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LAWYERS ON AUCTION – PROTECTING CLASS MEMEBERS

Ittai Paldor[†]

INTRODUCTION

When class actions settle, class attorneys often receive hefty fees, while class members only receive illusory benefits.¹ Coupled with the fact that nearly all class actions settle and that the number of class actions that are adjudicated is virtually zero,² this creates a serious problem. The class action system ends up harming individual class members, who are bound by the terms of suboptimal settlements. Class actions benefit class attorneys and defendants at the expense of individual class members—precisely those individuals that the class action mechanism was put in place to empower. More than corrective justice for class members is sacrificed. If class settlements are systematically under-compensatory, deterrence of wrongdoers is also compromised.

The problem is not surprising. Class members are rationally apathetic, due to each member's small individual claim. The same rational apathy that brings about the need for class actions in the first place renders class supervision of settlement terms ineffective.³ As a result, class counsel may be induced by the defendant to knowingly agree to a deal that is suboptimal from the class' perspective in return for increased fees for counsel. Class counsel may also unintentionally negotiate a deal that is

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1. U.S. CHAMBER INST. FOR LEGAL REFORM, UNSTABLE FOUNDATION – OUR BROKEN CLASS ACTION SYSTEM AND HOW TO FIX IT 4-5 (Oct. 2017), *available at* http://instituteforlegalreform.org/uploads/sites/1/UnstableFoundation_Web_10242017.pdf; Howard M. Erichson, *The Problem of Settlement Class Actions*, 82 GEO. WASH. L. REV. 951 (2014); CONSUMER FINANCIAL PROTECTION BUREAU, ARBITRATION STUDY: REPORT TO CONGRESS, PURSUANT TO DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT § 1028(A) 7 (Mar. 2015), *available at* https://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf; EMERY G. LEE III & THOMAS E. WILLGING, FED. JUDICIAL CTR., IMPACT OF THE CLASS ACTION FAIRNESS ACT ON THE FEDERAL COURTS: PRELIMINARY FINDINGS FROM PHASE TWO'S PRE-CAFA SAMPLE OF DIVERSITY CLASS ACTIONS (2008); *Creative Montessori Learning Ctrs. v. Ashford Gear L.L.C.*, 662 F.3d 913 (7th Cir. 2011).

2. Erichson, *supra* note 1, at 952; CONSUMER FINANCIAL PROTECTION BUREAU, *supra* note 1, at 48-54; LEE & WILLGING, *supra* note 1, at 11; *Creative Montessori Learning*, 662 F.3d at 915.

3. John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 883-89 (1987) (identifying additional issues that exacerbate the problem).

suboptimal from the class's perspective.⁴ Both are manifestations of the same agency problem. Class counsel acts as an agent but is not accountable to the principals.⁵

As the basic problem is long-recognized, several mechanisms have been put in place that are geared toward alleviating it. In lieu of effective supervision by class members, Rule 23 of the Federal Rules of Civil Procedure requires court approval for class settlements. Rule 23 stipulates that a court will approve a settlement only if it is fair, reasonable, and adequate, after considering whether the class was adequately represented, the proposal was negotiated at arm's length, and the relief provided for the class is adequate.⁶ The Rule also sets the procedure for such approval.⁷

However, court supervision is notoriously ineffective when class actions settle.⁸ The key reason for this has to do with courts' institutional capacity and with the parties' incentives. When class actions are adjudicated, the parties before the court are adversaries. Class counsel's incentives are diametrically opposed to defendant's incentives. Class counsel wants the court to award the highest possible amount to the class.⁹ Defendants naturally try to persuade the court to award the lowest possible amount. By contrast, when class actions settle, both parties before the court—class counsel and the defendant—seek approval of the settlement. Consequently, the court finds itself in a peculiar position. It must act as an adversary to the parties before it and as a fiduciary for

4. *Creative Montessori*, 662 F.3d at 918; Jay Tidmarsh, *Auctioning Class Settlements*, 56 WM. & MARY L. REV. 227, 234 (2014); Theodore Eisenberg & Geoffrey P. Miller, *Attorney Fees in Class Action Settlements: An Empirical Study*, 1 J. EMPIRICAL LEGAL STUD. 27, 30 (2004).

5. Brian Wolfman & Alan B. Morrison, *Representing the Unrepresented in Class Actions Seeking Monetary Relief*, 71 N.Y.U. L. REV. 439, 441 (1996) (focusing on class members' whose interests do not coincide with those of class representative); Coffee, *supra* note 3; Paul Harzen Beach, *The Parens Patriae Settlement Auction*, 52 GONZ. L. REV. 455, 466-72 (2016) (focusing on the specific context of *Parens Patriae* settlements. The analysis is equally applicable to class actions).

6. FED. R. CIV. P. 23(e)(2)(a) – (c); *Quimby v. United States.*, 107 Fed. Cl. 126 (Fed. Cl., 2012); *In re Uponsor, Inc.*, F1807 Plumbing Fittings Products Liability Litigation, 716 F.3d 1057 (8th Cir. 2013); *Hefler v. Wells Fargo & Company*, No. 16-cv-05479-JST, 2018 WL 6619983 (N.D. Ca. Dec. 17, 2018).

7. FED. R. CIV. P. 23(e)(1), (3), (4), (5).

8. Beach, *supra* note 5, at 466; Theodore Eisenberg & Geoffrey P. Miller, *Attorney Fees and Expenses in Class Action Settlements: 1993–2008*, 7 J. EMPIRICAL LEGAL STUD. 248 (2010).

9. If only because the class's recovery is a key determinant of class counsel's fees. Although the court does not necessarily award class counsel a percentage of the class's recovery. *See infra* notes 94 – 100 and accompanying text.

absent class members.¹⁰ This is a task courts are ill-equipped to perform.¹¹ Courts in an adversarial system are dependent on parties' rivalry. The adversarial system is based on the notion that each of the parties will collect and present the best evidence and arguments to support its position in an attempt to further its own interests. The court is then vested with the task of deciding between what are presumably the best cases for each of the competing positions.¹² When cooperation substitutes rivalry, courts are at an inherent disadvantage vis-à-vis the settling parties. As Professor Coffee puts it: "the trial court's approval is a weak reed on which to rely once the adversaries have linked arms and approached the court in a solid phalanx seeking its approval."¹³

In addition to their institutional inadequacy, courts also have little incentive to challenge settlements. Courts are overloaded with cases. Settlements resolve cases at a relatively low cost to the judiciary and clear up the docket quickly, and are therefore greatly favored.¹⁴ Challenging a settlement to which the parties have agreed is, from the court's perspective, counterproductive, even if the settlement is socially suboptimal.¹⁵

10. *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277 (7th Cir. 2002); *In re GMC Pick-Up Truck Fuel Tank Prods. Liab. Litig.*, 55 F.3d 768, 784-85 (3d Cir. 1995); Nancy Morawetz, *Bargaining, Class Representation, and Fairness*, 54 OHIO ST. L.J. 1 (1993); Chris Brummer, Note, *Sharpening the Sword: Class Certification, Appellate Review, and the Role of the Fiduciary Judge in Class Action Lawsuits*, 104 COLUM. L. REV. 1042, 1060-62 (2004). For a brief account of the effect of the various fee (and cost) mechanisms on plaintiffs' attorneys see also Arthur R. Miller, Keynote Address: The American Class Action: From Birth to Maturity 15 (Jan. 4 2017); Eisenberg & Miller, *supra* note 8, at 249.

11. *Creative Montessori Learning Ctrs. v. Ashford Gear L.L.C.*, 662 F.3d 913, 917 (7th Cir. 2011); Theodore Eisenberg et al., *Attorney's Fees In Class Actions: 2009 – 2013*, 92 N.Y.U. L. REV. 937(2017).

12. See Luke M. Froeb & Bruce H. Kobayashi, *Evidence Production in Adversarial vs. Inquisitorial Regimes*, 70 ECON. LETTERS 267 (2001)); Gregory Firestone & Janet Weinstein, *In The Best Interests of Children – A Proposal to Transform the Adversarial System* 42(2) FAM. CT. REV. 203, 203 (2004). For a critique of the distinction (although not of the idea that courts may be dependent on the parties' submissions) see Monroe H. Freedman, *Professionalism in the American Adversary System*, 41 EMORY L.J. 467, 469 (1992). Although the arguments focus on the criminal setting, the observations with respect to adversarial versus inquisitor systems are equally valid in the civil setting.

13. *Creative Montessori*, 662 F.3d at 917-18; John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 26-27 (1985). *In re Dry Max Pampers Litig.*, 724 F.3d 713, 718 (6th Cir., 2013).

14. See *infra* notes 86 – 88.

15. In this context, the history of patent litigation is instructive. Much like class settlements, settlements in patent litigation allow the settling parties to negotiate a mutually beneficial deal at the general public's expense. Specifically, a generic pharmaceutical company challenging a weak patent may agree to drop the challenge, thereby extending the brand company's monopoly, in return for a share of the rents accruing to the brand company (on the legal framework that enables such deals in the pharmaceutical industry see C. Scott Hemphill & Mark A. Lemley, *Earning Exclusivity: Generic Drug Incentives and the Hatch-Waxman Act*, 77(3) ANTITRUST L.J. 947 (2011)). And indeed, although the potential for abuse has long been recognized in the context of patent litigation, courts have often sanctioned settlements that clearly harm the public simply because the parties before the court agreed to the settlement (see *FTC v. Actavis, Inc.*, 570 U.S. 136 (2013)). For an analysis and an overview of court rulings pre- and post- *Actavis* see Michael A. Carrier, *Three Challenges for Pharmaceutical Antitrust*, 59 SANTA CLARA L. REV. 615

As an alternative to a review of the terms of the settlement themselves, the court may attempt to ensure the adequacy of settlements through class counsel's fees. Specifically, the court may award class counsel fees that are a percentage of the class's recovery, thereby incentivizing class counsel to achieve the best possible outcome for the class. However, the percentage-of-recovery fee method is also ineffective. Several issues with the award of a percentage-of-recovery fee are discussed subsequently.¹⁶ In the current context, we may focus on the two most important issues. First, the percentage-of-recovery does not in any way safeguard against class counsel's genuine miscalculations. Setting fees as a percentage of the class's recovery incentivizes class counsel to do the best job it can. But it does not correct class counsel's errors. Second, even under a percentage-of-recovery fee regime, court discretion is unavoidable. A fixed, one-size-fits-all percentage is inadequate. The precise percentage must be calibrated to compensate counsel for case-specific effort, risk, resources, labor, etc. Otherwise, riskier class actions (from the class's perspective), as well as class actions that require more labor than average, will not be filed. Therefore, some degree of court discretion must be maintained, which reintroduces the court's institutional inadequacy (and disincentive) to act as the parties' adversary. The parties may present the case as more complex than it is, argue that an irregular amount of labor was required, and so on. Finally, as the examples at the beginning of this Article illustrate, a settlement may seem to award class members a different amount than it actually does. This Article provides several additional examples of gross misrepresentations of the class's recovery.¹⁷

In addition to the two court supervision mechanisms—review of the settlement terms and judicial control of class counsel's fees—there are two additional mechanisms that rely on class members and may theoretically alleviate the agency problem in the context of class settlements. First, class members may file objections to settlements.¹⁸ Second, class members may opt out of the class if they find the settlement to be unfair.¹⁹ These mechanisms also fail to adequately protect class members against abuses of class settlements. In a nutshell, both mechanisms rely on class members taking action. Therefore, they are subject to the same issue that brings about the settlement-inadequacy problem in the first place—class members' rational apathy. They also suffer from additional shortcomings that this Article surveys at greater

(2020)).

16. *See infra* text accompanying notes 92 – 111.

17. *See infra* text accompanying notes 25 – 32.

18. *See infra* note 112.

19. *See infra* note 124.

length.²⁰

Ultimately, the existing mechanisms fail miserably. It has been argued that “most class actions lead to no recovery for absent class members, at all, and those that do quite often provide only minimal benefits”.²¹ Studies have found that gains reaped by plaintiffs’ lawyers are grossly disproportionate to the supposed benefits of attorney-driven class actions,²² and that “too many cases are settled with illusory benefits to class members and large fees for lawyers”.²³ There is an abundance of examples where “class members received nearly worthless coupons and class counsel walked away with large fees”.²⁴ Some settlements nominally award class members a large amount, but effectively make individual compensation not worth the trouble of collecting it.²⁵ For example, in a nationwide Sears class action settlement, class members were compensated in the form of coupons. Plaintiffs’ attorney received approximately \$1 million, while the 1.5 million class members redeemed a total of \$2,402.²⁶ In an alleged price-fixing cartel in the airline industry, customers received coupons that could be redeemed for future flights. The coupons were severely restricted, could not be combined with other

20. In fact, they introduce a host of additional complications, such as strategic objections designed to extract a share of class counsel’s payment. *See infra* text accompanying notes 118 – 123.

21. Letter from David Hirschmann & Lisa Rickard on behalf of U.S. Chamber of Commerce & Institute for Legal Reform to Monica Jackson, Office of the Executive Secretary, Consumer Financial Protection Bureau 4 (Aug. 22, 2016), available at https://www.instituteforlegalreform.com/uploads/sites/1/2016_8_22_Chamber_Arbitration_Comment_Letter.pdf [hereinafter Letter from Hirschmann and Rickard]; Erichson, *supra* note 1, at 952; Robert H. Hayes & William J. Abernathy, *Managing Our Way to Economic Decline*, 58 HARV. BUS. REV. 67, 70, 77 (2007).

22. Letter from Hirschmann & Rickard, *id.*, at 3. *See also*, in the specific context of The Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 77a (“PSLRA”), Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 534-37 (1997). CONSUMER FIN. PROTECTION BUREAU, *supra* note 1, at Section 6, 37. > (“CFPB Study”); *Do Class Actions Benefit Class Members? An Empirical Analysis of Class Actions*, MAYER BROWN (Dec. 11, 2013), at: <https://www.mayerbrown.com/files/uploads/Documents/PDFs/2013/December/DoClassActionsBenefitClassMembers.pdf> (“Chamber Study”); Jason Scott Johnston, *High Cost, Little Compensation, No Harm to Deter: New Evidence on Class Actions Under Federal Consumer Protection Statutes*, U. VA. L. & ECON. RESEARCH PAPER SERIES 2016-12 (May 2016), available at <http://ssrn.com/abstract=2777618>. *See* Andrew Pincus, *Assessing ‘The Value of Class Actions,’* LAW360 (Aug. 22, 2017), <https://www.law360.com/foodbeverage/articles/956215/assessing-the-value-of-class-actions->.

23. U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, UNSTABLE FOUNDATION, *supra* note 1, at 2.

24. Tidmarsh, *supra* note 4, at 236. *See also* Eversheds Sutherland, LLP, *A Study Abroad: Will Europe Adopt the US Class Action Mechanism?*, LEXOLOGY (June 4, 2018), <https://www.lexology.com/library/detail.aspx?g=7d6ceae7-700a-4984-90ec-4d94ecfd5edd>. Deborah L. Rhode, *Frivolous Litigation and Civil Justice Reform: Miscasting the Problem, Recasting the Solution*, 54 DUKE L.J. 447, 465 n.136 (2004).

25. Rhode, *id.*, at 465. Steven B. Hantler & Robert E. Norton, *Coupon Settlements: The Emperor’s Clothes Of Class Actions*, TRUTH IN ADVERTISING 1 (Oct. 2013), <https://www.truthinadvertising.org/wp-content/uploads/2013/10/Exhibit-C.pdf>.

26. Ted Frank, *Moody v Sears: Lawyers, \$1M. Class, \$2,402*, OVERLAWYERED (May 5, 2007), http://www.overlawyered.com/2007/05/moody_v_sears_lawyers_1m_class.html.

discounts, were only good for up to 10% off a flight and were subject to black-out dates.²⁷ Class attorneys collected more than \$50 million in fees, in what critics argued was in fact “a promotional scheme to induce travelers to fly’ during off-peak travel periods”.²⁸ A class action against Blockbuster Video settled in a cumbersome coupon arrangement, according to which clients would have to visit the store at least twice²⁹ for the benefit of a \$1 discount off a rental.³⁰ Class attorneys received \$9.25 million in fees.³¹ The problem is omnipresent in cash settlements as well.³²

This Article suggests a simple market-based mechanism that guarantees the adequacy of class settlements: an *ex post* auction of appointment as class counsel. Once a settlement has been reached, the right to step in as class counsel is auctioned. The minimum bid is the amount the defendant agreed to pay class counsel in accordance with the settlement agreement. The highest bidder pays original class counsel the amount bid and is then appointed as class counsel. Newly-appointed class counsel may then pursue the case as she deems fit. She may renegotiate a settlement with the defendant, adjudicate the case, or combine the two by continuing to litigate the case and settling with the defendant at a later stage. There is only one limitation on the fees new class counsel may be paid in any future settlement or ruling: the ratio between class recovery and class counsel’s fees remains as it was in the original settlement. The only way for new class counsel to receive more than she paid original class counsel is to increase class members’ recovery.

The mechanism developed here spontaneously assures the appropriateness of the settlement. Both instances of a sellout by class counsel and instances of genuine under-estimation of the value of the class’s claim will be corrected by the market. This result will be shown in greater detail in subsequent sections. But a simple numeric example is

27. Hantler & Norton, *supra* note 25, at 1 – 2.

28. *Id.* at 2 (citing David Johnson, *Settlement of Airline Suit Draws Critics; Coupons May Bring Carriers More Business*, HOUS. CHRON., Jan. 2, 1993, at 1 (Business)). *See also In re GMC Pick-Up Truck Fuel Tank Prods. Liab. Litig.*, 55 F.3d 768, 784-85 (3d Cir. 1995).

29. Class members could only collect and file a claim form at a Blockbuster outlet. After the claim had been processed, the customer was required to visit the store again to rent the video at a discount.

30. *Johnson v. Scott*, 113 S.W.3d 366 (Tex. App. 2003). Compensation would not, in any case, exceed \$18 per client.

31. Some commentators labeled the Blockbuster settlement ‘Exhibit A’ in the case against class actions, that had been attacked as “shakedowns that mainly enrich the lawyers who bring them.” *See, e.g.*, Dan Ackman, *Top Of The News: Bogus Blockbuster Settlement*, FORBES (June 6, 2001), <https://www.forbes.com/2001/06/06/0606topblock.html#36aa181bcea6>. *See also* Hantler & Norton, *supra* note 25, at 3; Ameet Sachdev, *Coupon Awards Reward Whom?*, CHI. TRIB. (Feb. 29, 2004), <https://www.chicagotribune.com/news/ct-xpm-2004-02-29-0402290522-story.html> (offering the Cheerios case as another illustrative example)).

32. *See also* Robert G. Bone, *Walking the Class Action Maze: Toward a More Functional Rule 23*, 46 U. MICH. J.L. REFORM 1097, 1110 (2013).

helpful at this stage. Let us suppose that class counsel and a defendant reach a settlement whereby class members receive \$100, and class counsel is paid \$10 in fees. If the settlement is the best attainable settlement from the class's perspective,³³ no one will find it worthwhile to purchase the right to step in as class counsel. The prospects of recovering more than \$100 for the class are not promising. Consequently, receiving more than \$10 in fees is unlikely. Any attorney who purchased the right to act as class counsel would be paying original class counsel \$10 to receive an asset (appointment as class counsel) that is worth no more than \$10. However, if the settlement is suboptimal for whatever reason, acting as class counsel becomes a lucrative investment. Fees are fixed at 10% of class recovery, and the true value of the class's claim is higher than \$100. The more gross the inadequacy of the settlement, the more lucrative it becomes to be appointed as class counsel. If, for example, the case can be settled for \$500, the right to act as class counsel is worth \$50. Whether class counsel mistakenly negotiated a deal it genuinely thought was beneficial to class members, missed some piece of important evidence, or knowingly agreed to a bad deal in return for an increase in fees, acting as class counsel presents a lucrative investment opportunity for any attorney that identifies this inadequacy.

Importantly, the mechanism obviates the need for court overview of settlements. The court need not review the adequacy of the settlement, its reasonableness, or its fairness. The court need not even bother itself with the appropriateness of class counsel's fees as agreed within the framework of the settlement. There is no need for any court involvement at all, and public expenditure is completely curbed.

The method developed in this Article economizes on public expenditure and court resources (that are, as explained, ineffective in the current setting). At the same time, it also guarantees that terms of class settlements will be closely monitored by a large number of law firms competing amongst themselves to identify inadequate class settlements. Because potential class counsel is only required to pay a fraction of the value of the total payment to the class,³⁴ any law firm capable of handling

33. The best attainable settlement is one in which class members receive the largest possible amount given the expected value of their claim, taking into account all relevant information, a fair assessment of the defendant's chances of success, the time it would take to try the case, the defendant's sensitivity to the reputational cost of litigation and an adverse ruling, and any other factor.

34. Attorney's fees are a *fraction* of the class's recovery, which implies that there will be a larger supply of competitors if they are required to pay attorney's fees rather than the full amount of the class's recovery. The ratio of attorney's fees to total recovery is, of course, important. This point is elaborated on subsequently, largely following Eisenberg et al., *supra* note 11. Generally, attorney's fees are approximately 25% of the class's recovery. But there is also a scaling effect. The larger the case, the smaller the percentage of attorney's fees. For current purposes, the general point is important – attorney's fees are smaller than the class's recovery by orders of magnitude.

the case on behalf of the class can participate in the auction. The number of economic agents reviewing the adequacy of settlements is thus multiplied by thousands. Rather than ineffective supervision by the court, a single disincentivized agent, at the public's expense, numerous law firms of the plaintiffs' bar can be expected to closely follow the terms of class settlements.

If a second settlement is reached by new class counsel, the process is repeated. The process repeats until a settlement is reached after which no one is willing to bid for appointment as class counsel. This provides comfort that the final settlement will be the best attainable one. Given that law firms of the plaintiffs' bar compete between them in the first auction, one can expect there to typically be only one round of bidding. The price paid for appointment as class counsel in the first round should reflect the best attainable settlement. In the numeric example presented above, in which the value of the class's claim is \$500, the price paid for appointment as class counsel in the first auction should be \$50 (or marginally less). Second class counsel can then be expected to negotiate a \$500 settlement (otherwise she will not have profited at all), and no one should be willing to bid in the second auction. But if, for whatever reason, neither first class counsel nor second class counsel have negotiated the best attainable settlement for the class, subsequent auctions should rectify this. Regardless of how many settlements have been negotiated, if additional sums can be extracted from the defendant, someone should be willing to bid for appointment as class counsel. Once again, the court never needs to review the terms of any of the settlements. It simply auctions appointment as class counsel until there are no bids, and rubberstamps the last settlement reached.

By solving the problem of inappropriate settlements, the mechanism developed in this Article also indirectly solves another extremely perplexing problem of class actions—the so called 'reverse auction' that plagues the initial appointment of class counsel. Often enough, specifically when a class action is filed in the wake of a scandal that has received significant media coverage, various firms of the plaintiffs' bar compete amongst themselves for appointment as class counsel. One way in which a law firm may secure such appointment is by reaching a settlement with the defendant. Once such a settlement is reached and sanctioned by the court, all other law firms are preempted from adjudicating the case. This competition amongst law firms of the plaintiffs' bar allows the defendant to negotiate a settlement with those class attorneys that are willing to settle for the smallest amount, thereby precluding all other claims.³⁵ A race to the bottom ensues. The different

35. *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277, 282 (7th Cir. 2002).

firms seeking appointment as class counsel, each afraid to be underbid by others and receive nothing for their efforts, compete by offering the defendant a low-ball settlement. Courts are forced to devote significant resources to address this concern.³⁶ This problem too is solved through the use of the method developed in this Article. The terms of the first settlement and the initial race to the bottom become moot.

The remainder of this Article is structured as follows: Part I elaborates on class action settlements and on the inadequacy of existing monitoring mechanisms. Part II elaborates on the mechanism developed in this Article and explains how it overcomes the problems associated with monitoring class action settlements. Part III discusses a theoretical alternative to the mechanism proposed in this Article and explains why the method proposed in this Article is superior to the alternative. Part IV concludes.

I. MONITORING CLASS SETTLEMENTS: THE INADEQUACY OF EXISTING MECHANISMS

Class actions provide a legal tool for redressing small-individual, but large-overall harm.³⁷ In such settings, each class member's expected private recovery is typically far less than the expected costs of litigation.³⁸ Therefore, no individual class member will find it worthwhile to incur the expenses of litigation.³⁹ It is also impractical for class members to actively join forces with each other so that the costs of litigation may be shared. Coordination among an extremely large and regularly dispersed group of individuals is difficult and costly, and very often impossible.⁴⁰ The transaction costs of such coordination and the possibility of (rational) strategic free riding on the part of some class members leave little hope of joint action being taken.⁴¹ Consequently, wrongdoers who inflict harm on a dispersed group might go undeterred, and class members might go uncompensated. The Federal Rules of Civil Procedure governing class

36. For a survey of this issue (and a suggested solution to the problem of initial appointment of class counsel) see Alon Klement & Moran Ofir, *Auctioning Class Action Representation* (Apr. 15, 2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3329380.

37. James N. Phillips, *Class Actions*, 3 J. CORP. L. 649 (1978).

38. James E. Lyons, *Class Actions*, 1974 ANN. SURV. AM. L. 349 (1975); Tom Ford, *Rule 23: A Device for Aiding the Small Claimant*, 10 B.C. IND. & COM. L. REV. 501 (1969).

39. Christopher R. Leslie, *The Significance of Silence: Collective Action Problems and Class Action Settlements*, 59 FLA. L. REV. 71, 76-77 (2007).

40. David Rosenberg, *Mandatory-Litigation Class Action: The Only Option for Mass Tort Cases*, 115 HARV. L. REV. 831, 848 (2002); Tidmarsh, *supra* note 4, at 230-31; Bone, *supra* note 32, at 1103.

41. For an analysis of the transaction costs of taking joint action (for example by retaining a single firm) and the resulting under deterrence problem see Bruce Hay & David Rosenberg, *"Sweetheart" and "Blackmail" Settlements in Class Actions: Reality and Remedy*, 75 NOTRE DAME L. REV. 1377, 1387-88 (2000).

actions are designed to address these issues. They lay the legal foundation for representation of the class by attorneys who have not been appointed by class members.⁴² They also incentivize these attorneys to act on behalf of the class by allowing them to collect fees without negotiating these fees with their “clients”—class members.⁴³

A. *The Basic Problem*

The rational apathy of class members and the formidable transaction costs of taking joint action, which bring about the need for this mechanism in the first place, plague the relationship between class members and class counsel as well.⁴⁴ Class counsel’s identity, fees, and performance are of very little importance to individual class members. Class members’ incentives to get involved in any of these is even smaller than their interest in the action itself.⁴⁵ Consequently, there is a real risk that attorneys may seek to be appointed as class counsel even though they are unfit to serve as class counsel, whether due to incompetence, lack of resources to litigate a complicated case, or any other reason.⁴⁶ Once class counsel has been appointed, she has both the incentive and ample opportunity to act

42. Formally, two economic agents, neither of whom has been appointed by class members, act on behalf of the class – class counsel and class plaintiff (or ‘named plaintiff’). The latter is a class member who also acts on behalf of the class. However, class plaintiffs may be disregarded for current purposes. To begin with, class actions are normally driven by attorneys, with class plaintiffs as mere eponyms, whose name only “graces the marquee.” Geoffrey P. Miller, *Competing Bids in Class Actions*, 31 HOFSTRA L. REV. 633, 634 (2003); see also Noel Hensley, *Notes: Law Partner of Class Plaintiff Barred from Serving as Class Counsel: Kramer v. Scientific Control Corp.*, 31 SMU L. REV. 601 (1977); Leslie, *supra* note 39, at 81; Klement & Ofir, *supra* note 36, at 2 (“For over fifty years, class actions in the US have been initiated and litigated by self-driven entrepreneurial lawyers.”). Closely related, class plaintiffs’ service awards are normally insignificant amounts, in the tune of several thousands of dollars. Finally, and most importantly, even if class plaintiffs are actively involved and control the class action in any meaningful way, the analysis of class counsels’ incentives is equally applicable to class representatives’ service awards. On the possible convergence of the two see Neil L. Rock, Note, *Class Action Counsel as Named Plaintiff: Double Trouble*, 56 FORDHAM L. REV. 111 (1987). See also Bone, *supra* note 32, at 1103.

43. Leslie, *supra* note 39, at 76 (citing *Shaw v. Toshiba Am. Info. Sys., Inc.*, 91 F. Supp. 2d 942, 952 (E.D. Tex. 2000)). See also Tidmarsh, *supra* note 4, at 234.

44. Leslie, *supra* note 39, at 76 – 77; Klement & Ofir, *supra* note 36, at 2.

45. Theoretically, each of these factors—the identity of class counsel, class counsel’s fees, and class counsel’s performance—may be determinative of the full amount of recovery, making class members’ interest in the relevant factor equal to their interest in the class action itself. For example, if class counsel is entirely incompetent or sets her fees at 100% of recovery, this impacts the full amount of the recovery. But this will be the extreme case. In all other cases, each of these factors only affects a portion of the recovery – the portion lost because of counsel’s inability relative to alternative counsel, or the excessive share of the defendant’s payment charged by counsel as fees. Therefore, class members’ interest in each of these factors is no greater than their interest in the action itself, and in most cases will be much smaller.

46. Alon Harel & Alex Stein, *Auctioning for Loyalty: Selection and Monitoring of Class Counsel*, 22 YALE L. & POL’Y REV. 69, 71 (2004).

in her own self-interest. The principles, class members, are unlikely to effectively monitor the agent's performance.⁴⁷

The Federal Rules of Civil Procedure attempt to address these problems with a host of mechanisms for the appointment of class counsel, for monitoring class counsel's performance, and for awarding class counsel fees.⁴⁸ Common to these rules is the substitution of the court's discretion for the contractual relationship that would be expected had class members been regular clients. Rather than contracting with class members, class counsel seeks court approval on a variety of issues.

Class settlements present a unique setting in which class members' absence is most problematic.⁴⁹ Class settlements are unique, because class counsel and the defendant have a joint interest that is directly opposed to that of class members. This is true specifically with respect to two elements of the settlement: class members' compensation, and class definition. With respect to the settlement amount, both settling parties have a joint incentive to increase class counsel's fees at the expense of class members' compensation. With respect to class definition—deciding on whom the settlement will be binding—both parties have an incentive to define the class broadly. To explain this, it is helpful to first briefly review the concept of class certification.

Class certification is the process of allowing class counsel to act on behalf of class members and defining the class on behalf of which the case will be handled. In class settlements, the defendants pay class members in return for a release.⁵⁰ Naturally, defendants seek release from all class

47. In some circumstances, most importantly in securities cases, there may be an individual class member whose stake in the case is large enough to justify involvement in the case. For example, the class member who owned or purchased the largest number of shares in a public offering. Such a class member may engage with counsel. The PSLRA, *supra* note 22, establishes a rebuttable presumption according to which the person or persons with the largest financial interest in the case is the most adequate lead plaintiff. *See also* Fisch, *supra* note 22.

48. For example, courts appoint class counsel, *see* Fed. R. Civ. P. 23(g), and courts may demand a litigation plan as well as any other pertinent information, *see* Fed. R. Civ. P. 23(g)(1)(c). *See Parkinson v. Hyundai Motor America*, Nos. CV06-345AHS (MLGX), CV06-3161AHS(MLGX), 2006 WL 2289801, at *2 (C.D. Cal. Aug. 7, 2006); *Hill v. The Tribune Co.*, Nos. 05 C 2602, 05 C 2640, 05 C 2684, 05 C 2927, 05 C 3374, 05 C 3377, 05 C 3390, 05 C 3928, 2005 WL 3299144, at *3–4 (N.D. Ill. Oct. 13, 2005). *In re Air Cargo Shipping Servs. Antitrust Litig.*, 240 F.R.D. 56, 57 (E.D.N.Y. 2006); *Durso v. Samsung Elecs. Am., Inc.*, Nos. 2:12-cv-5352 (DMC)(JAD), 2:12-cv-5412 (DMC)(JAD), 2:12-cv-5440 (DMC)(JAD), 2013 WL 4084640 (Aug. 7, 2013). Courts may issue appropriate orders as the case is adjudicated. *See* FED. R. CIV. P. 23(d). *In re School Asbestos Litig.*, 977 F.2d 764 (3d Cir. 1992); *Oppenheimer Fund, Inc. v. Sanders*, 437 U.S. 340 (1978); *Gulf Oil Co. v. Bernard*, 452 U.S. 89, 100 (1981); *Reid v. Unilever U.S., Inc.*, 964 F. Supp. 2d 893, 925 (N.D. Ill. 2013). Naturally, the litigation plan courts may demand when appointing class counsel also allows them to monitor performance in the course of adjudication.

49. *Mars Steel Corp. v. Cont'l Ill. Nat'l Bank & Trust Co.*, 834 F.2d 677 (7th Cir. 1987).

50. The legal tool for precluding a plaintiff from relitigating a case is *res judicata*. An adjudicated case is said to create *res judicata* between the parties to the proceeding, preventing a future court from rehearing the case. *See generally* Robert Von Moschzisker, *Res Judicata*, 38 Yale L.J. 299, 334 (1929). For an elaborate account of *res judicata* in mass litigation (although in the context of *parens patriae*

members, or at least from as many class members as possible.⁵¹ Class members on whom the settlement is not binding may subsequently file lawsuits against the settling defendant. In order to sell the release on behalf of class members, the class must be certified. That is, class counsel must be appointed as the attorney for class members and be allowed to act on their behalf.⁵² Most certified class actions are certified for the purpose of settlement.⁵³ A recent survey encompassing 562 class action cases found that none of the class actions surveyed ultimately went to trial. Certification independent of settlement was found in less than two percent of the cases. “Where class certification occurs, it is typically in conjunction with class settlement”.⁵⁴ A similar survey for an earlier period reports similar results.⁵⁵ In practice, therefore, class certification is seldom sought as a means of allowing a lawsuit to be filed and adjudicated on the class’s behalf. It is obtained almost exclusively as a means of sanctioning a settlement negotiated between class counsel and the defendant.

Outside the context of settlements, class counsel and the defendant have diametrically opposed interests both with respect to class definition and with respect to the amount paid out to each class member. Class counsel prefers the largest award to the class, if only because this impacts her fees.⁵⁶ Defendants naturally prefer the lowest possible award. Similarly, class counsel benefits from the broadest class definition because the larger the class, the greater the overall payout. For the same reason, defendants prefer a narrow class definition. But when class actions settle, the incentives are reversed. A class settlement naturally

lawsuits) see Gabrielle J. Hanna, *The Helicopter State: Misuse Of Parens Patriae Unconstitutionally Precludes Individual And Class Claims*, 92 WASH. L. REV. 1955, 1957-58 (2017).

51. U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, UNSTABLE FOUNDATION, *supra* note 11, at 3. Under the Rules of Civil Procedure, class members are generally afforded an opportunity to opt out of the class before approval of a settlement, even if they have already been afforded the opportunity at the certification stage (subject to the court’s discretion – *see* FED. R. CIV. P. 23(e)(4)). Class settlements typically contain a provision addressing the possibility that some class members will opt out of the class. Normally, if an agreed percentage of class members opts out of the class, the settlement is altered or nullified. *See* Plaintiff Joy L. Bowens’ Motion for Final Approval of Class Action Settlement, Award of Attorneys’ Fees and Costs, and Approval of Class Representative Service Award and Suggestions in Support Thereof, *Joy L. Bowens v. Mazuma Credit Union*, No. 4:15-cv-00758-DW, 2018 WL 8756245 (W.D. Mo. July 16, 2018); *Castillo v. ADT, LLC*, Civ. No. 2:15-383 WBS DB, 2017 WL 363109 (E.D. Cal. Jan. 24, 2017).

52. FED. R. CIV. P. 23(e)(2).

53. Erichson, *supra* note 2, at 952.

54. U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, UNSTABLE FOUNDATION, *supra* note 1, at 6.2.2.

55. MAYER BROWN, *supra* note 23, at 1. (“In our entire data set, not one of the class actions ended in a final judgment on the merits for the plaintiffs. And none of the class actions went to trial, either before a judge or a jury”).

56. *See supra* note 9.

contains two elements that are negotiated in conjunction: compensation for the class and class counsel's fees. Class counsel's fees normally constitute a fraction of the overall payment.⁵⁷ But, naturally, this is the element of the settlement that class counsel is most sensitive to. This is what creates the foundation for a sellout deal, where class counsel receives an increased payment in return for agreeing to a reduced payment to class members or a subset of class members, or for a broader definition of the class.

First, and most intuitively, all class members' individual compensation may be reduced by an amount that is unlikely to be contested and may not even be observed. A "discount" of one dollar in the amount payable to each class member is likely to go unnoticed, or at least unchallenged. But if the class is comprised of a million individuals, this will decrease defendant's total payment by \$1 million. The defendant should be willing to increase class counsel's fees by up to that amount. Whether fees are collected directly from the defendant under a fee-shifting statute,⁵⁸ or nominally collected from the class's recovery (which the defendant pays), the outcome is no different. The total amount accruing to the class may be reduced in return for an increase in class counsel's fees.⁵⁹

A second form of sellout is the sellout of specific subclasses, or an overly broad definition of the class.⁶⁰ For example, in the famous *Amchem Products, Inc. v. Windsor* case,⁶¹ a class action against asbestos manufacturers, the purported settling class included all employees who had been exposed to asbestos as well as certain family members of those employees.⁶² Importantly, the class included all employees (and family members) who had been exposed to asbestos prior to the date of the settlement, whether or not they had already sustained injury or presented relevant symptoms (the so-called "exposure-only plaintiffs"). The settlement may have been fair to those class members who had already exhibited symptoms of one of the relevant diseases. But it aimed to create *res judicata* against those class members who had not yet exhibited

57. Erichson, *supra* note 2; Eisenberg et al., *supra* note 11.

58. Note, *State Attorney Fee Shifting Statutes: Are We Quietly Repealing the American Rule?*, 47 LAW & CONTEMP. PROBS. 321, 322-23 (1984); Staton v. Boeing Co., 327 F.3d 938, 965 (9th Cir. 2003); See also Eisenberg & Miller, *supra* note 4, at 30.

59. When the defendant does not directly pay class counsel's fee, the sellout cannot take the form of a side payment, as such side payments must be disclosed (see Fed. R. Civ. P. 23(e)(3)). The deal will thus take the form of not contesting a specific fee request, or not challenging certain arguments with respect to time invested, tasks undertaken, and the like. See *infra* text accompanying notes 89 – 102.

60. See FED. R. CIV. P. 23(c)(5).

61. 521 U.S. 591 (1997).

62. The class included people who had been exposed "...either occupationally or through the occupational exposure of a spouse or household member, to asbestos or to asbestos-containing products for which one or more of the Defendants may bear legal liability.", as well as "[a]ll spouses, parents, children, and other relatives... of [those class members]..." *Id.* at 603 n.5.

symptoms and prevented them from filing a future lawsuit, if and when they experienced bodily injury or other harm. The exposure-only subclass was not properly compensated for this waiver. Similarly, in a securities class action against Verifone Holdings,⁶³ a public company listed both in the U.S. and abroad, the settling class included both investors in the U.S. and in foreign countries.⁶⁴ The proposed notice of the settlement would have been sufficient for U.S. investors. But it would have likely resulted in very few foreign investors realizing that they were entitled to compensation, although they were to be bound by the settlement agreement.⁶⁵

Class counsel and defendants can be expected to choose between mistreating the entire class and mistreating a specific subclass or subclasses, based on the relative sensitivity of each of the subclasses. If there is a specific subclass that is least sensitive to the settlement, that subclass will be targeted. If not, all class members' compensation can be reduced by an amount that the parties believe will survive court scrutiny.

The upshot of this observation is that when a class settlement is presented, both the settlement terms themselves and class definition raise concern.⁶⁶

B. Existing Mechanisms

Of the various mechanisms that are currently in place for supervising class counsel, four may seemingly be harnessed to overcome the agency problem in the specific context of class settlements. First, and most directly, settlements require court approval. Courts will only approve a settlement if it is fair, reasonable, and adequate.⁶⁷ Second, courts decide on class counsel's fees.⁶⁸ Structuring fees as a percentage of the class's

63. Stipulation of Settlement, *In re Verifone Holdings, Inc. Sec. Litig.*, No. 3:07-cv-06140-EMC (N.D. Cal. Aug. 9, 2013), available at http://securities.stanford.edu/filings-documents/1038/PAY_01/201389_r01s_07CV06140.pdf.

64. *Id.* at 6.

65. See CA 22300-05-15 (Central District Court) *Moshe Hayit v. Verifone Systems Inc.* [published on Nevo, May 14th, 2018; in Hebrew].

66. While the two issues are intertwined in the context of settlements, they are analytically distinct. The two issues have now been clearly severed by the amended Civil Procedure Rules that came into force in December 2018. These require the court to consider whether it is likely to both approve the proposal and certify the class before notice of the proposed settlement is sent to class members – see FED. R. CIV. P. 23(e)(1)(b)(i)-(b)(ii). See also BOLCH JUD. INST., DUKE LAW SCHOOL, GUIDELINES AND BEST PRACTICES IMPLEMENTING 2018 AMENDMENTS TO RULE 23 CLASS ACTION SETTLEMENT PROVISIONS 2–3 (Aug. 2018), available at <https://judicialstudies.duke.edu/wp-content/uploads/2018/09/Class-Actions-Best-Practices-Final-Version.pdf> (“Guidelines and Best Practices”).

67. See *supra* note 6.

68. FED. R. CIV. P. 23(h). *In re Mercury Interactive Corp. Sec. Litig.*, 618 F.3d 988, 993 (9th Cir. 2010); *Keil v. Lopez*, 862 F.3d 685 (8th Cir. 2017); *Geneva Rock Prods., Inc. v. United States*, 119 Fed. Cl. 581 (Fed. Cl. 2015); *Saccoccio v. JP Morgan Chase Bank, N.A.*, 297 F.R.D. 683 (S.D. Fla. 2014).

recovery ostensibly overcomes the agency problem. Third, class members may voice objections to settlements.⁶⁹ Finally, class members may opt out of such settlements.⁷⁰ This Section reviews these mechanisms and their inadequacies.

1. Court Supervision

The first existing mechanism designed to secure the adequacy of class settlements is the court's review of the terms of the settlement. Rule 23(e)(2) of the Federal Rules of Civil Procedure stipulates that:

The claims, issues, or defenses of a certified class—or a class proposed to be certified for purposes of settlement—may be settled, voluntarily dismissed, or compromised only with the court's approval.

Fed. R. Civ. P. 23(e)(2) orders the court to approve a settlement that would bind class members only after finding that it is fair, reasonable, and adequate. In deciding whether the settlement is fair, reasonable, and adequate, the court must consider, among other factors, whether the class was adequately represented by class representatives and class counsel,⁷¹ whether the proposal was negotiated at arm's length,⁷² and whether the relief to the class is adequate, taking into account the costs, risks, and delay of trial and appeal.⁷³ In order to safeguard against side agreements,⁷⁴ the parties seeking approval must file statements identifying any agreement made in connection with the proposal.⁷⁵ Any such agreement is also to be considered by the court when evaluating the settlement.⁷⁶

The Federal Rules of Civil Procedure also address the appropriateness of certification and class definition. They allow the court to divide the class into subclasses, each of which may then be treated as a class.⁷⁷

Despite these formal requirements, court supervision is an ineffective measure for securing the adequacy of settlements. The reason, as briefly outlined above, is that the only parties before the court—class counsel and the defendant—have a joint interest in the approval of the settlement. The deal may or may not be fair, reasonable, and adequate. But once class

69. FED. R. CIV. P. 23(e)(2); (e)(5).

70. FED. R. CIV. P. 23(e)(2)(b), (e)(4).

71. FED. R. CIV. P. 23(e)(2)(A).

72. FED. R. CIV. P. 23(e)(2)(B).

73. Fed. R. Civ. P. 23(e)(2)(C)(i).

74. BOLCH JUD. INST., *supra* note 66, at 16; Gary E. Mason & Jennifer S. Goldstein, *Unveiling The New Class Action Rules*, AM. ASS'N FOR JUST. (Nov. 2018), available at <https://archive.justice.org/what-we-do/enhance-practice-law/publications/trial-magazine/unveiling-new-class-action-rules>.

75. FED. R. CIV. P. 23(e)(3).

76. FED. R. CIV. P. 23(e)(2)(C)(iv).

77. FED. R. CIV. P. 23(e)(5).

counsel and the defendant have reached an agreement, they both want it to be sanctioned. The hallmark of litigation is "a clash between proponents of conflicting views,"⁷⁸ and the court is deprived of the benefits of this clash when a settlement has been reached.

The most immediate problem arises in assessing the fairness, reasonableness, and adequacy of the settlement terms themselves. Courts build on the adversarial relationship between parties.⁷⁹ Litigation is normally a zero-sum game, in which any dollar paid to plaintiff comes out of defendant's pockets, and any dollar saved by defendant comes at plaintiff's expense. Each party can, therefore, be expected to do its best to improve its position vis-à-vis that of the opposing party. But litigation loses this feature if class counsel's fees can be increased in return for a reduction in the total amount paid to the class. The litigation process in this setting is, essentially, an *ex parte* process⁸⁰ with the illusion of an adversarial one. The parties before the court attempt to persuade it that a settlement is adequate. Whether or not this is the case, neither party can be expected to unearth evidence or conduct in-depth legal research in an attempt to challenge its opponent's contentions. A court cannot be expected to effectively supervise the adequacy of a specific outcome if neither party before it submits evidence, brings forward witnesses, or contests the adequacy of the settlement.

Court supervision is generally ineffective regardless of class counsel's motives for agreeing to an inappropriate settlement. Let us assume that class counsel genuinely believes that a settlement is optimal from the class's perspective (after factoring all relevant factors, *i.e.* the risks of litigation, costs, expected length of litigation, etc.). Let us further assume that class counsel is mistaken. Class counsel may have missed a "smoking gun", may have conducted insufficient legal research, may have underestimated how sensitive the defendant is to press coverage associated with litigation, or otherwise under-evaluated the full amount that can be extracted from the defendant. Regardless of the reason, defendant will naturally see little reason to point to class counsel's error, and the court will consequently be unlikely to realize that the settlement

78. Monroe Freedman, *Professional Responsibility of the Criminal Defense Lawyer: The Three Hardest Questions*, 64 MICH. L. REV. 1469, 1470 (1966). See also *Burmah Oil Co. v. Bank of England*, 1 WLR 473, 484 (1979) (H.L.) (Eng.); "Truth is best discovered by powerful statements on both sides of the question" Lord Eldon, *Ex parte Lloyd*, 70, 72 (1822).

79. KONRAD ZWEIGERT & HEIN KÖTZ, *INTRODUCTION TO COMPARATIVE LAW* 282 (2nd ed., 1987) Zweigert, K. & Kötz, H., *AN INTRODUCTION TO COMPARATIVE LAW* Tr. T. Weir (T. Weir trans., 2d ed. 1987).

80. Parties are notified of the hearing and may participate in it. Formally, the hearing is not an *ex parte* hearing. But the notice is generally ineffective, with the general exception of 'professional objectors', that do not serve absent class members. See FED. R. CIV. P. 23(e)(1)(B); see also *infra* notes 118 – 123.

is suboptimal.

Court supervision is also ineffective in monitoring class definition, the appropriate division into subclasses, and the inclusion of certain subclasses in the class.⁸¹ As with the terms of the settlement, the court is ineffective regardless of class counsel's motives for (inappropriately) including a subclass in the general class. Class counsel may intentionally sell out a specific subclass because that subclass is less sensitive to the settlement terms, or because including the specific subclass makes the sellout easier to conceal. Class counsel may also unintentionally include a subclass in the general class without realizing that the subclass has divergent interests. Once again, the defendant has little reason to flag this.

In general, regarding the effect certification has on the defendant, class certification within the framework of settlements is the exact opposite of certification for adjudication. When class actions are certified for litigation, certification is damaging to defendant's interests.⁸² A large number of individual lawsuits, which would otherwise never have been filed⁸³ (or would have been filed "only [by] a lunatic or fanatic")⁸⁴ are allowed to be jointly adjudicated by class counsel. And the larger the class, the larger the expected payment. By contrast, when a class action is settled, certification works to the benefit of the defendant. The larger the class, the more potential lawsuits are barred by *res judicata* and the larger the benefits of the settlement.⁸⁵

Thus, even if neither class counsel nor the defendant have intentionally targeted a specific subclass, the defendant cannot be expected to contest a definition of the class that is too broad. Absent any challenge from the defendant, the court is deprived of its main source of objections to class counsel's contentions.

To add to the court's incapability of reviewing the various elements of a settlement, the court also has little incentive to challenge a settlement. Courts are overloaded with cases,⁸⁶ and settlements are the easiest way to

81. Although it is nominally vested with this responsibility – FED. R. CIV. P. 23(c)(5).

82. *In re GMC Pick-Up Truck Fuel Tank Prods. Liab. Litig.*, 55 F.3d 768, 785 (3d Cir. 1995). In fact, as the court notes, the very threat of class certification may be abused to "create the opportunity for a kind of legalized blackmail." *Id.* at 784.

83. *Hantler & Norton*, *supra* note 25, at 2.

84. *Carnegie v. Household Int'l, Inc.*, 376 F.3d 656, 661 (7th Cir. 2004).

85. *Wolfman & Morrison*, *supra* note 5, at 444; *Bowling v. Pfizer, Inc.*, 143 F.R.D. 141, 154 – 55 (S.D. Ohio 1992).

86. Alessandro Martinuzzi, *Taking Justice Seriously: The Problem of Courts Overload and the New Model of Judicial Process*, 8 CIV. PROC. REV. 1, 65-106 (Jan.-Apr. 2017), available at www.civilprocedurereview.com. On the overload of class actions see Stephen E. Morrissey, *State Settlement Class Actions That Release Exclusive Federal Claims: Developing a Framework for Multijurisdictional Management of Shareholder Litigation*, 95 COLUM. L. REV. 1765, 1810 (1995).

clear the docket.⁸⁷ Settlements are generally favored,⁸⁸ and class settlements are no exception.

Ultimately, court supervision is ineffective in monitoring any element of class settlements. As Professor Coffee observed almost twenty-five years ago: “[C]ourts have little ability or incentive to resist the settlements that the parties in class litigation reach . . . the quest for accountability must look to other weapons and remedies”.⁸⁹

2. Monitoring Settlements Through Class Counsel’s Fees

Another mechanism that may be used as a check on the appropriateness of class settlements is the requirement that the court approve class counsel’s fees. Under the Rules of Civil Procedure, class counsel’s fees must be approved by the court. Parties are obligated to fully disclose any agreement and any payment made by the defendant to class counsel,⁹⁰ as well as “undertakings that, although seemingly separate, may have influenced the terms of the settlement by trading away possible advantages for the class in return for advantages for others”.⁹¹ Thus, the court can be expected to receive information relevant to identifying the ratio between class counsel’s fees and the class’s recovery.

Class counsel’s fees can be used to align class counsel’s incentives with those of class members. Specifically, class counsel’s fees can be set as a percentage of the class’s total recovery.

The first problem with the use of class counsel’s fees as a control mechanism is that this mechanism addresses only one of the two potential reasons for the inadequacy of a settlement. Neither the percentage-of-recovery nor the rule-of-thumb methods are effective when class counsel mistakenly agrees to a suboptimal settlement. When the case is one of a sellout, class counsel must be “bribed” by the defendant. Some excessive payment must be made, resulting in an irregular ratio between class counsel’s fees and the class’s recovery. But when the settlement is inappropriate because class counsel has underestimated the value of the claim itself, the ratio between class counsel’s fees and the class’s recovery will not be excessive in any way. Thus, controlling class counsel’s fees cannot address inadequate settlements that stem from class counsel’s

87. Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973).

88. *Id.*

89. John Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 COLUM. L. REV. 1343, 1348 (1995).

90. See FED. R. CIV. P. 23(e)(3).

91. See FED. R. CIV. P. 23, Committee Notes On Rules – 2003 Amendment (referring to subdivision (e)(2)).

mistake, incompetence, or negligence.⁹² This severely limits the efficacy of this mechanism.

The percentage-of-recovery method is ostensibly more effective in addressing intentional sellouts. And empirical studies have indeed found that “the amount of client recovery is by far the most important determinant of the attorney fee amount”,⁹³ and that “the dominance of the client’s recovery as a determinant of the fee is nearly complete”.⁹⁴

Upon closer examination, however, the percentage-of-recovery method is far from a solution to the incentive-alignment problem. First, the percentage-of-recovery method results in some misalignment, where additional hours of work are justified from the class’s perspective but not from the attorney’s perspective.⁹⁵ Although socially desirable in the sense that their marginal utility exceeds their marginal cost, these hours may not be invested by the attorney, who does not capture the full marginal utility of these additional hours, but bears their full marginal cost.

Scholars have long observed that the percentage-of-recovery method incentivizes counsel to settle too early for too little.⁹⁶ To address the under-investment problem, an alternative method, known as the lodestar method,⁹⁷ may be used. The lodestar method awards class counsel reasonable fees for a reasonable amount of work when the class has triumphed in litigation.

As a standalone method, the lodestar method is inadequate because it makes counsel indifferent to the class’s recovery and even incentivizes class counsel to overinvest and prolong litigation.⁹⁸ But as a

92. Coffee, *supra* note 89, at 1379.

93. Eisenberg & Miller, *supra* note 4, at 28.

94. *Id.* See also Eisenberg & Miller, *supra* note 8, at 249 – 50; Theodore Eisenberg & Geoffrey Miller, *The Role of Op-outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 VAND. L. REV. 1529, 1557, 1563 (2004). A newer study by Eisenberg, Miller and Germano focusing on 2009 – 2013 finds very similar results. Attorney’s fees were set as a percentage of recovery in 53.61% of the cases, and in 38.23% of the cases the percentage-of-recovery method was used in combination with the lodestar method. In total, the percentage-of-recovery mechanism was used in nearly 92% of the cases. Eisenberg et al., *supra* note 11, at 945. See also Klement & Ofir, *supra* note 36, at 2.

95. Eisenberg & Miller, *supra* note 4, at 32.

96. Written Submission of Judge Arlin Adams to the Third Circuit Task Force on Appointment of Counsel in Class Action Lawsuits 10 (Mar. 14, 2001), available at <https://www.ca3.uscourts.gov/sites/ca3/files/adams1.pdf>; Coffee, *supra* note 89, at 1388.

97. For a survey of these and earlier methods (specifically the multifactor approach, that considers ‘all relevant factors’ including the risk, expertise, reputation and experience of the attorneys, awards in similar cases, and the like), see Eisenberg & Miller, *supra* note 4, at 30 – 32.

98. *Id.* at 31; Charles Silver, *Due Process and the Lodestar Method: You Can’t Get There from Here*, 74 TUL. L. REV. 1809 (2000). Although in extreme cases the court will not grant class counsel payment for superfluous hours, it is very difficult to decide *ex post* precisely what amount of time should have been spent on a task. Often enough, research that did not yield benefits to the class was reasonable *ex ante*. *Ex post* review of time spent on a case is extremely difficult, and class counsel will normally be able to provide a compelling justification for investing the declared number of hours (or incurring a specific expense). In all but the very extreme cases, class counsel can obtain larger rewards by investing

complementary measure, it may be helpful. The lodestar method may be used in combination with (and sometimes as a substitute for) the percentage-of-recovery method to finetune class counsel's incentives.⁹⁹ Awarding class counsel a percentage of the class's recovery while allowing the court to finetune the amount based on a lodestar method generally (although imperfectly) aligns class counsel's incentives with those of class members.¹⁰⁰ But once the need for finetuning is acknowledged, court supervision again becomes indispensable. This reintroduces the court's institutional incompetence to function as an adversary to the parties before it. Parties can easily persuade the court to sanction a larger payment to class counsel.

The more important issue with the percentage-of-recovery fee is that even if the need to finetune fees through the lodestar method is ignored, court supervision remains essential. A fixed, one-size-fits-all percentage is insufficient. Some cases are riskier than others. The reward to counsel must be sensitive to the risk associated with the investment of work *ex ante*. If successful cases are not rewarded in a manner that compensates attorneys for work invested in unsuccessful cases, class actions may never be brought.¹⁰¹ Innovative class actions will certainly be under-incentivized. Additionally, specific cases may require more work than the average case. Even if the case is not innovative in the sense that it argues for some novel interpretation of the law, the factual inquiry may be very costly. Certain cases may require in-depth pre-suit investigations. Class counsel may have to unearth evidence, interview corporate officers, or solicit whistleblowers that were privy to wrongdoings. In some areas—most specifically in securities litigation—the *modus operandi* of the plaintiffs' bar has become to conduct such pre-suit investigations.¹⁰² Such

unnecessary time on the case. This is even more problematic in the settlement context, given the lack of an adversary who may challenge overbilling.

99. Beach, *supra* note 5, at 491 – 92. Coffee, *supra* note 3, at 883 – 89. Eisenberg & Miller, *supra* note 4, at 32. Elizabeth Chamblee Burch, *Financiers as monitors in Aggregate Litigation*, 87 N.Y.U. L. REV. 1273, 1291 (2012) (focusing on non-class mass litigation, but identifying the misalignment problem in the context of class actions as well); Miller, *supra* note 42, at 637 (pointing to the inadequacies of each method in the context of settlement).

100. *Olden v. LaFarge Corp.*, 472 F. Supp. 2d 922 (E.D. Mich. 2007); Supplemental Expert Report, *In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2008 WL 827995 (S.D. Tex. Feb. 18, 2008); *Blum v. Stenson*, 465 U.S. 886, 900 n.16 (1984); *Hensley v. Eckerhart*, 461 U.S. 424, 433 (1983). As mentioned, Eisenberg et al. find that between 2009 – 2013 this combination was used in nearly 40% of the cases. Eisenberg et al., *supra* note 11.

101. In this respect, class actions are similar to investment in research and development, where the reward for successful projects (inventions) must compensate for unsuccessful projects. See Ariel Katz, *Making Sense of Nonsense: Intellectual Property, Antitrust, and Market Power*, 49 ARIZ. L. REV. 837, 859 (2007).

102. For a comprehensive account of the development of these pre-complaint investigations as a response to heightened pleading standards (that are a prerequisite for disclosure) laid down by the PSLRA, see PSLRA, *supra* note 22; see also Roy Shapira, *Mandatory Arbitration and the Market for Reputation*,

class actions should be encouraged, or at least should not be discouraged. They contribute to deterrence in greyer areas of law and improve enforcement when other methods are likely to fail. But a fixed percentage will attract only those cases in which the fixed percentage is, *ex ante*, sufficient to justify the investment; that is, those cases in which the legal case is straightforward and the facts are easily discovered and proven.¹⁰³

A one-size-fits-all percentage is inadequate not only for cases that deserve larger compensation, but also—naturally—in the opposite setting. At times, it may be justified to award counsel a percentage that is smaller than the rule-of-thumb percentage. Specifically, when the expected amount of work or level of risk is far smaller than the amount of work and level of risk that would, *ex ante*, require award of the fixed percentage, the percentage must be adjusted downward.

If the rule-of-thumb figure becomes a *de facto* fixed percentage, a “lemon market” will ensue.¹⁰⁴ Attorneys will only bring cases in which the expected investment or level of risk are smaller than (or equal to) the amount of investment and level of risk that are justified (*ex ante*) by the fixed percentage. Over time, the average risk and average amount of work will become smaller, and the percentage will need to be adjusted downward to reflect the new (smaller) average amount of investment and level of risk. This, in turn, will further reduce the level of risk and amount of work that are justified *ex ante*, and so on.

The percentage-of-recovery awarded in a specific case or in a specific kind of cases must thus be calibrated. As the parties have control over how the case is presented to the court, they can easily argue that cases were (*ex ante*) more complex than they actually were, thereby increasing class counsel’s fees. Ultimately, the percentage-of-recovery method must include a significant degree of court discretion. This reintroduces the court’s incompetence and lack of incentives to act as an adversary to the parties before it.¹⁰⁵

Combining the lodestar method with the percentage-of-fee method exacerbates the problem. The lodestar method clearly requires a large degree of court discretion in deciding what amount of time was reasonable, what hourly-rate is reasonable, etc.

Both setting the percentage-of-recovery and finetuning it with the

99 B.U. L. REV. 873, 895-96 (2019). For a real-life example see *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 437 F.3d 588 (7th Cir. 2008).

103. See Adams, *supra* note 96, at 10.

104. See generally George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

105. Eisenberg et al., *supra* note 11, at 938. Eisenberg et al.’s article is in fact an attempt to offer courts some guidance based on a large number of cases. But this will not solve the issue of parties’ ability to manipulate where the specific case should fall in the given range that can be gleaned from the larger population of cases.

lodestar method thus require court discretion. And the parties may lock arms with respect to both methods. They can agree on, and argue for, a different percentage;¹⁰⁶ they may agree that additional fees are required to compensate for expenses incurred; the per-hour payment may be increased;¹⁰⁷ or counsel may be allowed to bill additional hours the defendant may otherwise have contested.¹⁰⁸

Finally, it must be noted that real-life sellouts are likely to result in relatively minute changes in the percentage-of-recovery argued for by the parties. Even very small changes to the percentage, which are likely to be nearly impossible to challenge, may well be extremely lucrative from class counsel's perspective. They may thus be sufficient to induce a sellout that is extremely harmful to class members. To use realistic figures,¹⁰⁹ suppose that a class action settles for \$50 million. Further, suppose that the rule of thumb is that class counsel is awarded twenty percent of the amount as fees, or \$10 million. Suppose that the case is a relatively easy one, and that class counsel's efforts, as anticipated *ex ante*, justify awarding a fee of fifteen percent of the class's recovery instead of the standard twenty percent. If parties argue for fees in the tune of sixteen percent, the inadequacy may be too fine for the court to notice. It is very difficult to calibrate a legal rule that is sensitive enough to differentiate between fifteen and sixteen percent when both figures are significantly less than the standard. The difference is trivial in terms of *ex ante* risk-assessment. But it increases class counsel's fees by \$500,000. A sellout remains very lucrative, and thus a very troubling possibility.¹¹⁰ The general point is that small changes in the percentage-of-recovery that the court cannot realistically condemn can result in very troubling sellouts.

This analysis should not be taken to suggest that court supervision is of no value at all. Egregious sellouts may be observable, and the court can be expected to disapprove settlements in which the sellout is obvious.¹¹¹ At the very least, when it is clear that very little work has been done and

106. *E.g. In re Activision Sec. Litig.*, 723 F. Supp. 1373 (N.D. Cal. 1989).

107. *See Rode v. Dellarciprete*, 892 F.2d 1177 (3d Cir. 1990); *Student Pub. Interest Research Grp., Inc. v. AT&T Bell Labs.*, 842 F.2d 1436 (3d Cir. 1988); *Blum v. Witco Chem. Corp.*, 702 F. Supp. 493, 498 (N.J. 1988). *See also* William R. Mureiko, *A Public Goods Approach to Calculating Reasonable Fees under Attorney Fee Shifting Statutes*, 1989 DUKE L. J. 438, 461-72 (1989).

108. Charles Silver, *A Restitutionary Theory Of Attorneys' Fees In Class Actions*, 76 CORNELL L. REV. 656 (1991); *Pennsylvania v. Del. Valley Citizens' Council for Clean Air*, 483 U.S. 711, 726-27 (1987).

109. Based on Eisenberg et al.'s research, these seem to be reasonable real-life examples. *See Eisenberg et al.*, *supra* note 11, at 938.

110. If the best attainable settlement exceeds \$54.6 million, class counsel will earn more by reaching the best attainable settlement for the class. Of course, if this is the case, the settlement figure itself can be slightly increased, so that a fee that is somewhere between 19% and 19.75% of the class's recovery will make the sellout profitable.

111. *E.g. Amchem Prods. v. Windsor*, 521 U.S. 591 (1997).

class counsel is paid a fee that is very large in comparison to the class's recovery, the court may notice the inadequacy of the settlement. But even in the most extreme settings, detection and condemnation are far from certain. Even if the court is confident that, from a legal perspective, the case was not a risky one *ex ante*, it is not at all clear that class counsel has not performed in-depth research, unearthed evidence, obtained statements from defendant's corporate officers, or located other "smoking guns." Each of these may be costly and very effective in persuading the defendant to settle at an earlier time. Instances of generous fees paid early on may be nothing more than a result of demanding work, for which class counsel should be adequately compensated. Ultimately, even very generous compensation for class counsel at an early stage does not necessarily indicate an inadequate settlement.

Setting class counsel's fees as a percentage-of-recovery thus fails to address the inadequacy of class action settlements. First, it is completely ineffective when the reason for the inadequacy is class counsel's innocent mistake and not an intentional sellout. Second, it does not obviate the need for court discretion in a setting in which the court lacks the ability (and incentive) to effectively monitor the adequacy of the terms of the settlement. This problem is exacerbated by the fact that the percentage-of-recovery method is often combined with the lodestar method. Third, small changes in the ratio between class counsel's fees and the class's recovery may greatly enrich class counsel, but may, nonetheless, be practically immune from court condemnation. Finally, even in egregious sellouts, the percentage-of-recovery method can only serve as a red flag.

Despite its intuitive appeal, the percentage-of-recovery method is a far cry from an effective control mechanism. The findings according to which class attorneys often receive excessive fees and class members receive illusory benefits should come as no surprise.

3. Class Members' Objections To Proposed Settlements

An alternative (or a supplement) to court supervision is class members' supervision. Specifically, when class actions settle, class members are notified of the settlement, and are afforded an opportunity to participate in a hearing and raise any objection they may have to the settlement.¹¹²

Class members can regularly be assumed to have received appropriate notice of the settlement. For reasons that have to do with personal

112. FED. R. CIV. P. 23(c)(2). *See also, e.g., Girsh v. Jepson*, 521 F.2d 153, 155 n.3 (3d Cir. 1975); *Greenfield v. Villager Indus.*, 483 F.2d 824 (3d Cir. 1973); *Edelson PC v. Bandas Law Firm PC*, No. 16 C 11057, 2018 U.S. Dist. LEXIS 122141 (N.D. Ill. July 20, 2018); *Pearson v. Target Corp.*, 893 F.3d 980 (7th Cir.2018).

jurisdiction and due process,¹¹³ courts are vigilant in ensuring that class members receive proper notice of settlements, even when the costs of notifying the class are high.¹¹⁴

Nevertheless, class participation remains an ineffective safeguard against inadequate settlements. Notice to class members guarantees only that class members know (or can reasonably know) that a settlement has been reached. But potential awareness of the fact that a settlement has been reached is insufficient. Class members must also realize that the terms of the settlement are inadequate and find it worthwhile to act on this realization. Neither of these is likely, at least with respect to individual class members.¹¹⁵ Realizing that a settlement is inappropriate requires a thorough review of the terms of the settlement, a comprehensive legal analysis of the merits, and an understanding of the evidentiary basis of the action. A class member is unlikely to undertake this effort given class members' trivial individual stakes.

Second, even if class members realize that the terms of the settlement are inadequate, acting on this realization is costly. Taking action requires appearing before the court and arguing against the settlement. Class members' private gains from taking such action are insufficient to justify the cost.

In lieu of supervision by individual class members, objectors acting on behalf of a large number of class members may seemingly serve as a safeguard against inadequate settlements. These objectors may then be paid for the value added to the class as a result of their objection. However, this possibility also provides little comfort.

First, the objector must persuade the court of the inadequacy, against class counsel's and defendant's vigorous objections. Once the parties have reached a settlement, they naturally do not want the court to reject it. Even if the objection is valid, the cost of overcoming the parties' objections may be significant, and the chances are not necessarily promising. Many objections may not be worth the trouble of filing. Moreover, the court cannot order the settling parties to agree to an alternative settlement. It can only reject their settlement or a certain aspect thereof and order the parties to renegotiate. This, in turn, means that there is an ever-present risk that the parties will not agree on an alternative settlement, which reintroduces the issue of the court's incentive. The

113. *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974). For a comprehensive account (and an alternative perspective) see Ryan C. Williams, *Due Process, Class Action Opt Outs, and the Right Not to Sue*, 115 COLUM. L. REV. 599 (2015); Hanna, *supra* note 50, at 1958.

114. *E.g. In re Domestic Air Transp. Antitrust Litig.*, 148 F.R.D. 297 (N.D. Ga. 1993); *In re Lorazepam & Clorazepate Antitrust Litig.*, 289 F.3d 98 (D.C. 2002); *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277 (7th Cir. 2002); *But see* Leslie, *supra* note 39, at 76-77.

115. On professional objectors see *infra* text accompanying notes 118 – 123.

court should be reluctant to strike down a settlement and risk having to hear the case. Finally, even when the objection is vindicated, the court may not view the improvement in the settlement terms as very significant or may not view the work associated with the objection as very demanding. The fees awarded by the court may therefore not justify the objector's investment.

Second, the improvement in the settlement brought about by objectors can only be minimal. It is impossible for a court to pinpoint a single figure that constitutes a fair settlement. The fairness determination requires a multi-factor analysis, accounting for legal and non-legal considerations such as the defendant's sensitivity to the reputation associated with litigation, the chances of witnesses not appearing at trial, etc. There is thus a very broad range of reasonable settlements. Some of the factors impacting the analysis are intangible and cannot be assessed by the court. Thus, any settlement within the reasonable range, and even some settlements falling outside this range, will survive court scrutiny. If the objections sway the court, the settling parties can change the terms of the settlement to the minimum necessary to pass court scrutiny. Even when successful, objections can only provide minimal improvements to settlements, bringing the settlement into the tolerable range. Objections have no chance of resulting in the best attainable settlement from the class's perspective. Settlements remain suboptimal from the class's perspective. Additionally, even slight inadequacies may be an opportunity for a lucrative sellout that imposes a great loss on class members.¹¹⁶

The inadequacy of the post-objection settlement, a formidable issue in its own right, exacerbates the first issue of the objector's cost-benefit analysis. If objectors can only push settlements into the tolerable range, the value added to the class is smaller and the objector can only hope to receive relatively small fees, derived from the difference between the original settlement and the minimally tolerable settlement. This chills the incentives to undertake the uphill battle of filing the objection in the first place, even disregarding the court's incentives.

Therefore, objections are helpful only in very grossly inappropriate settlements and can never result in the best possible settlement. Objections provide a very limited solution to the inadequacy of settlements.

Not surprisingly, the reality is that objections—or, more accurately, the potential for abuse of objections—have become a problem for adequate settlements rather than a solution for inadequate ones.¹¹⁷

116. See *supra* text accompanying notes 109 – 110.

117. *Barnes v. FleetBoston Fin. Corp.*, No. 01-10395-NG, 2006 U.S. Dist. LEXIS 71072, at *3 (D. Mass. Aug. 22, 2006); *But see* Eric Alan Isaacson, *A Real-World Perspective on Withdrawal of Objections to Class Action Settlements and Attorney's Fee Awards: Reflections on the Proposed Revisions to Federal*

The possibility of filing an objection has also attracted what have come to be known as “professional objectors.”¹¹⁸ The practice of professional objections entails filing a meritless objection to class settlements on behalf of unnamed class members. When the court approves the settlement despite the objection, the professional objector appeals the ruling.¹¹⁹ The objector does not typically intend to see the appeal through.¹²⁰ The appeal imposes litigation costs as well as the costs of delay in execution of the settlement on the settling parties. This allows the professional objector to extract a payoff from class counsel and the defendant in return for withdrawing the appeal. At times, even an appeal is unnecessary. Sometimes, the delay caused by filing an objection with the district court is enough to extract a payment.¹²¹ Professional objectors have been characterized as “pariah[s] to the functionality of class action lawsuits”.¹²²

Rather than solving the problem of settlement inadequacy, the possibility of filing an objection has become “what is effectively a tax on class action settlements, a tax that has no benefit to anyone other than to the objectors.”¹²³

Rule of Civil Procedure 23(e)(5), 10 ELON L. REV. 35 (2018). As the Advisory Committee on Civil Rules noted: “Although [such] payment may advance class interests in a particular case, allowing payment perpetuates a system that can encourage objections advanced for improper purposes.” BOLCH JUD. INST., *supra* note 66, at 20.

118. John E. Lopatka & D. Brooks Smith, *Class Action Professional Objectors: What to Do About Them?*, 39 FLA. ST. U. L. REV. 865, 867-70 (2012). For an opposing view see Isaacson, *id.*, at 35.

119. The Supreme Court has ruled that such non-named class members are a ‘party’ to the action, and therefore have a right to appeal the decision. *Devlin v. Scardelletti*, 536 U.S. 1, 14 (2002). As Lopatka and Smith note, the case may have been decided differently had the action not been one brought under Rule 23(b)(1) that does not afford class members the opportunity to opt out of the class. Lopatka & Smith, *id.*, at 868).

120. Lopatka & Smith, *id.*, at 868.

121. *Vollmer v. Selden*, 350 F.3d 656, 660 (7th Cir. 2003).

122. *Snell v. Allianz Life Ins. Co. of N. Am.*, Civ. No. 97-2784 RLE, 2000 WL 1336640, at *9 (D. Minn. Sept. 8, 2000). See also references in Lopatka & Smith, *supra* note 118, at 866, 869.

123. *Barnes v. FleetBoston Fin. Corp.*, No. 01-10395-NG, 2006 U.S. Dist. LEXIS 71072, at *3 (D. Mass. Aug. 22, 2006). But see Isaacson, *supra* note 117. The recent amendments to the Federal Rules of Procedure that came into force in late 2018 attempt to address these concerns by limiting settling parties’ ability to pay off objectors. Such payments must be disclosed, and require court approval. FED. R. CIV. P. 23(e)(5)(B). See also BOLCH JUD. INST., *supra* note 66, at 20 – 30. Following these amendments, objections are less attractive as a mean to extract payments from the settling parties.

But this does not rectify the problem. First, the amendments do not address the problems associated with filing genuine objections. It is still costly to file genuine objections, and these objections can only drive settlements into the tolerable range, not optimize them. The recent amendments may change the ratio of good-faith to bad-faith objections changes, but will not rectify the inadequacy of settlements. Perhaps even more importantly, the amended rules do not truly eliminate the possibility of payoffs to the objector. The requirement for court approval of the terms of any agreement between the settling parties and the objector suffers from the same deficiencies that court approval of the original class settlement suffers from. Class counsel, the defendant and the objector can easily join forces. Class counsel and the defendant may apply minimal changes to the settlement, present the objector’s role in improving the settlement as such that justifies a generous reward, and file for approval of the amended settlement with a payment to

4. Opt Outs

The last way to theoretically address the inadequacy of settlements is the opt out mechanism. This mechanism is similar to objections in that it relies on class members rather than on courts to supervise settlements. When class members are notified of the settlement, they may opt out of the class whether or not they had a chance to opt out of the class at an earlier stage.¹²⁴

Opting out of the class indirectly addresses the adequacy of class settlements. Opt outs make the settlement less attractive from the defendant's perspective because the class bound by *res judicata* is smaller. If a large enough number of class members opts out of the class, class counsel and the defendant may renegotiate a more appropriate settlement. Indeed, many class settlements contain a provision making the settlement contingent on a certain percentage of class members not opting out.¹²⁵

However, this mechanism too is ineffective. First, much like filing an objection, opting out requires that class members not only know that a settlement has been reached, but also incur the costs of reviewing the settlement itself and the underlying evidence and legal argumentation in order to realize that the settlement is inadequate.¹²⁶

Second, although it is relatively easy to opt out of a class (as opposed to objecting to a settlement, which is costly), focusing on the ease of opting out is myopic. If the class member does not intend to pursue her individual cause of action separately, she is better off not opting out of the class at all. It is far better to receive inadequate compensation than to receive no compensation at all. Opting out can only function as a check on the appropriateness of settlements if opting-out class members subsequently file their own suit.¹²⁷ And filing a class member's individual

the objector. The three parties will argue that the objection has been addressed and justifies remuneration. The previous issues with court supervision will resurface, and it will still be possible to "make a living simply by filing frivolous appeals." *Barnes*, 2006 U.S. Dist. LEXIS 71072, at *3.

124. FED. R. CIV. P. 23(e)(1). For an analysis of the necessity of notice to class members for this purpose, as well as the shift from an opt-in rule to an opt-out rule in 1996 see *Amchem Prods. v. Windsor*, 521 U.S. 591, 614-15, 628-29 (1997). See also *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812 (1985); *Brown v. Ticor Title Ins. Co.*, 982 F.2d 386, 392 (9th Cir. 1992), *cert. denied*, 511 U.S. 117 (1994).

125. Eisenberg & Miller, *supra* note 94, at 1538. For a report on such a provision in the recent multi-billion credit-card settlement recent case see Jennifer Surane, *Visa, Mastercard Face Next Fight After \$6.2 Billion Settlement*, BLOOMBERG (Sept. 18, 2018), <https://www.bloomberg.com/news/articles/2018-09-18/visa-mastercard-reach-6-2-billion-settlement-over-swipe-fees>.

126. For this argument in the specific context of opt-outs, see Geoffrey P. Miller, *Conflicts of Interest in Class Action Litigation: An Inquiry into the Appropriate Standard*, 2003 U. CHI. LEGAL REFORM 581, 586.

127. *Settlement in Blockbuster class-action suit approved*, THE VICTORIA ADVOC., Jan. 13, 2002, at C1 (noting that 500 approximately customers had opted out of the settlement and could bring their own suit, but that this was impractical given the small amounts to which individual customers were entitled).

suit is, of course, even more costly than filing an objection. Not surprisingly, empirical studies and anecdotal evidence suggest that the number of opt outs is in the vicinity of one to two percent—possibly even less.¹²⁸ When opting out occurs, it is often for strategic reasons. Larger class members, for example institutional investors in securities class actions, can often extract greater compensation from the defendant¹²⁹ not because they have a better case than other class members,¹³⁰ but because they can make a more credible threat to pursue the case or because the defendant is worried about its ongoing relationship with these important customers. Although this would seem to increase the total amount paid out to the class, it in fact allows the defendant to reduce the total payment.¹³¹ The original class is left with no member that has any significant interest in the outcome.¹³² The dispersed class members subsidize the larger payments made to those large consumers who can credibly threaten the defendant with litigation, or with whom the defendant wants to maintain an amicable relationship.

Finally, not all class actions can be opted out of. There are three types of class actions from which members cannot opt out: class actions seeking injunctive or declaratory relief;¹³³ class actions that are certified because separate trials would create the risk of inconsistent adjudication;¹³⁴ and “limited fund” class actions, which may be allowed because if tried separately the lawsuits might be “dispositive of the interests of the other members . . . or would substantially impair or impede their ability to

128. Jay Tidmarsh & David Betson, *Optimal Class Size, Opt-Out Rights, and "Indivisible" Remedies*, 79 GEO. WASH. L. REV. 542, 544 (2011); Thomas E. Willging et al., *Empirical Study Of Class Actions In Four Federal District Courts: Final Report To The Advisory Committee On Civil Rules*, FED. JUD. CTR. 1, 21 (1996); Jay Tidmarsh, *Mass Tort Settlement Class Actions: Five Case Studies*, FED. JUD. CTR. 1, 10-11 (1998).

129. Tidmarsh & Betson, *id.*, at 544; Tidmarsh, *id.*, at 39; Reed R. Kathrein, *Opt-Outs, MFNs and Game Theory: Can the High Multiples Achieved by Opt-Outs in Recent Mega-Fraud Settlements Continue, A Discussion Draft*, in SEC. LITIG. & ENFORCEMENT INST. 583,587 – 590 (PLI Corp. L. & Practice, Course Handbook Ser. No. B-1620, 2007); Kessler, Topaz, Meltzer, Check LLP, *Opt-Out Lawsuits Advantages and Considerations*, (Aug. 18, 2016), <https://www.ktmc.com/blog/opt-out-lawsuit-advantages-and-considerations>; Shepherd, Finkelman, Miller, & Shah, LLP, *Opt-Out Litigation*, <https://www.sfmslaw.com/securities-regulation-corporate-governance/opt-out-litigations/> (last visited Oct. 10, 2020).

130. Which would have raised a conflict of interest between class members in the first place. See Miller, *supra* note 126, at 586.

131. See Surane, *supra* note 125.

132. On the importance of institutional investors specifically, and larger class members generally, see *supra* the discussion in notes 22 & 47. The larger consumers are important class members, because their larger stakes make monitoring of class counsel more likely. But their ability (and propensity) to ‘abandon ship’ is the negative side of the same observation.

133. FED. R. CIV. P. 23(b)(2). See also *Bratcher v. Nat'l Standard Life Ins. Co. (In re Monumental Life Ins. Co.)*, 365 F.3d 408 (5th Cir. 2004).

134. FED. R. CIV. P. 23(b)(1)(A). See also *Corley v. Entergy Corp.*, 222 F.R.D. 316 (E.D. Tex. 2004).

protect their interests.”¹³⁵ For these types of class actions, the possibility of opting out is not even a hypothetical safeguard.¹³⁶

5. The Inadequacy Of Existing Mechanisms—Summary

Ultimately, none of the existing mechanisms provides a safeguard against inadequate class settlements. The two mechanisms that rely on court supervision are ineffective mainly due to the court’s inability to act as an adversary to the parties before it. And the two mechanisms that rely on class members taking action are ineffective mainly due to class members’ lack of individual incentive to take any action at all. The findings according to which “too many cases are settled with illusory benefits to class members and large fees for lawyers”,¹³⁷ and the numerous examples of such cases,¹³⁸ should come as no surprise.

III. THE PROPOSED METHOD—AUCTIONING APPOINTMENT AS CLASS COUNSEL

This Article proposes a post-settlement auction of the appointment as class counsel, a mechanism which spontaneously guarantees the adequacy of settlements.

A. *The Basic Mechanism*

Once a settlement has been reached, the right to step in as class counsel is auctioned. The minimum bid is the amount the defendant is to pay original class counsel in accordance with the settlement. The highest bidder pays original class counsel the amount bid and is appointed as class counsel. Newly-appointed counsel may then pursue the case as it deems fit. She may adjudicate the case, renegotiate a settlement with the defendant, or combine the two by continuing to litigate the case and settling with the defendant at a later stage.

There is only one limitation on new class counsel’s fees: the ratio between class recovery and class counsel’s fees remains as it was in the original settlement. New class counsel’s only way to receive more than she paid original class counsel is to increase the class’s recovery.

135. FED. R. CIV. P. 23(b)(1)(B). *See also Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 833 (1999). *See also* FED. R. CIV. P. 23(e)(4).

136. This last qualification may not be as significant as it might seem on first blush, because these types of class actions are far less frequent than “classic” class actions governed by Fed. R. Civ. P. 23(b)(3). But nonetheless, this is another limitation on the efficacy of opt-outs as a mechanism for assuring the adequacy of settlements.

137. U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, UNSTABLE FOUNDATION, *supra* note 1, at 2.

138. *See supra* text accompanying notes 24 – 32.

Theoretically, the process of *ex post* auctioning of appointment as class counsel may be repeated indefinitely. If new class counsel reaches a second settlement with the defendant, the process is repeated until a settlement is reached after which no bids are received for appointment as class counsel. As this Section will illustrate, because the right to act as class counsel is auctioned, there should normally be no need for more than a single auction. But as a purely theoretical matter, the process may be repeated.

Importantly, the court need not devote any resources to the excruciating and ineffective attempt to assess the adequacy of the settlement. It also need not review of the appropriateness of class counsel's fees. Neither of these needs to be looked into by the court. The court need not review them when the settlement is first presented. And it need not review them at any subsequent stage, including the final stage, when the court sanctions the final settlement. The court simply relies on the market to spontaneously correct any inadequacy, and sanctions the last settlement presented to it, when no one else is willing to bid for appointment as class counsel.

This method provides the optimal result regardless of the reason for the settlement's inadequacy. Whether class counsel has intentionally received a (legal) kickback in return for selling out the class, or unintentionally negotiated a bad deal for the class, the market will self-correct.

To demonstrate this, assume—as in the numeric example presented in the Introduction of this Article—that a settlement is reached according to which class members receive \$100, and class counsel is paid ten dollars in fees.

We may begin with the possibility that class counsel has unintentionally negotiated a suboptimal deal. Class counsel does not realize that the defendant is actually willing to pay the class \$300. The defendant may be willing to pay \$300 because the case's legal foundation is stronger than class counsel realizes, because the evidence contains a "smoking gun" that class counsel has not noticed, or simply because the defendant is concerned with the costs of litigation and the reputational costs associated with such litigation, such as negative press coverage. Any attorney identifying this inadequacy would be willing to bid for the right to receive the difference in fees. Original class counsel has done all the work and new class counsel simply pays ten dollars to immediately approach the defendant with an offer to settle for \$300, and receive thirty dollars in fees. Potential class counsel would be willing to pay anything up to thirty dollars for the right to step in as class counsel. Original class counsel is no worse off than she was under the original settlement if she is paid exactly ten dollars, or better off if she is paid anything more than ten dollars. The transaction is Pareto efficient from the perspective of both original class counsel and new class counsel. Importantly, class members

will ultimately receive \$300 instead of \$100.

Now suppose that, although newly appointed class counsel is a better negotiator than original class counsel, he is not the best negotiator on the plaintiffs' bar. After purchasing the right to act as class counsel for ten dollars, he quickly settles the case for \$150, receiving a fee of fifteen dollars. A more vigilant negotiator can then be expected to step in, pay second class counsel fifteen dollars, and negotiate a better deal for the class and for herself.

In reality, the auction process will likely not need to be repeated. This is because the right to act as class counsel is auctioned and any law firm or individual lawyer can participate in the auction and bid. Competition amongst law firms to purchase the right to act as class counsel should thus drive up the bid in the first round of the auction. The price paid for the right to act as class counsel in the first auction should be equal to (or marginally lower than) the fee that can be expected when the best possible settlement is negotiated. In the previous example, law firms can be expected to bid up to thirty dollars for the right to act as class counsel, and then negotiate the \$300 settlement with the defendant. Once the second settlement is reached, there should be no one willing to bid for appointment as class counsel. But at least in theory, cases may exist in which only one potential bidder realizes the true value of acting as class counsel and the price paid to original class counsel is only marginally higher than (or equal to) what the defendant would have paid original class counsel. Even if this is the case, future auctions can be expected to rectify any inappropriateness.

For example, suppose that, in the same setting of the previous numeric example, only one law firm notices a smoking gun in the evidence. It realizes that the value of acting as class counsel is thirty dollars, but it only bids ten dollars because it does not expect competition for the right to act as class counsel. If this first bidder (new class counsel) is subsequently willing to take measures to extract the full settlement-potential (\$300), the class's recovery will be optimal. The class will have received the full obtainable amount of \$300, original class counsel (who missed the smoking gun) will have been paid ten dollars, and the second class counsel will have been paid thirty dollars, for a profit of \$20. If, however, the first bidder (second class counsel) is unwilling or unable to incur the hardships of an additional round of negotiations with the defendant, it can then reveal the inadequacy of the settlement and reauction the right to act as class counsel, which could this time be expected to be sold for thirty dollars, as its true value has become known to all. Once the right to act as class counsel has been purchased, the first bidder has little reason not to reveal the inadequacy of the settlement. It wants to resell the asset that is now in its possession—the right to act as

class counsel—and has everything to gain and nothing to lose from potential bidders realizing the true value of this asset. Therefore, even if the first round of the auction does not yield the best-attainable result, subsequent rounds will. But in reality, the first auction should yield the optimal result.

This method provides even more comfort in cases of an intentional sellout—the case in which class counsel realizes that the settlement is suboptimal from the class’s perspective, but is “bribed” by the defendant to agree to it. If original class counsel receives a “bribe”, the method essentially guarantees the same “bribe” (measured as a percentage of the class’s total recovery) to all future class counsel as well. Assume, as in the previous example, that the best obtainable settlement is \$300 and that the fair fee for class counsel is ten percent of the class’s recovery. However, defendant and class counsel agree to a \$200 settlement for the class, and fifty dollars as class counsel’s fees. The immediate implication is that class counsel’s fees are fixed at twenty-five percent of the class’s recovery, whatever that recovery may ultimately be. The value of acting as class counsel instantly becomes seventy-five dollars: twenty-five percent of the true value of the claim—\$300. The larger the “bribe”, or the more egregious the sellout, the more lucrative it becomes to purchase the right to act as class counsel.

The more conspicuous the sellout, the more likely it is that other law firms will notice the inadequacy of the settlement. The settling parties cannot manipulate this. If class counsel’s fees are set too low, original class counsel will not agree to the settlement. It will prefer to insist on a better one or pursue the case. If fees are set too high, they become a call for others to purchase the right to act as class counsel. As long as there are no undisclosed side payments, which would be illegal (and would require both parties to submit falsified statements),¹³⁹ the mechanism cannot be manipulated.

There is, of course, no reason to force new class counsel to settle the case immediately after purchasing the right to act as class counsel. To be sure, normally a new settlement can be expected to be reached shortly after the right to act as class counsel has been purchased. New class counsel will have presumably identified the inadequacy of the original settlement, suggesting that the current value of the claim exceeds the amount agreed to by the defendant. Otherwise, new class counsel would not have purchased the right to act as class counsel. This, in turn, implies that the defendant can be quickly persuaded to settle for a larger amount. Even if the reason for the inadequacy of the settlement is one that may only come into play at a later stage in litigation—for example, a “smoking

139. FED. R. CIV. P. 23(e)(3).

gun” missed by both original class counsel and the defendant—new class counsel can reveal this to the defendant immediately after purchasing the right to act as class counsel and update the defendant’s assessment of the outcome of the case. Thereafter, class counsel can quickly negotiate a better deal for the class.¹⁴⁰ Therefore, it is likely that settled class actions will resettle shortly after the right to act as class counsel has been purchased.

But if, for whatever reason, new class counsel finds it profitable to adjudicate the case, there is no reason to prohibit her from doing so. Original class counsel will have already been paid for her efforts up to the settlement. The amount paid will be at least the amount original class counsel agreed to receive within the framework of the settlement, so there is no concern that this payment is inadequate compensation for these efforts. New class counsel will have internalized these costs because it will have paid original class counsel this amount. And the class is well protected because new class counsel can only make a profit if the class’s recovery is increased.

To be sure, if new class counsel ultimately loses the case, the class will have lost. But this is not unique to settlements or to the proposed mechanism. Class members are always exposed to the risk of class counsel losing the case. And under the proposed method, class counsel has more skin in the game than it usually does. Normally, if the case is lost, class counsel loses the time spent on the case. By contrast, under the proposed mechanism, class counsel will have lost not only the time spent on the case, but also the payment made to original class counsel. Class counsel is incentivized to carefully assess the merits of the case and professionally adjudicate it to a far greater extent than class counsel normally is.

B. The Ex Ante Effect of the Method—Securing the Adequacy of the First Settlement

This Article has thus far focused on the expected response of law firms of the plaintiffs’ bar to inadequate settlements. But of course the threat of the *ex post* auction should work back to the original (first) settlement and guarantee its adequacy.

If a defendant “bribes” class counsel in the first settlement, the low-ball settlement (from class members’ perspective) is sure to attract bidders, as purchasing the right to act as class counsel becomes a lucrative investment opportunity. Ultimately, the settlement will be more costly for

140. This is a straightforward extension of the shadow-of-trial model. See Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979).

the defendant than a fair original settlement would have been. It will ultimately pay the class the fair value of the settlement and pay fees that are greater than it would have otherwise paid. Defendant thus has an incentive to reach a fair first settlement, in which class counsel's fees are not excessive. At the same time, class counsel has little reason to agree to a suboptimal settlement. Therefore, class counsel can be expected to negotiate the best attainable settlement in order to extract the largest fees possible. This method should normally result in the first settlement being the best possible one.

In any event, courts never need to review the terms of class settlements. Whether the first settlement is the best attainable one and no firm is willing to bid for appointment as class counsel or some subsequent settlement is the best attainable one, the court applies a simple process that never requires any substantive review: it continues to auction the right to act as class counsel every time a new settlement is reached, awarding this right to the highest bidder. Once there are no bids for appointment as class counsel, it sanctions the most recent settlement.

C. Eliminating The 'Reverse Auction' Problem

The method proposed in this Article also solves the "reverse auction" problem. The reverse auction is a result of competition between different attorneys of the plaintiffs' bar to be appointed as class counsel. At times, different attorneys will file certification motions in different courts against the same defendant or defendants, alleging similar causes of action on behalf of identical or similar classes. This is extremely common when class actions are filed in the wake of a scandal.¹⁴¹ This results in competition between counsel for appointment as class counsel. In such settings, the Rules of Civil Procedure require courts to appoint the applicant "best able to represent the interests of the class".¹⁴² Much of courts' resources at the earlier stages of class actions are devoted to resolving this rivalry, and the courts are forced to consider numerous intangible factors such as experience, willingness and ability to commit to time-consuming litigation, willingness to cooperate with other counsel, access to resources to litigate in a timely manner, and any other relevant factors.¹⁴³ Different courts use different methods. At times, courts appoint different lead counsels for each putative class. Sometimes, multiple firms

141. Pretrial Order No. 2: Application for Appointment of Plaintiffs' Lead Counsel and Steering Committee Members, *In re Volkswagen "Clean Diesel" Marketing, Sales Practices, and Prods. Liab. Litig.*, 148 F. Supp. 3d 1367 (N.D. Cal. Dec. 22, 2015) (MDL No. 2672).

142. FED. R. CIV. P. 23(g)(2).

143. FED. R. CIV. P. 23(g)(1)(a)(i) – (iv), (g)(1)(b).

are appointed as class counsel and steering committees are established.¹⁴⁴ Often, the need arises to appoint interim class counsel until courts render a final decision on the appointment of class counsel.¹⁴⁵

This process is demanding and requires coordination between the various courts in which the certification motions are filed. This coordination problem can be abused by both class counsel and the defendant. One of the ways in which a firm competing with others can secure its appointment as class counsel is by reaching a settlement with the defendant and having the agreement sanctioned by the relevant court. A reverse auction occurs when the defendant uses competition among firms of the plaintiffs' bar to obtain a low-ball settlement. As the court in *Reynolds* observed:

[T]he defendant in a series of class actions picks the most ineffectual class lawyers to negotiate a settlement with in the hope that the district court will approve a weak settlement that will preclude other claims against the defendant.¹⁴⁶

The *ex post* auction mechanism rectifies the reverse auction problem.¹⁴⁷ If the reverse auction pushes the price of the first settlement down, the subsequent auctions will drive it back up. The simple mechanism this Article proposes guarantees that the best possible settlement from the class's perspective will ultimately be negotiated. The terms of the first settlement become a moot issue.

D. Applicability of The Method To Coupon Settlements

The application of the method to coupon settlements, in which class members receive coupons for future purchases from the defendant, is not immediately apparent. Nonetheless, the mechanism is very easily applied to coupon settlements as well.

Before proceeding to explain how the method can be applied to coupon settlements, it is important to note that coupon settlements are a valuable tool. Although coupon settlements may be abused, as demonstrated in the preceding Sections, they can also significantly increase the value class members receive in a settlement. If the cost of a coupon to the defendant is lower than the value of the coupon to class members, paying class members in the form of coupons will allow class members to receive greater value than they would have received in a cash settlement.¹⁴⁸

144. BOLCH JUD. INST., *supra* note 66, at 31 – 35.

145. *Id.* at 33.

146. *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277 (7th Cir. 2002).

147. For the significant resources devoted to such scrutiny see *Figueroa v. Sharper Image Corp.*, 517 F. Supp. 2d 1292 (S.D. Fla. 2007).

148. This will be the case even the coupon redemption-rate is 100%; that is, all class members

Settings in which the value of the coupon to class members exceeds the cost of the coupon to the defendant seem to be relatively common. Whenever the defendant produces the product or provides the service for which the coupons can be used, the cost to the defendant of the coupons is smaller than their value to purchasers (or class members). If coupons have additional benefits from the defendant's perspective, for example because they serve as a promotion for the defendant's products,¹⁴⁹ the defendant may again be willing to pay a larger amount in coupons than it is willing to pay in cash.

Generally, coupon settlements may be a way to increase class members' total benefits from the settlement. The real issue with coupon settlements is not that coupons are inherently under-compensatory, but that their redemption rate may be too low. Calculating the value of the settlement by multiplying the number of class members by the coupons' face value may largely overstate the real value of the settlement to the class. Class counsel and the defendant may intentionally set the face value of the coupon to be small enough to ensure that redemption rates remain low. This manipulation allows class counsel and the defendant to abuse coupon settlements.

To address this, the proposed mechanism can simply be applied based on the face value of a single coupon, rather than on the purported class recovery. The ratio fixed by the first settlement would not be the ratio of class counsel's fees to total class recovery. Rather, it would be the ratio of class counsel's fees to the face value of the coupons. If the face value of the coupons has been set too low, the defendant will be willing to increase the face value of the coupons because the true value of the settlement to the defendant is much higher. If this happens, new class counsel can significantly increase its own fees.

Consider the extreme example of the ITT Financial Corporation settlement.¹⁵⁰ In the framework of the settlement, class members were awarded coupons. Only two of the 96,754 coupons—or 0.002 percent—were redeemed. Class counsel's fees were calculated based on the value of nearly 100,000 coupons.¹⁵¹ The defendant would clearly have been willing to increase the face value of the coupons by orders of magnitude. Increasing the face value of the coupons would have had a double effect. First, it would have increased the amount recovered by those class members who redeemed their coupons. Second, it would have

redeem all of the coupons.

149. As some have argued was the case in the ITT case, subsequently discussed. See Hantler & Norton, *supra* note 25, at 3 (citing Barry Meier, *Math of a Class-Action Suit: "Winning" \$2.19 Costs \$91.33*, N.Y. TIMES, Nov. 21, 1995). See also Rhode, *supra* note 24, at 465.

150. *Id.*

151. See *supra* note 27.

presumably increased redemption rates. But even if the face-value of the coupons were increased tenfold, it is hard to believe that this would have made the settlement cost-prohibitive from the defendant's perspective. And new class counsel would have received ten times what original class counsel received. Similarly, in the Blockbuster settlement, in which class members received a coupon for a one-dollar discount on rentals,¹⁵² even if the defendant could only have been persuaded to increase the face-value of the coupons to \$1.25, new class counsel could have earned nearly \$2.5 million—(twenty-five percent of original class counsel's fees. Clearly, this would have been incentive enough to renegotiate a deal that was unattractive to class members.

Precisely assessing the effect of an increase in coupon face-value may be slightly more complicated than assessing the effect of an increase in the amount of cash settlements because it requires considering two elements rather than one. Potential bidders for appointment as class counsel must consider both the increased per-class-member payment and the effect on redemption rates. But this is done anyway. All parties to a settlement obviously engage in estimating these effects as it is. Defendants necessarily engage in such an estimate because it affects their total exposure. And class counsel necessarily engages in such an estimate, because even under the current regime, higher face-value means greater fees.¹⁵³ Parties obviously assess the true costs and benefits of coupon settlements under the current regime as well, and would-be bidders have a strong incentive to identify inadequate settlements.

In fact, if coupon settlements are indeed abused, the proposed mechanism will likely be a very effective tool in securing their adequacy. As explained in the context of cash settlements,¹⁵⁴ the more extreme the level of under-compensation, the higher the profitability of being appointed as class counsel. If coupon settlements allow parties to conceal the settlements' inadequacies from the court, potential bidders have an offsetting incentive to discover and reveal such inadequacies. If the truly extreme sellouts occur in coupon settlements, it should be easy enough for attorneys of the plaintiffs' bar to identify gross inadequacies. Returning to the ITT Financial Corporation settlement, it seems nearly certain that ITT could have easily been persuaded to increase the face value of the coupons tenfold. Given the redemption-rate of less than 0.002%, this seems like an extremely moderate assumption. And this would have meant a 900% return on the investment of any attorney who identified the inadequacy. This seems to be a very strong incentive to get

152. *See supra* note 31.

153. Because this allows the parties to present the settlement as providing class members with larger recovery – *see supra* notes 93 – 94.

154. *See supra* text accompanying notes 33 – 34.

involved in the case.

Finally, the costs of a mistaken assessment are unlikely to be extreme from new class counsel's perspective. Even if, for whatever reason, new class counsel miscalculates the defendant's willingness when bidding, and ultimately finds that it cannot negotiate a higher coupon-face-value, its loss can easily be cut. When new class counsel realizes that it cannot negotiate a better settlement, it can quickly resort to the terms of the original settlement. New class counsel will have paid original class counsel's fees but received the same fees from the defendant. It will have lost nothing in terms of out-of-pocket funds. To be sure, it will have lost the time invested in negotiating a better settlement. But this hardly seems like an extreme cost and will only be borne if class counsel somehow miscalculated the best attainable settlement. Law firms of the plaintiffs' bar may also develop a practice of obtaining portfolios of coupon settlements in which they attempt to renegotiate. Given the relatively low costs of the unprofitable cases (time spent before resorting to the original settlement), it is likely that improving settlement terms in some of the firm's portfolio will make the whole endeavor profitable.

Ultimately, the method is applicable to coupon settlements as well. It may, in fact, be even more powerful in this setting if indeed coupon settlements often conceal grave mistreatments of the class.

E. Limitations

The method proposed in this Article has two limitations that must be acknowledged.

1. Coupon Settlements Followed By Cash Settlements

The first limitation of this Article's proposed method is that it cannot automatically rectify settings in which there is a "change of currency" between the first and second settlements. Specifically, if the first settlement is a coupon settlement and the second settlement is a cash settlement, the conversion rate of coupon to cash cannot be set automatically.

Consider a coupon settlement, according to which 100 class members are to receive 100 one-dollar coupons. The settling parties also agree that class counsel will be paid ten dollars in fees. A law firm of the plaintiffs' bar realizes that only a small percentage of the coupons, say five percent, will be redeemed, given their trivial value. The firm purchases the right to act as class counsel for ten dollars—the fee negotiated by original class counsel. It then settles the case for a forty-dollar cash payment to class members. New class counsel's fees cannot be set based on the ratio set in

the original settlement.

This limitation is not significant. First, there is no reason to think that such an odd setting is very realistic. Why would the second settlement be a cash settlement if the first settlement was a coupon settlement? Nothing prevents second class counsel from reaching a better coupon settlement. Keeping the “currency” of the settlement as “coupon currency” will allow new class counsel to improve the settlement from the class’s perspective and increase its own payment. In the previous example, if the defendant is willing to settle for forty dollars in cash, and if indeed class members would have only redeemed five dollars in coupons under the original settlement, the defendant will presumably be willing to increase the face value of the coupons. This will allow new class counsel to receive a quick return on its investment, while at the same time improving class recovery. And as previously discussed, coupon settlements are not objectionable *per se*. When the face value of the coupons is appropriate, they add value to the class. New class counsel is fully motivated to reach a second coupon settlement, and at the end of the day class members should be no worse off than they would have been under a cash settlement.

Moreover, not *all* potential bidders must be able to reach a better coupon settlement for the method to provide spontaneous supervision of the adequacy of the coupon settlement. As long as there are any attorneys on the plaintiffs’ bar that can reach a better coupon settlement (i.e., higher coupon face value), the method will work perfectly. These attorneys will bid for appointment as class counsel and will ultimately achieve the optimal settlement from the class’s perspective. And of course, the possibility of such bidders will work back to the original settlement and secure its adequacy. Thus, the only settlements that pose an issue are those where no attorney believes it can improve as a coupon settlement. And if no attorney can improve the settlement as a coupon settlement, the settlement is probably not grossly inadequate.

For this limitation to be meaningful in any way, two extremely unlikely conditions must be met. First, all potential bidders of the plaintiffs’ bar must believe that they cannot improve the settlement in any way as a coupon settlement. Second, although none can improve the settlement as a coupon settlement, some must believe that they can improve the settlement as a cash settlement, otherwise the settlement is by definition the best attainable settlement.

Therefore, this limitation does not seem of any practical significance. But, indeed, if these two conditions are ever met, the method will not guarantee perfect and spontaneous supervision.

2. Smaller Class Recovery and (Much) Smaller Fees for Class Counsel

Another limitation of the method is that it fails to incentivize a specific type of attorney to bid for appointment as class counsel. Specifically, the method will not attract bids from an attorney who can only obtain a smaller overall settlement (because, for example, she is slightly less competent), but is nonetheless willing to accept a smaller fee, leaving class members with a larger net recovery.

Consider the following scenario. First class counsel settles the case for \$100, of which ten dollars are paid as fees, and class members' net recovery is ninety dollars. Any attorney who can obtain more than a total of \$100 will be incentivized to bid for appointment as class counsel. However, there may also be attorneys who can only achieve a total recovery of ninety-five dollars, but are nonetheless satisfied with only four dollars as fees. If such an attorney is appointed, class members will be left with a larger net recovery of ninety-one dollars instead of ninety dollars. But such an attorney will not find it worthwhile to bid for appointment as class counsel because she can only make a profit if she increases the class's total recovery.¹⁵⁵

This limitation is also not troubling. First, while such a settlement may leave class members with a larger net compensation, it is not necessarily more socially desirable. This is because such a settlement achieves more by way of corrective justice for class members, but less in terms of deterrence. The defendant ultimately pays less under such a settlement than under the original settlement (ninety-five dollars instead of \$100), which results in under-deterrence.¹⁵⁶ This must be the case, because if the defendant was to ultimately pay *more* under the second settlement, second class attorney would have found it lucrative to bid for appointment as class counsel. Therefore, only subsequent settlements which sacrifice deterrence will not be incentivized by the method.

Second, while this method cannot indeed incentivize the less-able-more-generous attorney, it will incentivize all more-able-equally-generous attorneys. And in this sense, it guarantees profitability for an extremely large number of firms of the plaintiffs' bar. As long as there are attorneys capable of achieving more for class members, sellouts and genuine mistakes will indeed be rectified.

155. I thank Ehud Guttel for pressing me on this point.

156. For a review of the various goals of tort law (focusing specifically on deterrence and corrective justice) see Ariel Porat, *The Many Faces Of Negligence*, 4 THEORETICAL INQUIRIES IN LAW 105 (2003).

III. A THEORETICAL ALTERNATIVE – FULL PURCHASE OF THE CLASS’S CAUSE OF ACTION

A theoretical alternative to the method developed in this Article is the auctioning of the class’s right of action itself. Rather than bidding for the right to act as class counsel, the class’s entire cause of action may be auctioned for the full amount agreed to by the defendant (i.e., the sum of the class’s recovery and class counsel’s fees). The new purchaser would then pay class members the amount they were to be paid in accordance with the terms of the settlement. The purchaser would also pay original class counsel its fees, as agreed in the settlement. Having internalized the full costs of the case up to that point, the purchaser could then be allowed to proceed and handle the action as it deemed fit, with no additional limitation. It could retain original class counsel to act on its behalf, hire different counsel, settle, or adjudicate.¹⁵⁷ There would be no need to place any additional limitations.

The full-purchase alternative is nonetheless problematic in two important respects. First, the full-purchase option addresses only one of the two goals of class actions. Class actions aim not only to deter wrongdoers, but also to compensate victims. The full-purchase option may achieve deterrence, but not compensation.¹⁵⁸

Defendants will indeed be perfectly deterred, as they will ultimately be held accountable for the full sum they should be held accountable for. If original class counsel settles for too little, a purchaser will buy the case and pursue it. The defendant will ultimately pay the full amount of the claim if the case is adjudicated or purchase a release for its true value, given the risks and costs associated with the lawsuit, if a second settlement is reached.

But this will not improve class members’ situation in any way. Class members will still only be paid the original-settlement amount. In the scenario described here, this amount is under-compensatory by definition.¹⁵⁹ The purchaser will pocket the full difference between the

157. A similar idea has been suggested to combat closely related (although not identical) concerns in *Parens Patria* settlements. Briefly, these are cases in which State Attorneys General hire private attorneys to pursue actions on their behalf. Although the problems in both settings are not identical, they are closely related. Beach has suggested a post-settlement auction of the full settlement amount in these cases. See Beach, *supra* note 5, at 492 – 505.

158. The full-purchase option functions as a Pigouvian tax. It may achieve optimal deterrence (or optimal output levels in tax-law jargon). But absent a distributive method allocating the tax collected (or the payment made by the defendant) to those harmed by the externality, it will not compensate the direct victims harmed by the externality. See William J. Baumol, *On Taxation and the Control of Externalities*, 62 AM. ECON. REV. 307 (1972).

159. Another closely related problem is class members’ cooperation. Because class members have nothing to gain once the lawsuit has been purchased, they will likely be less willing to cooperate with the new purchaser. Rather than willingly appearing, witnesses may need to be subpoenaed; documents and

value of the first settlement and the value of the second settlement or final ruling.

By contrast, the auction of the right to act as counsel for the class achieves both goals. Class members also share in the final outcome of the case. In fact, the lion's share of the additional amount ultimately paid will accrue to class members because class counsel's fees are only a fraction of the total value of the settlement.¹⁶⁰

A second problem with the purchase of the class's cause of action is that it requires paying an amount much greater than the amount required when auctioning the right to act as class counsel. The full amount of a settlement is, naturally, larger than class counsel's fees by orders of magnitude.¹⁶¹ Economic agents capable of providing such funds are scarce. When settlement amounts are large, as they often are, only a handful of agents are likely to be able to purchase the whole class's right of action. This makes this solution less practical. Moreover, as potential funders of such purchases are rare, they will naturally possess market power, which will in turn lead them to require a supra-competitive return on their investment. Inadequacies that are not extreme do not provide such a potential return and will not be worth the investment for funders that possess market power.

By contrast, this Article's proposed method allows the purchasing entity to pay a fraction of the total value of the settlement. Any law firm capable of handling the case on behalf of the class can participate in the

other pieces of evidence that are accessible to class members may not be provided to the new purchaser; and so on. This shortcoming of the full-purchase option is probably not an extremely important one in all class actions, because class members' incentive to cooperate with the lawsuit is practically non-existent in most cases anyway. Individual class members regularly stand to gain very little from the lawsuit, and the cost of cooperation normally far exceeds any potential (private) advantage of such cooperation. Nonetheless, at times individual class members who stand to receive more from the class action (for example, because they are larger purchasers who have purchased a large number of units from the defendant) may be more willing to cooperate when they stand to increase their individual compensation. These larger class members will regularly have more helpful evidence to provide than other class members, and so on. This willingness is lost under the full-purchase option. *See also supra* notes 22, 47 & 132.

160. Eisenberg et al., *supra* note 11, find that attorney's fees are approximately 25% of the class's recovery (at 947 – 948). Class members will thus normally receive 75% of the additional payment. It is unclear whether Eisenberg et al. measure the ratio between class counsel's fees and the class's recovery or class counsel's fees and the total payment (in cases in which class counsel's fees are not paid directly out of the class's recovery). If the latter is the case, class members will accrue 80% of the total payment.

161. As a general rule of thumb, bidders will only have to pay a quarter of the total value of the settlement (or a fifth, *see id.*). But even this might be an exaggeration. First, as explained, at present there is reason to believe that attorney's fees are excessive. Once a mechanism is put in place disincentivizing the payment of excessive fees, the ratio of attorney's fees to class recovery can be expected to decrease. Additionally, it should be noted that Eisenberg et al. find a scaling effect, whereby the larger the class's recovery, the smaller the percentage of attorney's fees (Figure 5). The larger the case, the *smaller* the percentage of attorney's fees. Where funding of the settlement is most costly, the payment required under the method suggested in this Article will comprise an even smaller fraction of the settlement amount.

auction. This, in turn, guarantees that terms of class settlements will be closely monitored by a large number of law firms competing amongst themselves to identify inadequate class settlements. In a recent survey of class actions between 2009 and 2013, Eisenberg et al. found that for ninety-two percent of class actions (those in which total recovery was \$100 million or less), the mean fee was approximately \$2.5 million, whereas the mean recovery was slightly greater than \$10 million.¹⁶² In all of these cases, a single law firm (or a very small number of law firms joining forces) should be able to participate in the auction. The outliers were very large cases in which the award was \$100 million or more. In such cases, certainly in the few in which total class recovery exceeded \$500 million (1.5% of the cases),¹⁶³ even the cost of class counsel's fees may have been too costly for any single firm, or even for a small number of firms.

In such cases, a larger number of law firms can form an ad hoc consortium. Several consortia of law firms of the plaintiffs' bar may be formed to compete amongst themselves to purchase the right to act as class counsel. There would still be a very large number of such consortia that would compete to purchase the appointment. The number of economic agents reviewing the adequacy of settlements is thus multiplied by thousands, if not more. Numerous law firms of the plaintiffs' bar can be expected to closely follow the terms of class settlements. And given competition between them, they would also be willing to invest even for a smaller rate of return, implying that even relatively minor inadequacies will be rectified. The tolerable-inadequacy range will be much smaller under the method proposed in this Article.

IV. CONCLUSION

One of the most perplexing issues of mass litigation is the inadequacy of class settlements. Class settlements are a unique setting, in which class counsel's interests are aligned with the defendant's interests, and in direct opposition to class members' interests. Class counsel and the defendant both have an interest in increasing class counsel's fees in return for a reduction in the amount payable to class members. Due to class members' rational apathy, class settlements also provide an opportunity for class counsel and the defendant to further this joint interest. Similarly, class counsel may mistakenly settle for a suboptimal amount.

Neither intentional sellouts nor genuine mistakes are properly addressed by the current supervision mechanisms. Mechanisms that rely

162. Eisenberg et al., *supra* note 11, at 943.

163. *Id.* at 944.

on court supervision are ineffective due to the court's institutional incompetence and lack of incentive to act as an adversary to the parties before it and strike down settlements. Mechanisms that rely on class members' participation fail because class members are, generally, rationally apathetic to the whole process. An abundance of research and caselaw suggests that class settlements enrich class attorneys but offer very little benefits to class members. There are many striking examples of extreme cases in which attorneys walked away with hefty fees and class members received illusory benefits. Class actions end up harming the very individuals they were set up to benefit. Individual class members find themselves bound by inappropriate settlements to the benefit of class counsel and defendants.

The method proposed in this Article results in spontaneous correction of class-settlement inadequacies. The proposed method would allow any attorney or law firm to bid for the right to act as class counsel once a settlement has been reached, while fixing the ratio of class counsel's fees to class recovery. The method aligns the various parties' incentives in a socially optimal manner both before and after a settlement is reached. Instead of the court, an incompetent and ill-incentivized agent, a practically infinite number of attorneys of the plaintiffs' bar will function as supervisors of class settlements. This method also relieves the court of the time-consuming and ineffective task of reviewing the adequacy of class settlements. No such review is ever necessary. The court may simply sanction the last settlement without ever reviewing its terms. Public expenditure is curbed and the socially optimal outcome is achieved.