slight because “the material
allegations of the complaint were supported by the unequivocal results of
public investigations conducted by the California State Controller’s
Office and the California Department of Health Services, as well as
significant public admissions by Quantum.”265

Judges also have recognized that investigations by the news media
reduce class counsel’s risk as well. In Bausch & Lomb, for example, the
court noted that Business Week magazine had published a pair of articles
detailing the alleged deficiencies in the company’s accounting.266 The
court determined that, even if class counsel did not directly use
information from the articles (the articles appeared after the initiation of
the lawsuits), “their publication certainly must have bolstered counsel’s
confidence in their chances of success, and strengthened their hand by
equally diminishing B&L’s own prospects in this litigation.”267 News
media involvement also influenced the court in In re Arakis Energy
Corp. Securities Litigation, a case involving misrepresentations
concerning a plan to finance an oil drilling expedition in Sudan.268 The
judge found that “substantial news coverage of the Arakis situation in the
financial press” reduced the risk of litigation for class counsel: “press
coverage undoubtedly aided counsel in their preparation for settlement
negotiations, as evidenced by the time spent by counsel reviewing this
coverage.”269

Just as defendant’s public admissions influenced the court in
Quantum to cut fees, courts have cited to corroborating evidence in the
public domain or other case-specific factors that may minimize counsel’s
risk of nonrecovery. For example, in determining a reasonable range of
fees in Cendant PRIDES, the Third Circuit noted that “the case was

265. Id. at 1259.
266. 183 F.R.D. at 87.
267. Id. at 87–88.
269. Id. at *12.
relatively simple in terms of proof, in that Cendant had conceded liability and no risks pertaining to liability or collection were pertinent. On remand of the related litigation, the district court seemingly voiced disagreement with the court of appeals, noting several “practical and procedural questions [that] made the risk of nonpayment not insubstantial” for the Cendant class counsel.

Other courts also have examined the stage of the litigation at the time of settlement in assessing the risk assumed by class counsel. In *In re Twinlab Corp. Securities Litigation*, the judge opined that class counsel had overstated the risk in the case because prior to settlement, plaintiffs’ complaint had survived defendants’ motions to dismiss several of the causes of action. So too in *In re Dreyfus Aggressive Growth Mutual Fund Litigation*, the court found that, because the plaintiffs had survived a motion to dismiss before settlement, the remaining questions dealt with damages rather than liability. The judge also decided that the risk that counsel might not collect a high premium was not the sort of “contingency risk” that courts should consider in awarding fees.

Often when assessing ex post the prospect of plaintiffs prevailing, courts also attempt to assess the novelty and complexity of the action. As the judge in *Bausch & Lomb* explained, “the complexity of the case is mostly relevant only insofar as it affects counsel’s degree of risk of litigation.” In *Varljen v. H.J. Meyers & Co.*, the court decided to award class counsel 20% of the fund rather than the 33% fee requested, holding that the lower award adequately recognized “the efforts of counsel and the risks and complexities of this litigation.” The fee decision in *In re Fidelity/Micron Securities Litigation* provides a further example. Plaintiffs had alleged in that case that the portfolio manager for the Fidelity Magellan Fund engaged in market manipulation to increase the value of a particular stock in the fund’s portfolio. In requesting 30% of the settlement fund, class counsel cited the high risk

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270. 243 F.3d 722, 735 (3d Cir. 2001).
274. Id.
and novel issues involved in the case. However, the judge rejected this argument and awarded a reduced fee, finding that the risk was not out of the ordinary and that the fraud-on-the-market theory relied upon by class counsel had been “thoroughly exposited in the existing case law.”

b. Penalizing for early (or late) settlements. Courts awarding reduced fees frequently reviewed the amount of work done by class counsel in support of their decisions to deny the amount requested. In at least two cases, judges focused attention on the total amount of time expended by class counsel in prosecuting the litigation, reducing the fee award on the grounds that the case settled at an early stage. For example, the judge in *In re Fine Host Corp. Securities Litigation* reasoned that the early settlement in that litigation weighed against an award of 33% of a common fund.279 The Third Circuit made a similar observation in the *Cendant PRIDES* case: reversing the district court for awarding excessive fees, the Third Circuit found that the litigation settled only two months after the attorneys filed for class certification.280 Of course, such decisions discourage the plaintiffs’ bar from resolving cases early and may encourage class counsel to engage in wasteful activities such as “confirmatory discovery” in order to justify a large fee award.

While settling too quickly has resulted in a lower fee award, plaintiffs’ counsel also face the risk of a reduced fee if the court perceives that they litigated too long. In awarding fees in *In re Fleet/Norstar Securities Litigation*, the court penalized class counsel for excessive litigation.281 The guardian ad litem appointed to monitor the reasonableness of the fee awards found a “remarkable absence of economy and efficiency,” as evidenced by the fee applications.282 Class counsel wasted “many, many hours” on a “deficient initial complaint [that] had to be amended after dismissal proceedings.”283 The applications also provided evidence of “overcharging” and “extensive duplication of efforts.”284 Based on these findings, the court awarded 20% of the fund to plaintiffs’ counsel, rather than the 30% requested.

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278. *Id.* at *3. The court also noted that, based on plaintiffs’ own estimate, the settlement recovered for class members represented only 20% of their potential damages. *Id.*
282. *Id.* at 107.
283. *Id.* at 110.
284. *Id.*
Similarly, in *In re Baan Co. Securities Litigation*, the court awarded class counsel 28% of the settlement fund rather than the 32% requested because of the “excessive delays and inefficiencies that plagued [the] litigation . . . due in large part to counsel’s less than exemplary performance.”285 The court specifically noted that plaintiffs’ counsel filed their original complaints some five years before they reached a settlement accord with the defendants, and that the parties litigated for nearly four years before the investor class was certified. In fact, because the court had “perceived . . . significant deficiencies in counsel’s performance,” the order certifying the class imposed on class counsel a monthly reporting requirement “so that the Court could be assured the counsel would faithfully comply with the dictates of the PSLRA.”286

286. *Id.* at *7.
c. Reviving the lodestar to reduce fee awards. Although the PSLRA mandates that courts award total fees and expenses not exceeding a reasonable percentage of the amount recovered for the class, judges reducing fees often employed the lodestar method, or, alternatively, determined a percentage-of-recovery fee but then “cross-checked” the reasonableness of that fee by reviewing a hypothetical lodestar calculation.\textsuperscript{287} Use of the lodestar does not necessarily violate the PSLRA,\textsuperscript{288} but this trend in post-reform fee jurisprudence may harm the class by encouraging excessive billing and by delaying resolution of the litigation; plaintiffs’ counsel has little motivation to settle the case until the lawyers have billed enough hours to justify their anticipated fee request. Lodestar cross-checks also impede counsel’s ability to evaluate potential lawsuits. The uncertainty created by judges using the lodestar method ultimately may reduce the expected value of such lawsuits for the plaintiffs’ bar and, as a result, diminish their financial ability and willingness to undertake the investments and risks associated with class action litigation.

Most of the courts that have attempted to value the work actually performed by counsel determined that the attorneys charged too much per hour or had billed an excessive number of hours. The district court’s decision in \textit{Zucker v. Occidental Petroleum Corp.}\textsuperscript{289} so held. Finding that the rates charged by class counsel (as much as $495 per hour) were unnecessarily high, the court quipped, “Even if the greats of legal history were to awaken from the dead and form their own mythical law practice, a senior partner at the firm Lincoln, Darrow, Holmes, Marshall, & Blackstone would not be worth such an eye-popping hourly rate.”\textsuperscript{290} In addition, the judge determined that counsel substantially inflated the total hours expended by recording its time in quarter hours rather than in

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{287} See, e.g., Gunter v. Ridgewood Energy Corp., 223 F.3d 190, 195 n.1 (3d Cir. 2000); \textit{In re BankAmerica Corp. Sec. Litig.}, 228 F. Supp. 2d 1061, 1065–66 (E.D. Mo. 2002).
\item \textsuperscript{288} \textit{CONFERENCE REPORT, supra} note 20, at 36 (“The Conference Committee does not intend to prohibit use of the lodestar approach as a means of calculating attorney[s’] fees. The [attorneys’ fees] provision focuses on the final amount of fees awarded, not the means by which such fees are calculated.”), cf. 141 CONG. REC. S17,957 (daily ed. Dec. 5, 1995) (“The conference report puts an end to this outrageous practice, called the ‘lodestar’ approach, by encouraging courts to award attorney’s fees based upon a reasonable percentage of the total amount of the settlement or judgment.”) (statement of Sen. Christopher Dodd).
\item \textsuperscript{289} 968 F. Supp. 1396 (C.D. Cal. 1997).
\item \textsuperscript{290} \textit{Id.} at 1402 & n.6.
\end{enumerate}
\end{footnotesize}
The combination of these factors led the court to reduce the total award from $3.0 million to $1.2 million.\textsuperscript{292}

Many other courts have employed an analysis similar to that used in \textit{Zucker}. In calculating the attorneys’ lodestar, the judge in \textit{Bausch & Lomb} found some of the claimed hourly rates to be “extraordinarily high.”\textsuperscript{293} In addition, this judge determined that both the number of lawyers who worked on the case and the amount of hours billed were excessive.\textsuperscript{294} Based on these findings, the court reduced the lodestar figure by 15%.\textsuperscript{295} In \textit{Feinberg v. Hibernia Corp.}, the court reduced the hourly fees of seventeen individual attorneys and refused to award fees for time spent on travel, copying documents, or arguing the issue of attorneys’ fees.\textsuperscript{296} Class counsel in \textit{Sunbeam} submitted time records detailing more than 80,000 hours of work; however, because the class settled with only one of the defendants, the court held that the attorneys should not receive compensation for the total number of hours worked on the case, and counsel’s request for an upward adjustment of the benchmark fee was refused.\textsuperscript{297}

Like the court in \textit{Sunbeam}, many courts that purport to use a percentage-of-the-fund methodology also employ a lodestar cross-check. In applying the cross-check, the judge in \textit{Arakis} discovered some evidence of excessive billing.\textsuperscript{298} The court in \textit{Lyons v. Scitex Corp.} also evaluated the attorneys’ proposed lodestar and concluded that the firm charged excessive rates.\textsuperscript{299} An examination of the lodestar in \textit{Twinlab} showed that class counsel based its calculation on rates ranging from $340 to $615 per hour for partners and up to $410 per hour for associates.\textsuperscript{300} In addition, the \textit{Twinlab} court found that many tasks performed by partners could have been delegated to less costly associates or paralegals.\textsuperscript{301} In \textit{Fidelity/Micron}, the attorneys did not provide sufficient information for the court to perform an accurate lodestar cross-

\textsuperscript{291} Id. at 1403.
\textsuperscript{292} Id.
\textsuperscript{293} 183 F.R.D. 78, 83 (W.D.N.Y. 1998).
\textsuperscript{294} Id. at 84–85.
\textsuperscript{295} Id. at 85.
\textsuperscript{297} 176 F. Supp. 2d 1323, 1334 (S.D. Fla. 2001).
\textsuperscript{298} 2001 WL 1590512, at *16 (E.D.N.Y. Oct. 31, 2001).
\textsuperscript{300} In re \textit{Twinlab Corp. Sec. Litig.}, 187 F. Supp. 2d 80, 87 (E.D.N.Y. 2002).
\textsuperscript{301} Id.
check, but the judge noted that their representations concerning total hours and hourly rates seemed excessive.\(^{302}\) The findings in each of these cases supported the courts’ decisions to award lower fees than those requested by counsel. Similarly, the court in *In re BankAmerica Corp. Securities Litigation* also used a lodestar cross-check and found that the number of hours billed and the rates charged by the lawyers “[fell] within the high end of reasonable.”\(^{303}\) Nonetheless, the court refused to award the requested 25% fee because “[s]uch an award would overcompensate counsel at the expense of the . . . plaintiffs.”\(^{304}\)

d. Comparing fees selectively. In six cases where the courts cut requested fees, judges reviewed fee awards in similar class actions to aid in their determinations. The Third Circuit endorsed this approach in the *Cendant PRIDES* litigation, holding that the district court had failed to properly consider the fees granted in other megafund settlements in awarding class counsel 5.7% of a $341 million fund.\(^{305}\) Examining fees awarded under the percentage-of-recovery method in a sample of seventeen cases settling for more than $100 million, the appellate court found that the awards ranged from 2.8% to 36%.\(^{306}\) However, it also determined that all of the cases awarding higher percentages involved complex issues and required extensive time and effort from the attorneys.\(^{307}\) After comparing the sampled cases with the case at hand, a comparison fraught with speculative assumptions, the Third Circuit concluded that the district court abused its discretion in awarding 5.7% of the settlement fund to plaintiffs’ counsel.\(^{308}\)

Other courts have reviewed a more limited number of fee precedents. In *Dreyfus*, for example, the trial court noted the emergence of a trend in the Second Circuit of “awarding attorneys considerably less than 30% of common funds in securities class actions, even where there is considerable contingency risk” and then listed three cases rejecting 30% awards and two others approving 30% awards based upon unique circumstances.\(^{309}\) The court in *Arakis* examined four cases preceding

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303. 228 F. Supp. 2d 1061, 1066 (E.D. Mo. 2002).
304. Id.
306. Id. at 737–38.
307. Id. at 738.
308. Id. at 741.
Goldberger as well as five subsequent decisions. The post-Goldberger awards demonstrated to that court a trend within the circuit away from the 30% benchmark award. Concerned that awarding the requested 25% fee from a $259 million megasettlement fund might be unreasonable, the court in In re 3Com Securities Litigation ordered class counsel to produce information about the number of hours worked by attorneys and paralegals and their hourly rates. Having calculated that the requested benchmark fee represented a multiplier of 9.27, the court summarily opined that a 25% fee indeed was “too high under all of the circumstances,” but an award of 18%, representing a 6.7 multiplier, was somehow “more reasonable” in light of uncited precedent.

The trial court overseeing the BankAmerica megalitigation studied a list of decisions submitted by plaintiffs’ counsel awarding 25% or more to class counsel. Noting its “fiduciary role in reviewing fee applications,” the court instead awarded 18% of the $490 million megasettlement fund to plaintiffs’ counsel, net expenses. Without elaboration, the court simply stated, “Having studied counsel’s list of cases in which the award of attorneys’ fees equaled or exceeded the requested 25%, the Court is nevertheless convinced that an award of 18% is reasonable considering awards in similar cases.”

The order cited, among other precedents, two other 18% fee awards recently ordered in the In re MicroStrategy, Inc. Securities Litigation and 3Com class actions.

Several other courts have reviewed hourly billing rates in determining the reasonableness of class counsel’s fees under a lodestar calculation. The use of a lodestar cross-check in Lyons v. Scitex Corp. is one example of such an analysis. There, the judge compared class counsel’s proposed hourly rates to average figures published by the New York State Bar Association and determined that the requested rates were excessive. Similarly, the court in Bausch & Lomb refused to award

313. Id. at 1064 n.5. The court also determined to calculate the amount of attorneys’ fees from the common funds available after deductions for all reimbursable litigation costs and expenses, thereby increasing the payout to absent class members. Id. at 1067.
314. Id. at 1064 n.5.
316. 987 F. Supp. 271, 279–80 (S.D.N.Y. 1997). The quality of representation also seems to have influenced this court’s decision. The fraud claims settled for $2.9 million, representing between 6.4% and 11% of the total losses suffered by the class. Id. at 278. In light of the small percentage of
rates as high as $525 per hour after reviewing three other decisions denying hourly rates in excess of $500.317

e. Slashing fees to advance public policy. More than a third of the courts cutting fees cited public policy concerns for reducing requested awards. Surprisingly, however, only one of these decisions, the opinion issued in MicroStrategy, mentioned the policies underlying Congress’s enactment of the PSLRA.318 In MicroStrategy, plaintiffs alleged that the company and its auditor, PricewaterhouseCoopers, misrepresented the company’s income, causing the company’s stock to trade at an inflated price.319 After settling with the company for $98.5 million in notes, stocks, and warrants, and with the accountants for $55 million in cash,320 class counsel applied for a total fee award equal to 27% of the value of the two settlement funds.321 Rejecting the request and awarding an 18% fee instead,322 the court interpreted the PSLRA to require that class counsel receive compensation for time spent in litigation, reward for the results achieved, and incentive to pursue similar cases in the future.323

Even without focusing on congressional policy, some courts have sought to preserve as much of the settlement as possible for members of the class.324 In Goldberger, the Second Circuit instructed lower courts to give “jealous regard to the rights” of absent class members.325 Ensuring that the class would receive sufficient funds was cited in combination with lack of risk in Varljen.326 In its award decision in In re Prudential Securities Inc. Ltd. Partnerships Litigation, the court made protecting the class the sole determining factor in its decision to reduce the class counsel’s award.327 The plaintiffs claimed that Prudential Securities fraudulently marketed and sold interests in numerous limited

loss recovered by investors in the litigation, the court decided to award class counsel only 10.4% of the fund. Id. at 280.
319. Id. at 782.
320. Id. at 781 nn.2, 3.
321. Id. at 788–89.
322. Id. at 790.
323. Id. at 787–88.
324. See id. at 786.
partnerships.\textsuperscript{328} Class counsel obtained a settlement of $22.5 million and requested a fee equal to 30\% of the fund.\textsuperscript{329} The court determined that the SEC investigation relating to the case actually aided the defendants rather than the plaintiffs and that the overall risk of the litigation was “extremely high.”\textsuperscript{330} Nonetheless, the court held that it had a “duty to avoid any sense of vicarious generosity” and granted a reduced fee amounting to 26\% of the settlement.\textsuperscript{331}

Similar considerations played a role in the court’s decision in \textit{Arakis}, where class counsel sought fees and expenses totaling one-third of the $24 million settlement fund.\textsuperscript{332} Noting that members of the plaintiff class made claims totaling only $7.2 million, the court held that public policy weighed against awarding compensation in an amount greater than that actually claimed by the injured parties.\textsuperscript{333} And in \textit{In re American Bank Note Holographics, Inc.}, the court acted to ensure that class counsel did not receive a benefit unavailable to absent class members.\textsuperscript{334} The judge approved a settlement providing absent class members with approximately $14.9 million in cash and $6 million in various securities, but the court recognized the risk associated with the securities component of the settlement.\textsuperscript{335} Reasoning that the class attorneys should share the risk of nonpayment borne by class members, the court rejected counsel’s request for 30\% of the settlement fund and awarded 25\% instead.\textsuperscript{336}

As these decisions demonstrate, ex post judicial regulation of attorney compensation after the PSLRA is highly fact-specific and is characterized by conflicting norms, especially following the abolishment of benchmark fees in two circuits. Fee awards in securities class actions are, if anything, less coherent and predictable after reform, even somewhat random.

A few judges have sought to avoid the inefficiencies associated with ex post decision-making by setting counsel’s fees at the inception of the litigation. The next two sections describe these judicial innovations and

\begin{itemize}
\item \textsuperscript{328} \textit{Id.} at 412.
\item \textsuperscript{329} \textit{Id.} at 415.
\item \textsuperscript{330} \textit{Id.} at 414–16.
\item \textsuperscript{331} \textit{Id.} at 417.
\item \textsuperscript{332} 2001 WL 1590512, at *5 (E.D.N.Y. Oct. 31, 2001).
\item \textsuperscript{333} \textit{Id.} at *13.
\item \textsuperscript{334} 127 F. Supp. 2d 418, 422 (S.D.N.Y. 2001).
\item \textsuperscript{335} \textit{Id.} at 421.
\item \textsuperscript{336} \textit{Id.} at 432–33.
\end{itemize}
discuss why these courts’ efforts at ex ante fee regulation contravene the PSLRA’s empowered lead plaintiff regime.

2. Selecting class counsel using competitive bidding

Rather than attempting to reduce agency costs by scrutinizing fees ex post, a few judges, most prominently Judge Vaughn Walker of the Northern District of California, have attempted to reduce class action agency costs by using competitive bidding to select lead counsel for the class.337 Judges employing this approach express dissatisfaction with both the lodestar and the percentage-of-recovery methods for awarding fees; neither approach effectively simulates the market nor ensures that class counsel will receive a reasonable fee.338 By soliciting competitive bids for the position of lead counsel and then using the winning bid to set counsel’s compensation ex ante, judges employing this innovation have attempted to appoint as class counsel the lawyers who would best represent the interests of the class at the lowest cost.339

Courts adopting so-called auction procedures select class counsel by soliciting first-price sealed bids from law firms seeking to represent the class. These courts often announce a preference for bids based upon a percentage of the recovery provided to the class in the litigation, and they require bidding firms to submit information concerning their qualifications, experience, malpractice insurance, and the like. After reviewing the bids and accompanying disclosures, the courts select the winning bid, appoint the winner as lead counsel, and order that counsel’s compensation will be determined in accord with its bid.


338. See, e.g., In re Oracle Sec. Litig., 131 F.R.D. 688, 692 (N.D. Cal. 1990) (explaining that, in the market, clients would “demand in advance of the litigation the following information: how much their lawyers will charge . . . and the best price available for those services.” (emphasis omitted)).

339. A review of judicial opinions in fourteen bidding cases found that “the most common reason judges gave for employing bidding was to foster competition among counsel by replicating the private marketplace for legal services.” LAURAL L. HOOPER & MARIE LEARY, AUCTIONING THE ROLE OF CLASS COUNSEL IN CLASS ACTION CASES: A DESCRIPTIVE STUDY 15 (2001), at http://www.fjc.gov/public/pdf/nsf/lookup/auctioning.pdf/$file/auctioning.pdf (last visited Nov. 20, 2003); see also Task Force 2001 Report, supra note 22, at 711 (“Judicial auctions were devised in part to foster greater loyalty by counsel to the class and to award reasonable fees . . . .”).
The several judges who have utilized the auction tool justified its use as a method to approximate an efficient market for class counsel. As Joseph Grundfest has opined, “if [class] counsel fees are set without regard to market standards, the possibility arises that fiduciary obligations to absent class members are being violated.” There is some evidence that courts have achieved success in reducing attorneys’ fees through the use of judicially supervised competitive bidding. Grundfest observed that, based on an admittedly small sample of cases, these lead counsel auctions substantially reduced fee awards from the 25% to 33% benchmark awards, to the benefit of investor classes.

Still, most courts and commentators have heaped criticism on the use of court-supervised competitive bidding for the selection and compensation of class counsel in securities cases. Most prominently, the Third Circuit held that the district court abused its discretion by conducting an auction to select lead counsel in *In re Cendant Corp. Litigation*. In that case, the district court initially appointed three public pension plans as co-lead plaintiffs. These institutions had selected and retained two law firms to represent the class and negotiated a retainer agreement providing for a decreasing percentage of recovery. However, the district court determined that it would select counsel using a competitive bidding (auction) process. According to the Third Circuit, the PSLRA prohibits the use of auctions if there is a sufficient showing that a properly appointed lead plaintiff selected lead counsel as a result of a “good faith selection and negotiation process . . . arrived at via meaningful arms-length bargaining.” Because the lead plaintiff in that case had selected and retained counsel through a sufficiently sophisticated and sincere search prior to the court-ordered auction, the district court should have appointed as lead counsel the firm selected by...


342. *Task Force 2001 Report*, *supra* note 22, at 720 (“It appears that the percentage of the recovery awarded to counsel in the auction cases is often less than that awarded by traditional methods.” (citing testimony provided to the Task Force)).

343. Grundfest Proposal, *supra* note 61, at 7–8 (observing that no fee award in an auction case has materially exceeded 20% of the gross settlement amount).

344. 264 F.3d 201 (3d Cir. 2001). A number of federal district courts also have criticized auctions. See, e.g., Osher v. Guess?, Inc., CV 01-00871, 2001 U.S. Dist. LEXIS 6057, at *15 (C.D. Cal. Apr. 26, 2001) (stating that courts should interfere with lead plaintiffs’ selection of lead counsel “only if it is necessary to protect the interests of the class”); *In re MicroStrategy, Inc. Sec. Litig.*, 110 F. Supp. 2d 427, 438 (E.D. Va. 2000) (stating that courts should address the subject of fees awarded to counsel at the conclusion of the litigation and not ex ante).

345. 264 F.3d at 276.
the lead plaintiff. The court of appeals vacated the fee award and remanded the case to the lower court to dismiss the fee application. In evaluating the resubmitted fee application, the Third Circuit instructed the district court to “seriously consider[]” the possibility that the presumption of reasonableness accorded to ex ante fee agreements was rebutted insofar as “this was a simple case in terms of liability with respect to Cendant, and the case was settled at a very early stage, after little formal discovery.”

Prompted by its then-pending review of the class counsel auction procedure adopted in the Cendant case, the Third Circuit also commissioned a Task Force on the Appointment of Counsel in Class Actions to “evaluate the emerging practice of several district court judges throughout the country of selecting class counsel and setting fees through [an] auction process.” Academics argued to the Appointment Task Force that class counsel auctions violate the letter and spirit of the PSLRA because they interfere with the lead plaintiffs’ right to select counsel and may discourage institutional investors from seeking the role of lead plaintiff as Congress intended. The Appointment Task Force agreed, concluding that “the risks and complications associated with a judicially-controlled auction counsel against its use except under certain limited circumstances.”

Other commentators have questioned whether auction methodologies could produce reasonable fees in any event. For example, Jill Fisch has asserted that the class counsel auctions employed by courts to date have been fraught with problems in their design and implementation. According to Fisch, even well-structured auctions are unlikely to produce reasonable fee awards or result in the appointment of the most qualified law firms, and, further, use of auction procedures reduces the

346.  Id. at 278. Further, because the retainer agreement negotiated by the lead plaintiff required lead counsel to obtain the lead plaintiff’s prior approval before submitting a fee application for court review, and because there was insufficient evidence that the lead plaintiff gave prior approval, the Third Circuit ordered that the district court should refuse to accept any other fee application submitted without the lead plaintiff’s prior approval. Id. at 286.
347.  Id. at 285.
accountability of class counsel and compromises the proper role of the court.351

3. Appointing lead plaintiffs based on selection of counsel

After receiving criticism for using competitive bidding to select lead counsel, Judge Walker took a different approach to controlling plaintiffs’ attorneys’ fees in In re Copper Mountain Networks Securities Litigation.352 In that case, three candidates—two individual shareholders, Quinn Barton and William Chenoweth, and a group of five individual investors led by David Cavanaugh—competed for the appointment of lead plaintiff in the consolidated actions.353 The Cavanaugh group collectively had the largest loss of the three contenders (in fact, each member of the Cavanaugh group claimed to have lost more money than the other two candidates combined), and the group qualified as the presumptively most adequate plaintiff.354 However, rather than simply appointing the Cavanaugh group as lead plaintiff, Judge Walker interviewed the three prospective appointees about their knowledge of the case, their negotiations with law firms, and their ability to monitor the performance of the lawyers for the putative investor class. Chenoweth revealed that he had not retained counsel, and Judge Walker disqualified him from further consideration as lead plaintiff.355 The Cavanaugh group represented that they had retained the nationally known plaintiffs’ firm Milberg Weiss and had entered into a contingent fee contract calling for the lawyers to receive an increasing percentage of the recovery up to 30%.356 Barton disclosed that he had hired Beattie and Osborne, a small New York firm, under a fee agreement that would pay between 10% and 15% of the recovery with a cap of $8 million.357 Based upon this evidence, Judge Walker determined that “[t]he significant differences in potential attorney fees” could not “be rationally explained by intangible factors such as the well-recognized brand name in securities litigation” of Milberg Weiss.358 The court entered an order

351. Id. at 725–26.
352. In re Quintus Sec. Litig., 201 F.R.D. 475 (N.D. Cal. 2001) (consolidated with In re Copper Mountain Networks Sec. Litig.).
353. Id. at 479.
354. Id. at 487.
355. Id.
356. Id. at 480.
357. Id. at 479.
358. Id. at 488.
finding that the Cavanaugh group was inadequate and appointing Barton as lead plaintiff.\footnote{359}{Id. at 488–89.}

After the Cavanaugh group petitioned for writ of mandamus, the Ninth Circuit reversed Judge Walker in \textit{In re Cavanaugh}.\footnote{360}{306 F.3d 726 (9th Cir. 2002).} On behalf of the panel, Judge Alex Kozinski admonished the lower court for “engag[ing] in freewheeling comparison of the parties competing for lead plaintiff.”\footnote{361}{Id. at 732.} Articulating its vision of the proper role of the court in reducing agency costs, the court of appeals held that the only statutory basis for comparing candidates for appointment as lead plaintiff is the size of their financial stakes in the case. Once it identifies the presumptively most adequate plaintiff, the district court then must provide other plaintiffs with the opportunity to rebut the presumption that the most adequate plaintiff meets the typicality and adequacy requirements under Rule 23(a). However, the court’s further inquiry is not normative; it is objective. According to the Ninth Circuit, “[s]o long as the plaintiff with the largest losses satisfies the typicality and adequacy requirements, he is entitled to lead plaintiff status, even if the district court is convinced that some other plaintiff would do a better job.”\footnote{362}{Id.; see also \textit{In re Cendant Corp. Litig.}, 264 F.3d 201, 268 (3d Cir. 2001) (“[O]nce the presumption is triggered, the question \textit{is not} whether another movant might do a better job of protecting the interests of the class than the presumptive lead plaintiff; instead, the question is whether anyone can prove that the presumptive lead plaintiff will not do a ‘fair[,] and adequate[’] job. We . . . stress that the inquiry \textit{is not} a relative one.”).}

Although Judge Kozinski could have ended his opinion at that point, he did not. The court went on to instruct that the presumptive lead plaintiff’s choice of counsel and fee arrangements have only limited relevance in the determination of adequacy under Rule 23(a). “[T]he district court has no authority to select for the class what it considers to be the best possible lawyer or the lawyer offering the best possible fee”\footnote{363}{\textit{Cavanaugh}, 306 F.3d at 732.} arrangement.\footnote{364}{Id. at 736. \textit{Contra Berger v. Compaq Computer Corp.}, 257 F.3d 475, 483 (5th Cir. 2001) (holding that the PSLRA raised the threshold for proof of adequacy), \textit{reh’g denied}, 279 F.3d 313,} Judge Kozinski articulated a more
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circumscribed role for presiding judges in reforming securities class actions: “While we share the learned district judge’s concern for reducing the cost of securities class actions, and for making plaintiffs more responsible, we believe the way to accomplish these purposes is to diligently apply the terms of the Reform Act.”365 The PSLRA confers on lead plaintiffs the right to select and retain lead counsel. The Cavanaugh decision stands for the proposition that the PSLRA thereby delimits the courts’ authority to take certain actions to reduce agency costs in securities cases.

Perhaps, however, federal judges possess extrastatutory authority to reduce agency costs. Perhaps the courts have a fiduciary obligation to protect absent class members from opportunistic lawyers. The next Part considers but rejects this possibility.

IV. JUSTIFYING JUDICIAL ACTIVISM: JUDGES AS FIDUCIARIES OF ABSENT CLASS MEMBERS

In many of their decisions reducing attorneys’ fees, judges refer to themselves as “fiduciaries” (or “agents” or “guardians”) of the absent class members.366 Similar language is found in the opinions of courts ordering competitive bidding by prospective lead counsel.367 How and why did judges become characterized as fiduciaries to absent class members? The origin of the fiduciary judge mantra is unclear. However, both the 1985 Third Circuit Task Force and a few appellate courts have articulated the following rationale for depicting judges as fiduciaries:

313 (5th Cir. 2001) (emphasizing that the lead plaintiff should be capable of understanding and controlling the litigation).

365. Cavanaugh, 306 F.3d at 736.


Once class counsel reaches agreement with the defendants to compromise the class claims, counsel assumes a position adverse to absent class members with respect to how large a fee she should receive from the class recovery fund. 368 Abandoned by their counsel, no one represents the absent class members at this point in the proceeding. In the absence of any other representatives safeguarding their interests, the presiding judge must become the advocate for absent class members and must serve as the “fiduciary” for absentee in reviewing class counsel’s fee application.369 In other words, presiding judges become fiduciaries by default. As the Ninth Circuit explained:

[A]t the fee-setting stage, “[p]laintiffs’ counsel, otherwise a fiduciary for the class, has become a claimant against the fund created for the benefit of the class. It is obligatory, therefore, for the trial court judge to act with ‘a jealous regard to the rights of those who are interested in the fund’ in determining what a proper fee award is.”370

Other appellate court opinions seem to indicate that the courts’ fiduciary status derives from Rule 23 itself. An early decision of the Third Circuit provided that “[t]he ultimate responsibility [to those not before the court] is committed to the district court in whom, as the guardian of the rights of the absentees, is vested broad administrative, as well as adjudicative, power.”371 Of course, characterizing any person as a fiduciary only begins the analysis.372 Although commentators have used this powerful rhetoric,373 the literature does not include any evaluations of the courts’

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369. In re Cendant Corp. Litig., 264 F.3d 201, 255 (3d Cir. 2001) (explaining that the court is the agent designated to oversee the relationship for class members because clients have no effective means to oversee counsel’s inherent conflicts of interest); In re Oracle Sec. Litig., 131 F.R.D. 688, 691 (N.D. Cal. 1990); see also Montgomery v. Aetna Plywood, Inc., No. 95C3193, 1999 WL 172313, at *4 (N.D. Ill. Mar. 18, 1999), vacated in part on other grounds, 1999 WL 299898 (N.D. Ill. May 3, 1999); Hallet v. Li & Fung, Ltd., No. 95 Civ. 8917, 1998 WL 698354, at *1 (S.D.N.Y. Oct. 6, 1998); In re Gould Sec. Litig., 727 F. Supp. 1201, 1203 (N.D. Ill. 1989) (“[T]his Court must act as ‘fiduciary for the fund’s beneficiaries and must carefully monitor disbursement to the attorneys by scrutinizing the fee applications.’” (quoting Skelton v. Gen. Motors Corp., 860 F.2d 250, 253 (7th Cir. 1988))).
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role as fiduciary or the consequences of the courts assuming fiduciary duties to absent class members. Review of fiduciary law principles makes clear that, as a matter of both law and public policy, courts cannot act as fiduciaries.

A. The Nature of Fiduciary Relationships

The concept of fiduciary originated in the law of trusts. Literally, the term fiduciary means “faithfulness” and denotes a trustee, or one in a position of trust. As applied in trust law, the fiduciary trustee holds title to, but not ownership of, the property of the beneficiary, who can claim the benefits of ownership but who lacks legal title. The common law imposed on trustees the duty to manage the trust corpus prudently, and fiduciary law strictly prohibited the trustees from personally dealing in trust property regardless of whether the self-dealing harmed the interests of the beneficiary.

The common law of fiduciary developed as courts applied the trustee-beneficiary construct in other contexts where the relation between fiduciary and principal was characterized by trust and confidence. Fiduciary responsibilities arise from diverse associations typically involving delegation of management power by the owner of assets to another person, the fiduciary, and some express or implied commitment by the fiduciary to exercise her discretion to promote the interests of the beneficiary. Some fiduciary responsibilities arise from the status of the trusted person and the trusting person, such as the obligations of trustees to beneficiaries, agents to principals, guardians to wards, partners one to another, directors to corporations, and lawyers to their clients. The law does not recognize the relationship of judge to litigant or judge to have long-standing fiduciary obligations to absentees to ensure the integrity, fairness, and legitimacy of settlements in aggregate litigation."; Grundfest Proposal, supra note 61, at 5 ("The court, name plaintiff, and counsel owe fiduciary obligations to absent class members."); see also Koniak & Cohen, supra note 92, at 1122 ("Ostensibly, the court stands in for the client as a fiduciary to ensure that the settlement is fair to the client and does not merely serve the lawyer’s interest.").


376. VINTER, supra note 375, at 9.
underrepresented party as a status-based fiduciary relationship. However, the law will recognize certain fiduciary relationships beyond those the law has already established based upon particular circumstances. Analytically, courts often determine whether a party acted as a fiduciary in fact by first identifying analogous status relationships where established law already has imposed fiduciary obligations. Then, courts decide whether the relationship under review is sufficiently similar to the paradigm case to support an extension of fiduciary obligations to that relationship.377

Once the courts determine that a relationship is fiduciary in nature, the inquiry turns to the obligations of the fiduciary to the beneficiary. Judicial opinions variously describe the responsibilities of fiduciaries to act in “utmost good faith,”378 or with “undivided and unselfish loyalty”379 or with “the punctilio of an honor the most sensitive.”380 Regardless of the phraseology chosen, fiduciaries cannot act simply in their own self-interest. In addition, fiduciary law articulates rules of conduct—so-called duties—applying to those persons found to be fiduciaries.381 Imposition of duties reduces the beneficiary’s risk that the fiduciary will take or otherwise misuse property belonging to the beneficiary as well as the risk that the fiduciary will behave carelessly. Here, too, courts resort to analogy in order to determine the rules applicable to fiduciaries in particular circumstances. Those legal rules then govern subsequent determinations as to whether the fiduciary has acted wrongly and, if so, what monetary and nonmonetary remedies are available to redress that wrongful conduct. For example, the law describes corporate directors as fiduciaries of the corporation, imposing on them duties of care and loyalty, including the duty to avoid usurping corporate opportunities. These duties enable beneficiaries to rely on their fiduciaries’ honesty. If a director violates her fiduciary duties, the corporation may sue to require her to disgorge all gains arising from her wrongful acts.

377. See generally id. at 11–12.
379. Id.
381. In his positivist theory of fiduciary duties, Robert Clark identified four legal attributes of fiduciary relationships: (1) affirmative duties to disclose; (2) open-ended duties to act; (3) closed-in rights to positional advantages; and (4) moral rhetoric. Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 55, 71–79 (John W. Pratt & Richard J. Zeckhauser eds., 1985).
As the law has evolved, the duties imposed by fiduciary status vary depending upon the circumstances of the relationship, including facts such as the positions of the trusted party and the trusting party; the ability of the trusted party to influence the trusting party; the allocation of function, if any, to the trusted party; and the potential for opportunistic behavior. Not surprisingly, then, the law subjects trustees to more stringent restrictions on their use of trust property than corporate officers face in transacting with the corporation. 382

B. Why Judges Cannot Serve as Fiduciaries

The imposition of fiduciary status on judges presiding over securities class actions is misplaced. In making awards of attorneys’ fees to class counsel under the common-fund doctrine, judges determine the allocation of the common fund, a fund consisting of assets belonging both to the class and, under equitable principles, to class counsel as well. 383 Neither the class nor its counsel actually entrusts property to the court, nor does the court accept property and consent to serve anyone. Judges derive their power to allocate the common fund from their judicial office and from the equitable common-fund doctrine. Despite their considerable discretion to award attorneys’ fees from the common fund, judges who rule on fee applications do not have legal title or even actual access to the assets in that fund, and the common-fund doctrine does not make absent class members’ assets vulnerable to judges themselves.

More importantly, imposing fiduciary status on the courts is inconsistent with the PSLRA’s empowered lead plaintiff model. Congress did not legislate reforms requiring judges themselves to act as class representatives. Instead, by enacting the lead plaintiff provisions of the PSLRA, federal lawmakers adopted a novel mechanism for regulating opportunism by class counsel, enabling enhanced oversight by financially interested class members who can better internalize the interests of the absent class members than can judges. Congress gave to the courts very specific statutory responsibilities: to approve the lead plaintiff’s selection and retention of lead counsel and to ensure that the

382. Id.

383. See Trustees v. Greenough, 105 U.S. 527, 536 (1881) (noting that attorneys have claim to fees payable out of common fund created through their efforts); see also In re Fine Paper Antitrust Litig., 751 F.2d 562, 589 (3d Cir. 1984) (dividing predistribution interest earned on the common fund between class counsel and the class in proportion to each party’s interest in the fund).
total fees and costs awarded to plaintiffs’ counsel do not exceed a reasonable percentage of any damages and prejudgment interest actually paid to the class. Nothing in the PSLRA evidences a congressional intent that courts fulfill fiduciary responsibilities to absent class members. Similarly, nothing in Rule 23 contemplates that the court itself will represent the investor class.

Instead, the PSLRA and Rule 23 require the courts to enforce the duties of others deemed to be fiduciaries to absent class members, namely, the lead plaintiff and lead counsel. Courts enforce these persons’ duties when courts engage in their statutorily mandated review of the lead plaintiffs’ selections for lead counsel and the proposed terms of retention. At the conclusion of the case, courts again consider whether the lead plaintiffs and lead counsel have fulfilled their duties in reviewing and approving the terms of any settlement and attorneys’ fees and costs requested by plaintiffs’ counsel. Thus, fiduciary jurisprudence gives content to the responsibilities of lead plaintiffs vis-à-vis the class, including the lead plaintiff’s duty to the class “to obtain the highest quality representation at the lowest price.” Just as courts do not become fiduciaries themselves in cases involving trusts, bankruptcies, corporate governance disputes, guardianships over infants or the mentally incompetent, or the like, so too in this context the law simply calls upon judges to evaluate other fiduciaries’ qualifications, activities, and requests for compensation.

If judges nonetheless attempt to act as fiduciaries, they may defeat the objectives of the PSLRA by disempowering lead plaintiffs. This possibility is not simply theoretical. In Wenderhold v. Cylink Corp., Judge Walker invoked his purported fiduciary responsibilities to absent class members when he disempowered the lead plaintiff from selecting and retaining counsel and ordered competitive bidding instead. “As a general matter, the lead plaintiff selects lead counsel to represent the class subject to the court’s approval. . . . The court, however, is charged with ensuring that the class receives quality representation at a fair price and cannot, therefore, simply defer to lead plaintiff’s choice of counsel.” The prospect that a fiduciary judge will select lead counsel

385. See In re Oracle Sec. Litig., 131 F.R.D. 688, 696 (N.D. Cal. 1990) (“For a court simply to fix a percentage contingent fee without seeking competitive alternatives is thus inconsistent with the court’s fiduciary duty to the class.”).
386. 188 F.R.D. 577 (N.D. Cal. 1999).
387. Id. at 587. The lead plaintiff, an individual,
herself through a bidding process or will disregard the retention agreement negotiated by the lead plaintiff may disable lead plaintiffs from obtaining prospectively binding compensation commitments from putative lead counsel.\textsuperscript{388} Also, the greater the likelihood that the court will substitute its judgment for that of the lead plaintiff, the fewer the number of law firms that will choose to compete for the appointment. The lead plaintiff’s ability to bargain for the benefit of the class will suffer. The result is a weakening of the incentives for institutional investors and others with greater stakes to participate as lead plaintiffs in securities class actions.\textsuperscript{389}

Applying fiduciary lexicon to judges presiding over class actions is also inconsistent with the mission of the federal bench under our adversarial system of justice. Article III judges decide cases or controversies on the law and the facts. They do not represent litigants or interested parties in litigation. They do not advocate on behalf of any of the parties. They are not loyal to any of the parties. The Code of Conduct for Judges makes clear the importance of an independent and impartial bench.\textsuperscript{390} “Judges have been schooled to remain independent and aloof . . .”\textsuperscript{391} Thus, fiduciary judging is contrary to the accepted model of appropriate judicial behavior. To use one analogy, courts more typically act like umpires, calling balls and strikes, or deciding whether a player is

almost certainly does not have the expertise and resources of a large institutional investor. His ability to select and monitor the conduct of class counsel on behalf of the entire class throughout the duration of this litigation is, therefore, inherently less than that of the ideal lead plaintiff contemplated by Congress.

\textit{Id.}

388. Judge Walker justified the need for judges to override the decisions of lead plaintiffs when he wrote, “If the court were acting as a private fiduciary, the law would require [the court] to obtain the best price the market would yield for the services of the class’s lawyers.”\textit{In re Oracle Sec. Litig.}, 131 F.R.D. 688, 692 n.10 (N.D. Cal. 1990).

389. Institutional investors have claimed that “the major incentive for [institutional] participation [as lead plaintiff] . . . is the opportunity to negotiate a counsel fee for the benefit of the class.” Task Force 2001 Report, supra note 22, at 754 n.227.

390. Canon 1 states that “a judge should uphold the integrity and independence of the judiciary.” CODE OF CONDUCT FOR JUDGES (2000). Canon 2 provides that “a judge should avoid impropriety and the appearance of impropriety in all activities.”\textit{Id.} Finally, Canon 3 states that “a judge should perform the duties of the office impartially and diligently.”\textit{Id.} The commentary for Canon 2 sets forth the test for the appearance of impropriety as “whether the conduct would create in reasonable minds . . . a perception that the judge’s ability to carry out judicial responsibilities with integrity, impartiality, and competence is impaired.”\textit{Id.}

The parties play the game in our adversarial system, not the judges. The judge as umpire looks over the parties’ shoulders to “keep[] the playing field level”393 but does not play the game for them. If the judge plays the game for or with the parties, he may become a “blind and blundering intruder, acting in spasms as sudden flashes of seeming light may lead or mislead him.”394 Given the mindset, not to mention the workload, of the federal bench, it is not realistic to expect that most district court judges can embrace the responsibility to advocate as fiduciaries for absent class members.

To be sure, the very nature of class action litigation makes absent class members vulnerable to opportunistic behavior by class counsel. Like other litigants, some, perhaps many, absent class members would say that they repose trust and confidence in the integrity and fidelity of the courts to police class action settlements for collusion and to award counsel a fair fee from the common fund. If polled, plaintiffs’ attorneys possibly would say that they, too, repose trust and confidence in the court’s ability to compensate them fairly. However, it does not follow from the fund claimants’ state of mind that the court assumes fiduciary obligations to them.395 Judges exercise legal or equitable discretion without presumptively assuming the responsibilities to advocate for and act in the best interest of one of the parties affected by their decisions. The courts rarely, if ever, express that they intend to act on behalf of a litigant, much less that they will act solely in that party’s best interests as her fiduciary. Indeed, trust and confidence in the courts are premised upon judges acting impartially when making their determinations. In order to maintain legitimacy for judicial decisions, the bench must remain an independent institution, unrestrained by the responsibility to advocate on behalf of a particular party, even if that party otherwise becomes underrepresented. Courts using this argot gratuitously undertake undefined obligations that absent class members cannot enforce in any event.

394. Marvin E. Frankel, supra note 393, at 1042; see also Stephen A. Saltzburg, The Unnecessarily Expanding Role of the American Trial Judge, 64 VA. L. REV. 1, 7 & n.20, 15 (1978).
395. In any event, the law does not require a finding of actual trust before imposing fiduciary duties. See Tamar Frankel, Fiduciary Duties as Default Rules, 74 OR. L. REV. 1209, 1227–28 (1995).
Even assuming some benefit in placing the fiduciary mantle on judges, courts portraying themselves as fiduciaries fail to articulate what the status requires in this context, much less what they have done to satisfy their fiduciary duties for the benefit of absent class members. The invocation of the court-as-fiduciary vernacular does not follow from judicial admissions that, unless restrained, judges awarding attorneys’ fees to class counsel may pursue their own self-interests at the expense of absent class members. Certainly courts describing themselves as fiduciaries have not intended to restrain their own discretion. Rather, courts seem to use this language to justify their discretion, i.e., to justify decisions to award reduced compensation (even absent any objection to class counsel’s petition for attorneys’ fees) or to auction the position of class counsel to the lowest bidding firm despite the lack of statutory authority to do so. If systematically adopted, such decisions, while well-intentioned, may damage the interests of defrauded shareholders in the long run by diminishing the incentives for the private attorney general to enforce the securities laws.

Perhaps characterizing presiding judges as “fiduciaries” performs an expressive function when used by appellate courts or their blue-ribbon panels. The rhetoric expresses that someone is looking out for the absent class members. When used by appellate courts, the language also may serve to communicate to the district bench that they should take care when engaging in the difficult task of approving settlements and awarding fees to class counsel. Further, by articulating to judges that they must act to protect the interests of absentees, the bench will review fee petitions with a heightened cognizance of the danger of lawyer opportunism. Nonetheless, the judge-as-fiduciary metaphor invokes images, if not rules, in conflict with the accepted notion of judges as unbiased umpires in our adversarial system of justice. In light of these prudential concerns, it is preferable for courts to avoid using such language in describing the role of district judges overseeing class actions.

Finally, courts need not assume the responsibilities of fiduciaries themselves in order to reduce agency costs in securities class actions. To reform securities class actions, the courts must require the lead plaintiffs to fulfill their fiduciary duties to the injured plaintiffs that they represent. One special competence of the judiciary as an institution lies in its ability to enforce fiduciary responsibilities and procedural requirements.396

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V. REDUCING AGENCY COSTS BY JUDGING FIDUCIARIES MORE EFFECTIVELY

If embraced by district court judges, the legislatively sanctioned mechanism for aligning the incentives of class counsel with those of the class—the PSLRA’s empowered lead plaintiff model—will reduce agency costs in securities class actions more efficiently and effectively than fiduciary judging without threatening the values inherent in the umpireal model of adversarial adjudication.

The PSLRA does not rely upon ex post judicial paternalism to protect absent class members from opportunistic class counsel, nor does the statute place responsibility on the federal bench to select and retain the lawyers. Rather, the statute divides responsibility for monitoring class counsel between the lead plaintiff and the court, as evidenced by the statute’s lead plaintiff selection rule, lead counsel selection rule, and the attorneys’ fee rule. Both the text of the PSLRA and the Conference Report make clear that presiding judges retain authority to approve fees and expenses, but it is fair to say that lawmakers recognized that ex post judicial review of the lawyers’ fee petition is “an imperfect safeguard” at best. Therefore, Congress provided the courts with a statutory standard for exercising their authority over class counsel compensation—the attorneys’ fee provision—as well as new procedures for doing so—the empowered lead plaintiff provisions of the PSLRA.

A. The Responsibilities of Lead Plaintiffs as Class Fiduciaries

In order to comply with the statute and fulfill their duties as fiduciaries, lead plaintiffs must search for high-quality counsel willing to do the work on the terms most favorable to the class. Unlike the presiding judge, the most adequate plaintiff (presumably a large and sophisticated investor, if not an institutional investor) has a substantial interest in the outcome of the lawsuit. Absent any reason to believe that the lead plaintiff is atypical or inadequate to represent the class (which should have disqualified the lead plaintiff from appointment), it is safe to

398. Moreover, Congress left undisturbed the courts’ authority to determine adequacy under Fed. R. CIV. P. 23(a)(4) and to determine the fairness of settlements under Fed. R. CIV. P. 23(e).
399. Unfaithful Champion, supra note 132, at 5, 31.
assume that the interests of the lead plaintiff in maximizing the recovery for the class are aligned with those of the absent class members. Thus, the lead plaintiff’s ex ante selection and negotiation with lead counsel over the terms of the representation best provide lead counsel with incentives designed to reduce agency costs. Because of their incentives, as well as their experience, sophistication, and access to information about the lawyers’ performance and compensation in prior comparable lawsuits, lead plaintiffs are in a better position than the courts to assess accurately the risk of opportunism.

Although the PSLRA initially inspired few institutional investors to come forward and volunteer for the role of lead plaintiff, 400 that situation has changed. In the past several years, as more and more public companies have restated their financials, and as the SEC has opened one accounting fraud investigation after another of major corporations, institutions have become active participants in private enforcement. 401 Most of the institutions volunteering to serve as lead plaintiff are public pension funds and union pension plans regulated under the Taft-Hartley Act, 402 but other institutions have sought appointments as well. 403 In fact, institutional investors increasingly have competed against each other for the role of lead plaintiff in financial fraud megacases like those brought against Cendant, Waste Management, Bank of America, Enron,


402. The Taft-Hartley Act regulates any employee benefit plan funded with employer contributions if a union or union representative has authority to administer the plan or manage its assets. 29 U.S.C. § 302 (2000). Union pension funds have invested more than $5 trillion in assets by recent estimates. Steven Greenhouse, Labor to Press for Changes in Corporate Governance, N.Y. TIMES, July 30, 2002, at C7.

Commenting on how the recent financial fraud scandals have encouraged institutional activism, Milberg Weiss’ Bill Lerach recently wrote,

Now institutional investors are involved in almost every securities class action case. I spend a lot of time with institutional investors.... Pension funds that would not have considered litigation five years ago—not even considered it—today are willing to march into federal or state court to assert their rights as shareholders.  

What motivates institutions to seek appointments as lead plaintiff? A number of institutions told the Third Circuit Task Force that they wanted to control the selection and compensation of class counsel. Experience demonstrates that institutions applying for the role of lead plaintiff can and do negotiate fee agreements with putative lead counsel before selecting the attorneys for the class. In the Waste Management megalitigation, for example, lead plaintiff Connecticut Retirement Plans and Trust funds negotiated a contingent fee agreement with lead counsel Goodkind Labaton Rudoff & Sucharow at the outset of the case. The pact included a provision capping the attorneys’ fees if the case settled after resolution of motions to dismiss but before a decision on motions for summary judgment. The court approved the contract fees as reasonable and awarded counsel 7.93% of the cash recovered for the class in the megasettlement, or $36,225 million of the $457 million recovery fund. Acting as lead plaintiff in the megalawsuit arising from the Enron debacle, the University of California Board of Regents also negotiated a contingent fee contract with lead counsel Milberg Weiss calling for a fee below 10% of any recovery—again, substantially lower than the 25% benchmark previously utilized by many courts.

404. See, e.g., Edward Iwata, Law Firms Tussle over Enron Case, USA TODAY, Feb. 12, 2002, at 1B.
405. LERACH, supra note 70, at 17.
406. Task Force 2001 Report, supra note 22, at 761–62 & n.258; see also Fisch, supra note 351, at 709 (reporting results of interviews with approximately a half-dozen counsel of public pension plans that have volunteered most frequently to serve as lead plaintiffs).
408. Acting outside the spotlight, some institutions not serving as lead plaintiffs also have persuaded class counsel to reduce their fee requests without filing formal objections. Keith L. Johnson & Douglas M. Hagerman, The Elephant in Your General Counsel’s Office: Managing
Reforming Securities Class Actions

To the extent public and union pension plans have assumed the role of lead plaintiff in a number of lawsuits, they have become repeat players rather than one-shot purchasers of class counsel services and can negotiate superior fee agreements with better information. Presumably, qualifying lead plaintiffs also are more sophisticated, “cost-conscious” purchasers of legal services than other investors. Many institutions serving as lead plaintiffs employ in-house attorneys and even outside law firms to investigate and evaluate potential claims in advance of interviewing putative lead counsel. In any event, applicants for lead counsel under the PSLRA must negotiate the terms of their retention with potential clients who are motivated by their greater losses to participate in the litigation. Lead plaintiff candidates (ideally, institutional investors) will bargain over fees and, perhaps, even send the engagement out for competitive bidding. In scrutinizing fee proposals, these injured investors can consider the likelihood that the lawsuit will generate a megafund or will settle early, the probability that the case will survive the defendants’ motion to dismiss, and the settlements and fee awards in like litigation. They also can assess the quality of service variations among potential counsel, evaluating which law firm proposal likely would maximize the net recovery for the class. Based upon good faith judgments about these and other similar factors, lead plaintiffs will select lead counsel and negotiate her retention accordingly. Perhaps lead plaintiffs and counsel will agree to more than one contingency fee, depending on the stage of the litigation or a particular litigation event (e.g., settlement, trial, appeal). Perhaps they will design a fee structure involving differing percentages, capped amounts, or some combination for each contingency. By bargaining at the inception of the litigation, “in the shadow of the litigation’s uncertainty,” lead plaintiffs and candidates for the position of lead counsel can assess intelligently “the costs and benefits of particular systems and risk multipliers.”

Losses to Legal Fees in Shareholder Class Actions, CORP. GOVERNANCE ADVISOR, March/April 2001, at 8 (citing various examples). In addition, public pension funds have assembled data used to evaluate fee applications in securities class actions. Id. Institutional Shareholder Services, a provider of proxy voting and corporate governance services to institutional investors, has established a proprietary database for tracking securities class actions from initial filing to payment of claims. See Governance Matters—Institutional Shareholder Services, at http://www.issproxy.com/institutional/analytics/scas/index.asp (last visited Nov. 21, 2003).

B. Judging the Lead Plaintiffs and Their Proposed Lawyers

The lead plaintiff cannot meet her fiduciary duty to maximize the recovery for the class unless she has bargained with the attorneys in good faith, employing independent decision-making. For this reason, courts should order appointees to access the market and negotiate the terms of a fee agreement with prospective lead counsel ex ante. After negotiating the terms of retention in the usual marketplace manner, the lead plaintiff then should submit the proposal in camera for the court’s approval. Before approving the lead plaintiff’s selection and retention agreement, the presiding judge should require the lead plaintiff to make sworn representations to the court sufficient to satisfy the court that the lead plaintiff negotiated counsel’s compensation in “an open and appropriately arm’s length manner” and that the retention agreement “include[s] all of the features normally contained in comparable arrangements that are negotiated directly between counsel and client.”

Putative lead counsel, too, should be ordered to disclose its qualifications to serve as lead counsel and the existence and extent of any conflicting interests.

Assuming these procedural prerequisites are met, the court should presume the reasonableness of the proposed agreement and simply retain the ultimate authority to revise the fee if later extraordinary circumstances occur.

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411. Task Force 1985 Report, supra note 54, at 256; see also In re Cendant Corp. Litig., 264 F.3d 201, 276 (3d Cir. 2001) (“[T]he ultimate inquiry is always whether the lead plaintiff’s choices were the result of a good faith selection and negotiation process and were arrived at via meaningful arm’s length bargaining.”). Grundfest has proposed a series of five appropriate questions for a presiding judge to ask lead plaintiffs before approving their selection and retention of lead counsel. Grundfest Proposal, supra note 61, at 10–11.

412. Where the court has appointed a public pension plan or Taft-Hartley plan as lead plaintiff, the court must not overlook the danger that potential class counsel may have exchanged political contributions for the right to represent the class. See Kevin McCoy, Campaign Contributions or Conflicts of Interest?, USA TODAY, Sept. 11, 2001, at 1B. If the law firm selected by the lead plaintiff has contributed to the campaign of any elected official with responsibilities for administering the fund or who could influence the selection of lead counsel, the court should exercise its discretion to disapprove the law firm as lead counsel.

413. See In re Cendant Corp. Litig., 264 F.3d 201, 282 (3d Cir. 2001) (“[U]nder the PSLRA, courts should accord a presumption of reasonableness to any fee request submitted pursuant to a retainer agreement that was entered into between a properly-selected lead plaintiff and a properly-selected lead counsel.”). The possibility that class counsel will under-invest in the litigation exists regardless of the method used to calculate the fee because no fee arrangement can perfectly align the interests of class counsel and the class in all circumstances.
circumstances warrant. This retention of authority is consistent with the courts’ statutory obligation to determine that total attorneys’ fees and expenses awarded do not exceed a reasonable percentage of any damages and prejudgment interest actually paid to the class,414 a finding the court cannot make without a determination of what monies the class will receive from settlement or, more rarely, by litigated judgment.

However, courts should not interfere with an arms-length negotiated fee except when presented with proof of fraud, duress, or unconscionability—the same extraordinary circumstances recognized for voiding agreements under contract law. As the Third Circuit recognized in *In re Cendant Corp. Litigation*, the appointed lead plaintiff is in the best position to determine the fee for lead counsel at the inception of the litigation.415 Courts should not second-guess the lead plaintiff at the conclusion of the case without evidence of some wrongdoing or conflict; judges cannot assess fairly the reasonableness of contingent fees after the outcome of the lawsuit and the hours of work expended on that outcome become known definitively. Furthermore, the advantages of the empowered lead plaintiff model will be undermined if, at the end of the litigation, counsel may not receive the full fee negotiated with the lead plaintiff or, alternatively, if counsel may renegotiate the terms of the retainer upward with the court.416

The court’s role, then, is not to be the fiduciary, but to judge the fiduciary—to assess whether the lead plaintiff has fulfilled its fiduciary duties to the absent class members and to enforce those duties. In approving the selection and retention of lead counsel, the presiding judge must satisfy herself that the appointed lead plaintiff has fulfilled its fiduciary obligations. Effective judicial oversight actually will empower the lead plaintiff to control agency costs by enhancing its bargaining power vis-à-vis potential class counsel. Unlike court-supervised competitive bidding and similar interventions by presiding judges,417 the “judging fiduciaries” approach reconciles the tension between the courts’ authority and the authority of empowered lead plaintiffs under the PSLRA.

415. 264 F.3d 201, 282 (3d Cir. 2001).
417. The lead plaintiff selection procedure struck down in *In re Cavanaugh*, 306 F.3d 726 (N.D. Cal. 2002), is an example of such an intervention. See supra Part III.B.3.
C. Judging Fiduciaries Reduces Agency Costs and Judicial Errors

By requiring the lead plaintiff to negotiate the terms of retention with lead counsel at the inception of the litigation, the court will have evidence of the market value of the attorneys’ services. Assuming competition in the market for legal services, market pricing should provide representation to the class at the lowest possible price that will award class counsel with a reasonable profit.\footnote{Competition in the market for lead counsel services requires further study. The same small group of law firms seems to compete for and win the appointment as lead counsel in securities class actions. See Thomas et al., supra note 135, at 194. There also is evidence that “Milberg Weiss and other big players in the industry... have actually tightened their hold on the litigation since 1995.” Alison Frankel, Class Warfare, AM. LAW., Mar. 2002, at 76, 81.} The market will produce a fee and other terms of retention that are presumptively reasonable. Courts can dispense with ex post market proxies such as lodestar calculations and lodestar cross-checks, thereby avoiding time-consuming investigations to determine the amount of actual work performed by class counsel and the customary hourly rates in a particular community.

Utilizing the actual compensation contract entered into by class counsel also reduces the risk of judicial error. The court can avoid subjective analyses biased by hindsight. No longer will the court have to speculate about risk or counsel’s skill. Assuming a successful prosecution, plaintiffs’ attorneys will receive the compensation explicitly agreed to by the lead plaintiff and approved by the court at the inception of the litigation. If the market for lead counsel services is competitive, lead counsel can be more certain about what compensation they will obtain if they successfully prosecute the lawsuit. Class counsel prosecuting similar claims for damages and facing similar risks will not receive widely differing fee awards. By according a presumption of reasonableness to the lead plaintiff’s ex ante negotiated terms of retention, more attorneys may enter the market to represent shareholder classes, and more institutions may apply for lead plaintiff positions. Only by safeguarding the lead plaintiff’s statutory authority to select and retain lead counsel will the courts fulfill the legislative scheme.

Finally, the “judging fiduciaries” model will enhance the legitimacy of the private enforcement regime. Judicial utilization of contracts negotiated by sophisticated lead plaintiffs may help dispel the public perception that private securities litigation benefits only the attorneys and not the investors they purport to represent. Presiding judges employing
this approach need not serve as advocates in the litigation nor become adversarial to class counsel.

VI. CONCLUSION

Congress attempted to reform securities litigation by inserting into the lawsuits class representatives, preferably institutional investors, with economic incentives to hire and monitor class counsel, much in the way that plaintiff-clients in traditional bipolar litigation oversee their lawyers. Because institutional involvement in securities class actions has become more prevalent only recently, it is still too early to evaluate whether the empowered lead plaintiff model actually is fulfilling its theoretical promise of reducing agency costs. Although some anecdotal evidence exists, there is much we do not know about lead plaintiffs’ performance in lawsuits. More evidence for review will come shortly, as megasecurities class actions arising from Enron, WorldCom, and other recent corporate frauds wind their way through the federal judicial system.

What is clear is that the objectives of the PSLRA’s empowered lead plaintiff model cannot be realized unless the bench allows—indeed requires—the most adequate plaintiff to select and retain class counsel.

419. For example, the legal press has reported that the University of California Board of Regents, appointed as the sole lead plaintiff in the Enron securities fraud litigation, has assigned five attorneys in its 40-lawyer in-house legal department to work on the case, that one attorney plans to attend every hearing in the case, and that the general counsel believes, “It is [the University’s] responsibility to make the choices for the direction the case will go.” Maureen Milford, UC Takes Charge of Enron Suit, NAT’L L.J., Mar. 4, 2002, at A15, A18; see also Fisch, supra note 351.

420. As more institutions receive appointments as lead plaintiffs, we can make more observations based upon actual performance. Do injured investors recover a greater percentage of their losses when represented by institutions? Do the settlements contain different terms for the benefit of the class? How do lead plaintiffs supervise class counsel? What decisions do lead plaintiffs participate in? How do they influence litigation strategies and objectives? What do lead plaintiffs do to monitor the lawyers? How much time, effort, and expense do they devote to the litigation? What mechanisms do lead plaintiffs use to evaluate the performance of lead counsel?

The limited empirical work available to date indicates that institutions tend to participate in larger cases, and that cases led by institutional investors “are associated with significantly higher settlement amounts.” Laura E. Simmons & Ellen M. Ryan, Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2002, at 6 (2003), available at http://securities.cornerstone.com/pdfs/LES%20Through%201202.pdf (last visited Nov. 21, 2003). Another recent study found that “settlements are about 20% higher in cases where the lead plaintiff is an institutional investor.” Buckberg et al., supra note 6, at 11. Although this settlement data may indicate that institutional investors retain higher quality lead counsel and/or supervise lead counsel more closely and effectively than other potential class representatives, it also is possible that institutions simply do not volunteer to participate as lead plaintiffs unless they determine that the investor class can assert strong fraud claims and recover large damages.
In exchange for receiving the right to act on behalf of the class and to select and retain lead counsel, the empowered lead plaintiffs assume fiduciary responsibilities to absent class members. They must act to maximize the net litigation recovery for the injured investors they represent. By requiring empowered lead plaintiffs to access the market for legal services and negotiate legal fees ex ante, courts can remain impartial and dispense with much of the cost, guesswork, and subjectivity associated with compensating class counsel. Judicial fee awards will come closest to duplicating compensation arrangements that the market would have produced if absent class members could contract with their lawyers directly, thus reducing the agency costs of the litigation. By more effectively and efficiently judging the persons who do have the fiduciary duty to maximize recoveries for injured investors, the courts may make securities class actions more “virtuous” after all.