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## An Economic Analysis of the Private Securities Litigation Reform Act: Auctions as an Efficient Alternative to Judicial Intervention

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# NOTES

## AN ECONOMIC ANALYSIS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT: AUCTIONS AS AN EFFICIENT ALTERNATIVE TO JUDICIAL INTERVENTION

### INTRODUCTION

In 2001, the Third Circuit affirmed a district court's approval of a \$3.2 billion settlement in a securities class action case brought principally against Cendant Corporation.<sup>1</sup> The district court selected lead counsel in this "mega case" through an auction<sup>2</sup>—a new, innovative tool for class action litigation.<sup>3</sup> Although the Court of Appeals for the Third Circuit ultimately held that the lower court erred in conducting an auction to determine who would represent the class,<sup>4</sup> use of court ordered auctions in securities litigation is on the rise. The law firms who represented the class in this case received a court-approved \$262 million in fees and an additional \$14.6 million in expenses.<sup>5</sup> With the realistic possibility of billions

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1. *In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001).

2. *Id.* at 218.

3. See Kathryn Kranhold & Richard B. Schmitt, *To Rein In Fees, Some Judges Ask Attorneys to Bid*, WALL ST. J., Dec. 6, 2000, at B1.

4. See *Cendant*, 264 F.3d at 286.

5. *Id.*; see also Max W. Berger et al., *Cendant: The Dawning of a New Age*, in FINANCIAL FRAUD IN PUBLIC COMPANIES: PREVENTION, DETECTION & LITIGATION 227, 235-36 (PLI Corp. Law & Practice Course Handbook Series No. 1203, 2000); Barren J. Robbins & Fred B. Burnside, *The Race to the Bottom: Bidding For Lead Counsel and its Impact on Securities Class Actions*, in ADVANCED SECURITIES LAW WORKSHOP 2001, at 311, 313-76 (PLI Corp. Law & Practice Course Handbook Series No. 1262, 2001) (analyzing the theory of competitive bidding for lead counsel in class action law suits).

of dollars at stake, it is imperative that individual investors, institutional investors, and law firms that anticipate representing potential classes know and understand the implications of the Private Securities Litigation Reform Act (PSLRA)<sup>6</sup> and, specifically, the role court-ordered auctions could play in securities litigation.

The PSLRA was designed to combat perceived failures in class action securities litigation. The legislative history behind the PSLRA, passed in 1995, reveals that Congress intended to reduce "abuse in private securities lawsuits," especially "the manipulation by class action lawyers of the clients whom they purportedly represent."<sup>7</sup> Through the PSLRA, Congress tried to correct the typical scenario of lawyers seeking clients instead of clients seeking lawyers.<sup>8</sup> To further this goal, the PSLRA provides increased access to the litigation system to more savvy and involved potential plaintiffs.<sup>9</sup> Lead plaintiffs under the PSLRA are now chosen not based on the timeliness of their filing, but upon the stake that they have in the litigation.<sup>10</sup> These plaintiffs, given an increased ability

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6. 15 U.S.C. § 78u-4 (2000).

7. H.R. CONF. REP. NO. 104-369, at 31 (1995).

8. A typical "race to the courthouse" often began with a professional plaintiff who held shares of numerous publicly traded companies. When a cause of action arose, this professional plaintiff would "race to the courthouse" and attempt to be the first to file suit. See Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1011 (1996). See generally John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 677-79, 681-84 (1986) (discussing the "bounty hunter" behavior of attorneys in class actions).

9. In particular, the PSLRA provides that the investor (or group of investors) with the largest stake in a securities class action has the option of representing the class, thus increasing the role of larger investors in the litigation process. Large institutional investors are presumed to be experienced consumers of legal representation and to have more resources available to dedicate to the litigation process. See Phillips & Miller, *supra* note 8, at 1040-41.

10. The PSLRA establishes a standard that the movant in an action must have "the largest financial interest in the relief sought by the class ...." 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb). *But cf.* Roger W. Kirby & Ira M. Press, *Analysis of Decisions Relating to Disputed Lead Plaintiff Appointments Under the PSLRA*, in 2 INSTITUTE ON SECURITIES REGULATION 2000, at 617, 627-28 (32d ed., PLI Corp. Law & Practice Course Handbook Series No. 1213, 2000) (commenting on the vagueness of the PSLRA's standard for establishing who has the "largest financial interest").

to control their own fate, began to participate with greater frequency in the class action process.<sup>11</sup>

Congress wished to provide the whole class, instead of a select few, with the best, most efficient litigation tools and measures. In every class action litigation, the plaintiff class is comprised of the lead plaintiff, who has the single largest stake in the litigation, and other nonparticipatory parties. To ensure that the rights of nonactive parties are represented, Congress has provided some limitations on the power vested in lead plaintiffs. The PSLRA provides that, upon the appointment of the lead plaintiff, she "shall, *subject to the approval of the court*, select and retain counsel to represent the class[.]"<sup>12</sup> thereby explicitly involving the court in the process of deciding who will represent the class. A qualified lead plaintiff's power to select counsel for the class is thus far from absolute.

Early interpretations of the PSLRA gave a broad range of freedom to lead plaintiffs in selecting and retaining counsel.<sup>13</sup> The only perceived limitation was that the counsel chosen withstand judicial approval. Still, the fact that courts maintain authority to approve or reject a lead plaintiff's selection indicates that the power of the lead plaintiff to choose legal counsel for the class is *not* absolute. Instead, lead counsel must be qualified to best represent the class in the eyes of the court.

The PSLRA still has wrinkles. The potential for corruption in choosing and retaining counsel still exists. Infirmities such as

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11. Craig C. Martin & Martin H. Metcalf, *The Fiduciary Duties of Institutional Investors in Securities Litigation*, 56 BUS. LAW. 1381, 1383 (2001) (noting that "[t]he PSLRA encourages institutional investors and pension funds to participate in securities [litigation] ... through provisions that provide them with enhanced opportunities to undertake the role of class representative"); see also Martin & Metcalf, *supra*, at 1389-1404 (noting that courts have looked favorably upon the increased role for institutional investors under the PSLRA); *Cendant*, 264 F.3d at 222 (approving decision of district court to appoint CalPERS as lead plaintiff); *Switzenbaum v. Orbital Sci. Corp.*, 187 F.R.D. 246 (E.D. Va. 1999) (appointing five city pension funds as lead plaintiffs); *Blaich v. Employee Solutions, Inc.*, [Supp. 1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,109, at 90,145 (D. Ariz. Nov. 21, 1997) (debating the adequacy of a city pension fund to represent the class as lead plaintiff).

12. 15 U.S.C. § 78u-4(a)(3)(B)(v) (emphasis added).

13. See SEC, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, at 15-16 (1997) (describing the lead plaintiff's selection of lead counsel as presumptively valid), available at <http://www.sec.gov/news/studies.shtml> (last visited Nov. 20, 2002).

overbilling, inadequate representation of the class, and improper focus on the needs of the lead plaintiff are problems still remaining, even after enactment and enforcement of the PSLRA. These problems arise, not because of the inherent nature of the PSLRA, but because the language of the Act allows self-interested lead plaintiffs to ignore the interests of the rest of the class.

A competitive bidding system for the determination of lead counsel is the most effective way to close the gaps left open by the PSLRA. Auctions effect an administrative allocation of sources as an alternative to deficient market forces.<sup>14</sup> This Note argues that the best, and most efficient, way to combat races to court and to protect nonparticipating plaintiffs is to open the lead counsel role to a competitive bidding process.<sup>15</sup>

How far does a court's power stretch when dealing with the issue of who represents the class? Under the terms of the PSLRA, courts maintain veto power over the selection of lead counsel.<sup>16</sup> This Note will show that a competitive bidding process is an efficient market clearing mechanism for the selection and retention of lead counsel, and that such a process is encompassed under the powers granted to the court by the PSLRA.<sup>17</sup> Court-ordered auctions are not only permissible, they should be used with greater frequency.<sup>18</sup>

This Note will (1) provide a brief discussion of the history of the PSLRA; (2) determine Congress' intent in passing the Act, emphasizing its consideration of the possibility of "competitive bidding;" (3) examine the economic rationale of a competitive bidding process and discuss the role it can have in securities

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14. Curt A. Monash, *Efficient Allocation of a Stochastic Supply: Auction Mechanisms*, in *AUCTIONS, BIDDING, AND CONTRACTING: USES AND THEORY* 231, 231 (Richard Engelbrecht-Wiggans et al. eds., 1983).

15. Competitive bidding and auction theory are discussed in depth throughout this Note. Unless otherwise stated, this Note uses the terms "auction" or "competitive bid" to describe the basic closed envelope, final bid system. Thus, a firm who participates in the auction process, after researching the "value" of the litigation, submits the price it would charge for representing the class if it was selected to serve as class counsel. No collusion among, or even knowledge of, other bidders should be permitted. If accepted by the court as adequate and realistic, all bids are final.

16. H.R. CONF. REP. NO. 104-369, at 31 (1995).

17. See *infra* Parts II, III.

18. For an opposing view, see Kendra S. Langlois, Note, *Putting the Plaintiff Class' Needs in the Lead: Reforming Class Action Litigation by Expanding the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 44 WM. & MARY L. REV. 855 (2002).

litigation; (4) analyze courts' experimentation with the auction process and evaluate whether auctions, in their present form, are an adequate answer to the concerns reflected in the PSLRA; (5) discuss the effect that auctions have had on prospective lead plaintiffs and prospective lead counsel; and finally, (6) suggest what should be done to correct the inconsistent interpretations regarding auctions and the PSLRA.

## I. HISTORY OF THE PRIVATE SECURITIES LITIGATION REFORM ACT

With the enactment of the PSLRA, Congress addressed two distinct interests: preventing securities fraud and ensuring that the "litigation process is not used for abusive purposes."<sup>19</sup> Still another purpose of the PSLRA is to protect and inform all members of the class.<sup>20</sup> Before enacting the PSLRA, lawyers who represented "lead plaintiffs"<sup>21</sup> would strive to be the first to file a claim, obviously dreaming of large rewards that could accrue as a result of litigation. This "race to the courthouse" had numerous adverse affects on the litigation process. For example, in an effort to expedite the filing process, firms representing potential lead plaintiffs often neglected to conduct an adequate investigation of the facts or likelihood of success.<sup>22</sup> Congress, therefore, had a strong desire to reform attorney-driven litigation.

To combat this problem, the PSLRA first mandated that, absent evidence to the contrary, the individual, institutional investor, or

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19. Phillips & Miller, *supra* note 8, at 1009. Phillips and Miller also suggest that Congress wished to correct the "professional plaintiff" problem that leads to the proverbial "race to the courthouse." *Id.* at 1011.

20. See *Wenderhold v. Cylink Corp.*, 188 F.R.D. 577, 583 (N.D. Cal. 1999); see also 15 U.S.C. § 78(j) 21(a)(3)(A) (2000). The notice requirement is necessary to "present a fair recital of the subject matter of the suit and to inform all class members of their opportunity to be heard." *In re Gypsum Antitrust Cases*, 565 F.2d 1123, 1125 (9th Cir. 1977) (emphasis added).

21. Many attorneys specialized in being lead plaintiffs, often holding a broad array of public stock. A rather humorous example of the problem Congress intended to remedy was given by a class action attorney who noted, "I have the greatest practice ... in the world .... I have no clients." William P. Barret, *I Have No Clients*, FORBES, Oct. 11, 1993, at 52.

22. See Phillips & Miller, *supra* note 8, at 1011 ("Complaints frequently were filed within days or even hours of a stock price drop precipitated by an unexpected earnings decline or other negative news about the company's operations.").

even group of investors with the largest stake in the action should represent the class.<sup>23</sup> The result of this provision of the Act is that large, institutional investors often have an increased role in the litigation process.<sup>24</sup> This appears, on its face, to have a favorable effect on class action lawsuits. The theory behind involving large investors, especially pension funds, mutual funds, or large corporate entities, is that they are presumed to be shrewd investors and sophisticated consumers of legal advice.

The second measure Congress established in the PSLRA was one allowing the lead plaintiff, "subject to the approval of the court, [to] select and retain counsel to represent the class."<sup>25</sup> Following the appointment of a lead plaintiff, the chosen counsel must withstand the protective scrutiny of the court. Courts, understandably, have shown much deference to the lead plaintiff's choice of counsel.<sup>26</sup> For example, the United States District Court for the Northern District of Texas took only cursory note of the lead plaintiff's choice of retained counsel.<sup>27</sup> The theory underlying such "blind" approvals of lead counsel is that the lead plaintiff, typically a sophisticated and knowledgeable investor who holds a large claim in the action, will be able to adequately choose and retain counsel that will best

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23. See 15 U.S.C. § 77z-1(a)(3)(B)(iii)(I)(bb) (establishing a rebuttable presumption of adequacy for the potential lead plaintiff who "in the determination of the court has the largest financial interest in the relief sought by the class"). For examples of appointing groups as lead, see Stuart M. Grant, *Appointment of Lead Plaintiff Under the Private Securities Litigation Reform Act*, in SECURITIES LITIGATION 547, 560 (PLI Corp. Law & Practice Course Handbook Series No. 1070, 1998) (citing *In re Informix Corp. Sec. Litig.*, No. C-97-1289-SBA, 1997 U.S. Dist. LEXIS 23687 \*1, \*7-11 (N.D. Cal. Oct. 17, 1997) (appointing the group with the largest loss as lead plaintiff because there was no institutional investor); *Malin v. Ivax Corp.*, No. 96-1843, 1996 U.S. Dist. LEXIS 22452 \*1, \*10-11 (S.D. Fla. Oct. 31, 1996) (denying an individual with a \$44,100 loss the co-lead plaintiff position in favor of a group of investors with losses of \$1.5 million).

24. See Elliott J. Weiss & John S. Beckman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2055-56 (1995) (proposing that "institutions acting individually or collectively, might be well situated to monitor the conduct of plaintiff's attorneys as proxies for all members of the plaintiff class" thus reducing agency costs inherent in class action litigation).

25. 15 U.S.C. § 78u-4 (a)(3)(B)(v).

26. See, e.g., *Gluck v. Cellstar Corp.*, 976 F. Supp. 542, 550 (N.D. Tex. 1997) ("Giving the lead plaintiff primary control for the selection of counsel was a critical part of Congress' effort to transfer control of securities class actions from lawyers to investors."); see also *In re Oxford Health Plans, Inc. Sec. Litig.*, 182 F.R.D. 42, 50 (S.D.N.Y. 1998) (reviewing and granting the plaintiffs' choice of counsel without more than a cursory glance at each firm's resume).

27. See *Gluck*, 976 F. Supp. at 550.

represent the class' interests.<sup>28</sup> These courts assume that the interests of the largest investor will coincide with the interests of the whole class; however, this argument does damage to the intent of the Act. Congress recognized that the interests of the class and the interests of the lead plaintiff may not always coincide. This is the reason Congress granted to the courts the power to approve or disapprove of the lead plaintiff's selection.<sup>29</sup> The objective of protecting the minority of the class' interest in the litigation is the underlying purpose of the PSLRA.

The possibility that the selected lead counsel will not act in the best interests of the class, but instead act for the sole interests of the lead plaintiff who selected the counsel, is ever present in securities litigation.<sup>30</sup> Conflicts of interest are likely to arise among lead counsel's various duties. These conflicts could result in a possible breach of fiduciary duty owed by lead counsel to the rest of the class because counsel could understandably favor its relationship with lead plaintiff. As large investors often use the same law firm for different matters, the duties a firm owes to the absent members of the class may become blurred with prior or continuing fiduciary duties owed to the lead plaintiff.<sup>31</sup> The *Cendant* court maintained that the "ultimate inquiry is always whether the lead plaintiff's choices were the result of a good faith selection and negotiation process and were arrived at via meaningful arm's-

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28. A potential fiduciary duty problem arises, however, if lead counsel neglects the interests of the class in favor of the powerful lead plaintiff who chose it.

29. See 15 U.S.C. § 78u-4 (a)(3)(B)(v).

30. It is also likely that class counsel may, "if self-interest gets the best of them ... inflate their hours, overstate the risks of litigation, or otherwise exaggerate the compensation they deserve." *Developments in the Law—The Paths of Civil Litigation*, 113 HARV. L. REV. 1753, 1827-28 (2000) [hereinafter *The Paths of Civil Litigation*]. Additionally, if the costs and benefits of pursuing litigation for the class are not in line with the incentives for the law firm, a premature settlement may arise.

31. It is natural for lead plaintiffs to select counsel with whom they have worked previously. The rules of ethics and the presumption that attorneys will act ethically at all times, notwithstanding the potential for conflict, increases when dealing in these types of situations. See MODEL RULES OF PROF'L CONDUCT R. 1.7-1.13 (2002); see also H.R. REP. NO. 104-1058, at 11 (1995) (noting that another purpose of the PSLRA is to prevent conflicts of interest between an attorney representing the class who may "own[] or otherwise [have] a beneficial interest in the securities that are the subject of the litigation").



length bargaining.”<sup>32</sup> At all times, the court holds the option to disapprove, with cause, any selected counsel.<sup>33</sup> The court, for example, could disqualify the selection of lead counsel and require that the lead plaintiff select a new counsel or, alternatively, require that the current firm revise its fee structure and resubmit it to the court.<sup>34</sup> In theory, the process of a lead plaintiff selecting counsel and the court rejecting her choice could go on forever, dramatically increasing legal costs and unnecessarily prolonging the litigation process. By opening the counsel selection process to competitive bidding, litigation could proceed without unnecessary debate about the character or loyalties of chosen counsel.<sup>35</sup> Thus, conducting an auction could function to improve judicial efficiency while maintaining litigation costs at a reasonable level.

## II. CONGRESSIONAL INTENT: ARE AUCTIONS AN APPROPRIATE METHOD?

### A. Congress' Intent

By way of the PSLRA, as shown in Part I, Congress attempted to address abuses in the litigation process by counsel who represent

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32. *In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001) (discussing the PSLRA's mandate that if the selected counsel is not up to par, it is the duty of the court to disapprove the lead plaintiff's selection and require the more adequate and acceptable counsel); *see also In re Nice Sys. Sec. Litig.*, 188 F.R.D. 206, 223 (D.N.J. 1999) (requiring that “the proposed counsel fees should be the result of hard-bargaining [and] the initial selection of counsel should be the result of independent decision-making by the lead plaintiff”). Most courts afford a “strong presumption” that the law firms selected by the lead plaintiff in securities litigation are both adequate and reasonable. *See, e.g., Cendant*, 264 F.3d at 201.

33. *Id.* (“[I]t is the court's obligation to disapprove the lead plaintiff's choice” when that “ultimate inquiry” has not been satisfactory.); *see* 15 U.S.C. § 78u-4 (a)(3)(B)(v) (2000); *see also* H.R. REP. NO. 104-1058, at 11 (explaining that the court has the authority to disqualify an attorney from representing the class if it is shown that there is sufficient conflict of interest).

34. *See, e.g., Cendant*, 264 F.3d at 225 (affirming the district court decision allowing selected lead counsel to revise its bid to match that of the lowest bidder).

35. Preserving judicial resources would be just one of the positive benefits of an auction system. Once guidelines are clearly demarcated, the award of a contract to the “highest bidder” is a very easy decision to make. No inquiry into the character of the firm, association with the lead plaintiff, or other various conflicts of interest would be necessary.

class action plaintiffs.<sup>36</sup> Congress intended to prevent abusive practices that foment litigation.<sup>37</sup> Is judicial supervision necessary to protect the interests of the class? Congress obviously felt that lead counsel chosen by lead plaintiffs, if left unchecked, had the potential to abuse the system.<sup>38</sup> What other reason would there have been for Congress to give courts the power to veto lead counsel?<sup>39</sup> It is therefore apparent that the dominant rationale of this decision by Congress was to ensure that the interests of the class remained protected throughout the litigation process.

The use of auctions to select lead counsel has been described as a "bold innovation" that has the ability to eliminate the problems inherent in lead counsel selection by "supplementing or supplanting conventional judicial regulation of class action attorneys' fees with market mechanisms."<sup>40</sup> A leading proponent of competitive bidding for lead counsel is Judge Vaughn R. Walker of the United States District Court for the Northern District of California. In *In re Oracle*,<sup>41</sup> Judge Walker attempted to establish a trading mechanism that would imitate a competitive market.<sup>42</sup> Though the PSLRA does not *explicitly* allow courts to introduce auctions for the selection of lead counsel, Judge Walker maintained that the authority for a

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36. See H.R. CONF. REP. NO. 104-369, at 31 (1995). The possibility of abuse is greater in large class action lawsuits because the plaintiffs accrue more costs in monitoring excessive counsel behavior than in ordinary attorney-client relationships. See generally Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) (discussing the barriers to effective monitoring).

37. S. REP. NO. 104-98, at 6-7 (1995) (providing measures to (a) eliminate bonus payments to named plaintiffs in class actions; (b) restrict professional plaintiffs; (c) set restrictions for fee awards and expenses; (d) prevent abusive conflicts of interest; and (e) encourage finality in settlement discharges).

38. In order to prevent conflicts, the House Conference Report noted that "if a plaintiff class is represented by an attorney who directly owns or otherwise has a beneficial interest in the securities that are the subject of the litigation," the court will have the power and authority to "make a determination of whether such interest constitutes a conflict of interest sufficient to disqualify the attorney from representing the class." H.R. CONF. REP. NO. 104-369, at 11 (1995).

39. 15 U.S.C. § 78u-4 (a)(3)(B)(v) (2000).

40. *The Paths of Civil Litigation*, *supra* note 30, at 1829.

41. 131 F.R.D. 688 (N.D. Cal. 1990).

42. *Id.* at 690. The judge noted that one concern class action auctions were meant to combat was *ex post* fee-setting. *Id.* at 689 & n.2.

competitive bidding structure is implicit in the text and history of the Act.<sup>43</sup>

The PSLRA granted courts great discretionary power to approve or disapprove of lead counsel. This Note suggests that the language of the Act, "subject to the approval of the court,"<sup>44</sup> grants discretionary power to the courts in deciding not only who is retained as counsel, but also in deciding the appropriate *method* of retaining counsel. The interpretation that courts have the authority to implement any necessary process when the lead plaintiff has failed to choose adequate counsel is implicit in the Act. Thus, in analyzing whether auctions are permissible in the selection of lead counsel "[i]t is emphatically the province and duty of the judicial department to say what the law is. Those who apply the rule to particular cases, must of necessity expound and interpret that rule."<sup>45</sup> Courts have the authority and duty to interpret the PSLRA in a manner consistent with its language and legislative purpose.

One purpose of the PSLRA was to protect members of the class who were not actively involved in the litigation process. The statute explicitly allows courts to correct the inadequate judgement of the lead plaintiff if that plaintiff has not conducted a hard bargain in choosing lead counsel.<sup>46</sup> The court has a duty to ensure that the plaintiff class pays no more than a reasonable fee.<sup>47</sup> Rather than having the court select counsel, undoubtably an unacceptable restriction on the free flow of commerce, auctions allow for the "invisible hand"<sup>48</sup> of the market to determine which law firm will

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43. *Id.* at 691-92.

44. 15 U.S.C. § 78u-4 (a)(3)(B)(v).

45. *Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 177 (1803).

46. 15 U.S.C. § 78u-4 (a)(3)(B)(v). Without an auction system in place, lead plaintiffs are left to their own measures in choosing the counsel that will represent the class. Factors which could show that a firm was chosen as a result of a "hard bargain" are the absence of conflicts of interest between the lead plaintiff and the law firm and an agreed-upon fee schedule that is the result of a direct market determination. For more discussion on the ability of members of the class lacking a sufficient stake in the litigation to conduct a "hard bargain," see *In re Amino Acid Lysine Antitrust Litig.*, 918 F. Supp. 1190, 1194-95 (N.D. Ill. 1996).

47. *In re Quintus Sec. Litig.*, 201 F.R.D. 475, 483 (N.D. Cal. 2001).

48. See ADAM SMITH, *THE WEALTH OF NATIONS* 62-72 (Edwin Cannan ed., The Modern Library 1994) (1784) (coining the term and describing how the "invisible hand" of economics plays a large role in the natural and market price of commodities).

represent the class. Auctions represent the least intrusive means of retaining the most effective lead counsel.

*B. The Competitive Bidding Model: An Appropriate Interpretation of the PSLRA*

The PSLRA provides that the selection of lead counsel is "subject to the approval of the court."<sup>49</sup> Additionally, the Act confers a significant fiduciary duty upon the lead plaintiff to act not only in her own interest, but also in the interests of the members of the class who are not participating in the litigation.<sup>50</sup> If there is a breach, or a perceived breach, of this fiduciary duty, the court has an obligation to redress the interests of the minority of the class. In addition to satisfying the PSLRA, the lead plaintiff must meet the adequacy requirement of Federal Rule of Civil Procedure 23.<sup>51</sup>

Is it appropriate for the courts to use market mechanisms in dealing with issues regarding traditionally private spheres? The Supreme Court has mandated on many occasions that the reasonable fee standard be measured on the basis of market rates, lending support to the auction system.<sup>52</sup> Congress has directed courts to evaluate the quality and price of legal services provided by class counsel. This Note will show that auctions are the least intrusive and most effective means of promoting reasonable fees.

The Supreme Court has recognized that courts are capable of determining the "reasonableness" of fees by comparing prevailing market rates:

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49. 15 U.S.C. § 78u-4(a)(3)(B)(v).

50. See *In re Quinxus Sec. Litig.*, 148 F. Supp. 967, 970 (2001) (noting that "the provisions of the PSLRA are consistent with and derived from the fiduciary obligations of the court, the lead plaintiff and the lead counsel that are mandated by FRCP 23"); see also *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 549 (1949) (discussing, more generally, the fiduciary duty imposed upon a plaintiff in a derivative action to use his "diligence, wisdom, and integrity" to act in the best interests of all the members of the class who have been wronged); *Martin & Metcalf*, *supra* note 11, at 1381.

51. See 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(cc); FED. R. CIV. P. 23(a)(4).

52. See, e.g., *Missouri v. Jenkins*, 491 U.S. 274, 283 (1989) (holding that "attorney's fees ... are to be based on market rates for services rendered"); *Blum v. Stenson*, 465 U.S. 886, 895 (1984) (noting that "[t]he statute and legislative history establish that 'reasonable fees' under § 1988 are to be calculated according to the prevailing market rates in the relevant community, regardless of whether plaintiff is represented by private or nonprofit counsel").

We recognize, of course, that determining an appropriate "market rate" for the services of a lawyer is inherently difficult. Market prices of commodities and most services are determined by supply and demand. In this traditional sense there is no such thing as a prevailing market rate for the service of lawyers in a particular community. The type of services rendered by lawyers, as well as their experience, skill and reputation, varies extensively—even within a law firm. Accordingly, the hourly rates of lawyers in private practice also vary widely. The fees charged often are based on the product of hours devoted to the representation multiplied by the lawyer's customary rate. But the fee usually is discussed with the client, may be negotiated, and it is the client who pays whether he wins or loses. [Court-determined] fee determination[s] [are] made by the court in an entirely different setting: there is no negotiation or even discussion with the prevailing client, as the fee—found to be reasonable by the court—is paid by the losing party.

... [Nevertheless, a] rate determined [with reference to industry standards] is normally deemed to be reasonable, and is referred to—for convenience—as the prevailing market rate.<sup>53</sup>

Accordingly, courts should not be adverse to investigating the quality and price of legal representation, and judges can and should be allowed creativity in implementing policies and measures to determine the appropriate price for class representation.

### III. AUCTIONS AND ECONOMIC THEORY

#### *A. Auctions Generally*

Auctions are governed by a "nonspecified mysterious entity called a 'competitive market' where price is determined by the forces of competition."<sup>54</sup> William Vickrey provides an economic rationale for using a competitive bidding process:

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53. *Blum*, 465 U.S. at 896 n.11.

54. Martin Shubik, *On Auctions, Bidding and Contracting*, in *AUCTIONS, BIDDING, AND CONTRACTING: USES AND THEORY*, *supra* note 14, at 9.

Economic theory tells us that perfect competition produces an optimum allocation of resources. One of the elements of a system of perfect competition is a system of markets in which uniform divisible commodities are traded in by large numbers of participants who accept the market price generated by the forces of supply and demand as a given not subject to their influence.... In situations where the commodity dealt in is not uniform or is not subdivisible ... it is not always clear just what can or should be done to generate a situation in which an optimal result is likely to be achieved.

.... The extreme of this type of case is where the universe of discourse contains only a single item to be transferred, and the only optimality-affecting question to be resolved is to whom it is to be transferred, the price being entirely a matter of distribution and not of optimality. This case admits of a fairly simple and frequently employed solution: the open auction, which assures Pareto optimality.<sup>55</sup>

A Pareto optimal result occurs when there is no other feasible alternative allocation of resources (i.e., legal services on one side and compensation on the other) that is preferred by one party over another allocation.<sup>56</sup> In a single item transfer auction, like that of awarding the opportunity to represent the lead plaintiff in a class action lawsuit, both the buyer and the seller have the highest probability of achieving a Pareto optimal result.<sup>57</sup>

A court-ordered auction can be an effective tool with which to decrease legal costs. There are, however, many concerns which must be addressed in order to fully understand a bidding process. Martin Shubik outlines several general factors to consider when evaluating auctions.<sup>58</sup> Discussion here will be limited to the four most relevant factors to an auction system that awards the opportunity to provide the class legal services to the most qualified bid. These four elements include: (1) the number of potential

55. William Vickrey, *Auctions, Markets, and Optimal Allocation*, in *BIDDING AND AUCTIONING FOR PROCUREMENT AND ALLOCATION* 13-14 (Yakov Amihud ed., 1976) (providing an economic background for general competitive bidding models).

56. See ROBERT H. FRANK, *MICROECONOMICS AND BEHAVIOR* 559 (3d ed. 1997) (explaining the concept of Pareto optimal allocations).

57. This conclusion assumes that the normal market mechanism would likely fail or be inefficient for the reasons discussed in the text accompanying notes 30-32.

58. Shubik, *supra* note 54, at 14-22.

bidders, (2) bid preparation costs, (3) bid preparation time, including the importance of information, and (4) estimation and evaluation problems.<sup>59</sup> Although Shubik considered these factors in the context of generalized auctions, they also must be taken into account in order for a lead counsel competitive bidding process to be successful.

### *1. Quantity of Bidders*

Opponents of a competitive bidding process in litigation often point to the number of participants or bidders as a factor that may decrease the effectiveness of the process compared to other auctions.<sup>60</sup> It is true that, if before submission, competing firms know the number of bidders involved in the auction, or the identity of the law firms involved in the process, there could be strategic incentives for the submitting firms to raise or lower their bids accordingly.<sup>61</sup> If the number of bidders is not disclosed and collusion prohibited, however, the bid submitted by each firm will not be influenced by this potential infirmity of auctions.<sup>62</sup> Accordingly, the auction will result in a Nash equilibrium, "[t]he combination of strategies in a game such that neither player has any incentive to change strategies given the strategy of his opponent."<sup>63</sup>

### *2. Bid Preparation Costs*

The amount of resources needed to enter an informed bid is unnecessarily attacked by opponents of court-mandated auctions.

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59. *Id.* at 14-16.

60. Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 90 (2001) (assuming that if an inadequate number of firms bid, the outcome will invariably be inefficient).

61. For example, if the only other firm against which a bid is placed maintains a consistent bidding strategy that is known to rival bidders, there is the potential for inefficient results. In this example, the informed firm will, if profitable, underbid just slightly—even though the firm could have bid far less.

62. See Shubik, *supra* note 54, at 3-31. Shubik notes that the number of bids is inconsequential when using a sealed bid auction process. However, if the auction is open to a competitive market, there must be a high number of potential suppliers to obtain an efficient result.

63. FRANK, *supra* note 56, at 442.

Jill Fisch notes that bid preparation is an expensive proposition.<sup>64</sup> In order to make and submit a rational bid, firms will always have to examine and predict the amount of time, energy, and resources that will be necessary to adequately represent potential clients. Investigation of a suit prior to filing, however, is not a novel idea, and is something every competent attorney should instinctively undertake.<sup>65</sup> Indeed, under the Federal Rules of Civil Procedure, any representation to the court must be pursuant to "an inquiry reasonable under the circumstances."<sup>66</sup> The fact that attorneys must do independent research before accepting a case has long been required. It is also commonly accepted that law firms must perform their own cost-benefit analysis of the profit potential in determining whether to represent a client.<sup>67</sup>

Firms may be dissuaded from entering the bidding process for fear that they will invest their resources and never see any results. One solution to this problem, however, could be to share bid preparation costs.<sup>68</sup> If an auction system is used, courts could maintain a common pre-discovery file open to all legitimate potential firms. This would reduce the cost of information while at the same time maintaining the anonymity of the firms participating in the bidding process. An alternative to a common pool of information could be a bartering of information between firms. Although this has the potential to undermine the inherent value of the auction process, "[t]he risk-sharing aspects of bid preparation can be modified virtually continuously by contracting."<sup>69</sup>

Additionally, the argument that firms will suffer a "deadweight loss" if they are unsuccessful in their bids is offset by the societal

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64. Fisch, *supra* note 60, at 90. Fisch concludes that "[a] bidding firm must investigate the case and predict the expected recovery under various litigation scenarios, as well as the cost associated with each possible recovery, to propose a rational bid structure." *Id.*

65. See generally George Cochran, *Rule 11: The Road to Amendment*, 2 ATTY SANCTIONS NEWSL. 138, 139-41 (1991) (noting the importance of a detailed examination of a prospective litigation).

66. FED. R. CIV. P. 11(b).

67. See Peter J. Hammer, *Antitrust Beyond Competition: Market Failures, Total Welfare, and the Challenge of Intramarket Second-best Tradeoffs*, 98 MICH. L. REV. 849, 891-95 (2000) (describing the general cost-benefit analysis that a firm undertakes when deciding to pursue litigation).

68. See Shubik, *supra* note 54, at 14-15.

69. *Id.* at 15.



gain of a more efficient judicial process.<sup>70</sup> Firms already allocate resources to evaluate the prospects of class litigation and are accustomed to some "dead weight." The fact that firms should be careful in evaluating the potential gains of entering litigation is unaffected by the use of auctions.

### *3. Bid Preparation Time*

The arguments regarding bid preparation time parallel the arguments about preparation costs discussed above. The time it takes to prepare an earnest bid is an understandable concern. Law firms will undoubtedly expend much time and energy in preparing acceptable and competitive bids.<sup>71</sup> Naturally, there are time constraints placed on firms when calculating whether to submit a bid, and if the firm decides to bid, the amount of its bid.<sup>72</sup> An auction, however, has time constraints nearly identical to those imposed in free market selection of counsel. If a lead plaintiff could conduct a hard bargain in her search for lead counsel, the time expended by each law firm in an auction system would be nearly identical to that of an open market process.

Even when courts do not use auctions, plaintiffs face costs: "There are costs of searching for the right prices and quality, of negotiating and closing the contracts. These costs can be substantial, particularly when the choice is between pure exchange with a multiplicity of external organizations ...."<sup>73</sup> In a typical, non-auction system, lead plaintiffs, assuming they are rational in their selection of counsel, will act to avoid the costs described above by selecting a firm that they have employed in the past or conducting

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70. As discussed in Part III, an auction system would reduce litigation concerning whether a lead plaintiff's selection of counsel was sufficiently "adequate" to represent the remainder of the class.

71. According to one author, "the first requisite for successful bidding is to carry a sharp pencil." GENE GAROFALO, *SECRETS OF COMPETITIVE BIDDING: STRATEGIES FOR FINDING AND WINNING MILLION DOLLAR CONTRACTS 2* (1990). Thus, firms interested in competing for the role of lead counsel must be willing to expend resources for the sole purpose of creating a bid.

72. When a law firm enters an auction, it is well aware that if its bid is unsuccessful, the time and resources spent to evaluate the case and prepare a bid will be "sunk costs."

73. SIMON DOMBERGER, *THE CONTRACTING ORGANIZATION: A STRATEGIC GUIDE TO OUTSOURCING 14* (1998) (discussing the numerous costs generally associated with outsourcing). Outsourcing in the context of this Note, is the search for a law firm to represent the class.

only a cursory investigation of which firm could most adequately represent the class. This has the potential, however, to result in the problems that the drafters of PSLRA specifically wished to address, specifically, the lead counsel's failure to act in the class' interest.<sup>74</sup>

Concerns about the time and money spent bidding reflect a general fear that if auctions are promoted and used regularly, firms may be dissuaded from participating by the fear that large investments in the preliminary stages of pending litigation may never materialize; however, this has not been the result. In fact, firms have become more efficient in their research methods and are becoming increasingly better at developing bids.<sup>75</sup> David Boies' Wall Street firm, Boies, Schiller & Flexner LLP, represented the class in the *Auction Houses Antitrust Litigation*,<sup>76</sup> and had little difficulty making and submitting a bid.<sup>77</sup> In fact, Boies welcomed the opportunity to stir up the legal world by revealing how efficient the representation process can be—much to the chagrin of competing law firms.<sup>78</sup>

Additionally, the fear that small firms will be effectively eliminated is unfounded. Smaller firms that are qualified to take on security class action litigation are in the best position to prove their ability to adequately represent the class in an auction system, thus providing lead plaintiffs with an enlarged pool of potential lead counsel.<sup>79</sup> There is a direct positive correlation between increasing

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74. See *supra* notes 6-12 and accompanying text.

75. See James B. Stewart, *Bidding War: Christie's, Sotheby's, and the Art of Betrayal*, NEW YORKER, Oct. 15, 2001, at 158, 168 (describing the strategy of one successful bid).

76. 197 F.R.D. 71 (S.D.N.Y. 2000).

77. See Stewart, *supra* note 75, at 168; see also Laural L. Hooper & Marie Leary, *Auctioning the Role of Class Counsel in Class Action Cases: A Descriptive Study* 55 (2001) (noting that Boies had the winning bid in *Auction Houses* and that the judge compared the bid's terms to the "mean of 'X' bid of \$96 million submitted by four firms who were members of a proposed executive committee organized by the attorneys for the various plaintiffs in order to have the committee designated as lead counsel").

78. See Sindy Goldman & Greg Sargent, *It's Boies' Town: Microsoft Hotshot Hordes Sotheby's Pie*, N.Y. OBSERVER, at <http://www.observer.com/pages/story.asp?ID=2933> (commenting on Boies' successful bid in the Auction House Litigation) (last visited Nov. 10, 2002).

79. See GAROFALO, *supra* note 71, at 1 ("Competitive bidding is a quick way for small companies to reach [large results] ...."). Some commentators feel that small firms will be unable to overcome the economics of scale inherent in large firms. Yet "[i]f small firms can win auctions based on reputation for producing quality results for the class, they may be able to compete with the biggest firms." Randall S. Thomas et al., 80 N.C. L. REV. 115, 196 (2001).

the number of potential bidders and the likelihood of a Pareto optimal result. Thus, small firms and large firms will both play an integral role in the development of auctions pursuant to the PSLRA.<sup>80</sup>

#### 4. *Estimation and Evaluation Problems*

Competing firms could incur the risk of an inaccurate assessment of a settlement price or prospective reward. Obviously, it is not easy to value the potential reward of a class action lawsuit. Due to the inherent difficulty in establishing bids, firms may underbid, successfully obtain the role as lead counsel, and later discover that their bid was not high enough for them to profitably follow through with the litigation. This has aptly been called the "winner's curse."<sup>81</sup> This "curse" could result in incentives to settle a case too early or hold on to a case for too long in the hope of a long-shot payout.<sup>82</sup> However, the "winner's curse" problem is also present in non-auction litigation where, after retaining a law firm, the plaintiff finds that the interests of the firm and the interests of the client do not coincide. A "winner's curse" problem is thus, not solely an auction phenomenon but is instead endemic to class action litigation.<sup>83</sup>

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A firm also may syndicate, or "agree by contract, or less formally, to coordinate services on a particular project." *Id.* at 122-23.

80. Courts reserve the authority to dispose of obviously unqualified bids. *See, e.g., In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001). The court of appeals noted that the district court did not abuse its discretion when it rejected a bid that would have resulted in fees of only one to two percent of total recovery. The Third Circuit characterized the bid as "quasi-philanthropic" and eliminated it because "such an apparently 'cheap' fee does not make professional sense." *Id.*

81. *See generally* RICHARD H. THALER, *THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE* 50-62 (1992) (describing the literature on this theory).

82. *See* RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 627 (5th ed. 1998). Posner notes that the problem resulting from underbidding is that

[t]he lawyer for the class will be tempted to offer to settle with the defendant for a small judgment and a large legal fee, and such an offer will be attractive to the defendant, provided the sum of the two figures is less than the defendant's net expected loss from going to trial.

*Id.*

83. We must assume that participants will internalize all available information and will understand the care necessary in developing a bid. Thus, the "winner's curse" correction, under standard auction assumptions, can yield sale prices that are an unbiased estimate of the underlying value.

### *B. The Double Auction Model and Economic Efficiency*

The legal auction model can be compared to what has been termed a "double auction," a "blind match environment without market makers with market making obligations and without the possibility to lock in prices for large blocks without exposing prices to the pit."<sup>84</sup>

Double auction markets are fascinating institutions. They establish a simple set of rules that organize the interaction of a large number of individual traders. *In spite of the diversity of choice and the complexity of interaction, the markets bring on efficient allocations.* This is most probably true in the double auction markets in business and finance but certainly true in experimental double auction markets.<sup>85</sup>

In his seminal work, Abdolkarim Sadrieh examines the high market efficiency of auctions which positively correlates to "a remarkable convergence to the market clearing price."<sup>86</sup> This is a very interesting model to follow. It Sadrieh is correct, a high degree of "diversity of choice" in potential lead counsel will result in a greater degree of efficiency in the auction model.

### IV. THE EXPERIMENT OF AUCTIONS IN THE COURTHOUSE

Using auctions to determine lead counsel has two important benefits. First, it resolves the problem of the "race to the courthouse," thus providing judges with increased control over quality and price of representation.<sup>87</sup> Second, auctions have the potential

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84. Andrea M. Corcoran, *The Argument for a Professional or Wholesale Futures Market—Where is it Going in the United States—And Why?*, in *BROKER-DEALER REGULATION* 179, 186 (ALI-ABA Course of Study, 1997); see also Juin-jen Chang et al., *Casual Police Corruption and the Economics of Crime: Further Results*, 20 INT'L REV. L. & ECON. 35 (2000) (explaining the mathematical theory behind double auction models); Karim Jamal & Shyam Sunder, *Bayesian Equilibrium in Double Auctions Populated by Biased Heuristic Traders*, 31 J. ECON. BEHAV. & ORG. 273, 287 (1996). See generally ABDOLKARIM SADRIEH, *THE ALTERNATING DOUBLE AUCTION MARKET: A GAME THEORETIC AND EXPERIMENTAL INVESTIGATION* 1-5 (Lecture Notes in ECON. & MATH. SYS., Series No. 466 (1998)).

85. SADRIEH, *supra* note 84, at 1.

86. *Id.*

87. See *In re Cendant Corp. Litig.*, 264 F.3d 201, 258 (3d Cir. 2001).

to lead to lower legal fees.<sup>88</sup> Reducing excessive attorneys' fees in class action litigation is not a novel idea; in fact, much debate surrounds the high fees that attorneys charge.<sup>89</sup> There is an even greater concern when nonparticipatory plaintiffs, who have no say in their legal representation, are forced to pay a price for which they had no ability to bargain.<sup>90</sup> Thus, courts have the unique opportunity to deal with a contemporary problem within the current system without having to resort to changing ethical or procedural rules.

A competitive bidding process can be used to correct the failures in fee structures that have plagued class action litigation.<sup>91</sup> Essentially, a lack of competition among attorneys<sup>92</sup> has limited the number of firms with the ability or influence to be retained as lead counsel in these "mega" class action lawsuits.<sup>93</sup> A choice among attorneys who have the ability to represent the class is consistently viewed to have more positive effects on consumers of legal counsel, thus resulting in societal gains. When there are only a limited

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88. *Id.* at 258-59; see also *supra* Part III (explaining the cost effectiveness of auctions).

89. See, e.g., David M. Young, *Plaintiffs' Attorneys' Fees in Class Action Litigation: An Ethical Solution*, 2 J. INST. FOR STUDY L. ETHICS 255, 255-56 (1999). Young argues that there are too many instances where the attorneys for plaintiffs are receiving unjustifiably high fees. This "unhealthy byproduct" is most notable in class action litigation. *Id.*

90. *Id.* Young observes:

The current challenge to the legal system is whether it can responsibly deal with this problem within the current structure of ethics rules and the rules of court procedure, or whether more draconian reforms will be necessary through amendments of the federal rules, the rules of ethics for lawyers, or through legislative restrictions.

*Id.*

91. See, e.g., Kranhold & Schmitt, *supra* note 3. The article notes that in the recent past "a small group of firms has come to control class action lawsuits." *Id.* These "firms haven't had to compete on the basis of fees—and the fees have gone relatively unchecked by judges who have the authority to set them." *Id.*

92. See Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT. L. REV. 625, 644 (1995) (noting that "for many litigants, lawyers' domination of the market for champerty is an unavoidable fact of life"). There are three factors that, if present, indicate that a firm maintains monopolistic power: (1) there is only one firm producing a good or service; (2) the firm does not have rivals or competitors; and (3) there are prohibitions on new firms entering the market. S. CHARLES MAURICE ET AL., *MANAGERIAL ECONOMICS: APPLIED MICROECONOMICS FOR DECISION MAKING* 496-503 (4th ed. 1992).

93. See generally Young, *supra* note 89, at 255-56. A monopoly is defined as "[a] market structure in which a single seller of a product with no close substitutes serves the entire market." FRANK, *supra* note 56, at 381.

number of firms with the ability or inclination to represent an aggrieved class, the potential for monopolistic behavior increases. As a matter of public policy, monopolies should be avoided as a matter of "fairness" to potential consumers and because of an "efficiency objection ... [to] lost consumer surplus."<sup>94</sup> The auction Judge Walker proposed in *Oracle* was designed to allow for "[even] a single buyer or seller [to] simulate the operation of the competitive market,"<sup>95</sup> thereby simulating market mechanisms even if a small number of firms bid for the role of lead counsel.

Judge Walker's idea was to simulate market competition in a selection process prone to inefficiencies.<sup>96</sup> Judge Walker maintained that in certain situations a competitive bidding process is necessary to guard against "the inherent conflicts and agency problems in class actions."<sup>97</sup> Walker proposed a "sealed bid" auction that allowed the court to take the following factors into account in deciding which firm would be appointed lead counsel:

- (1) the firm's experience in securities class action litigation and the background and experience of those lawyers in the firm who, it is anticipated, will be engaged in representing the class ...;
- (2) the bona fide qualifications of the firm to complete the work necessary for representation of the class, including the willingness of the firm to post a completion bond ... for the faithful completion of its services to the class ...;
- (3) the firm's insurance coverage for malpractice;
- (4) evidence that the firm has evaluated the case, including specifically the range and probability of recovery;
- (5) the percentage of any recovery the firm will charge ...; [and]
- (6) a certification ... that ... [the firm's] proposal was prepared independently of any other firm ....<sup>98</sup>

The Walker model described above takes into account many different factors, and bidding firms should try to conform to this

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94. FRANK, *supra* note 56, at 411 (emphasis omitted).

95. Andrew K. Niebler, *In Search of Bargained-For Fees for Class Action Plaintiffs Lawyers: The Promise and Pitfalls of Auctioning the Position of Lead Counsel*, 54 BUS. LAW. 763, 763 (1999) (discussing *In re Oracle Sec. Litig.*, 131 F.R.D. 688 (N.D. Cal. 1990)).

96. See *In re Oracle*, 131 F.R.D. 688 (N.D. Cal. 1990); see also *Wenderhold v. Cylinck Corp.*, 188 F.R.D. 577, 577 (N.D. Cal. 1999) (ordering another auction in Judge Walker's court).

97. *Wenderhold*, 188 F.R.D., at 587.

98. *Id.* at 587-88.

model if they are serious about submitting a bid in any court. These guidelines are important in conforming the behavior of firms, but law firms are still left wondering exactly what a successful bid looks like.<sup>99</sup>

If the auction process is to be successful, firms must know and understand what courts are looking for in the submission of bids. Much like a contractor submitting a bid for a construction project, to be successful in this environment lawyers must have full information on how, when, and at what price to submit bids.<sup>100</sup> Judge William H. Walls suggested that the most telling characteristics of a winning bid were three-fold:

(1)[l]itigation experience, including (a) demonstrated ability to try successfully a case, if necessary, and (b) demonstrated ability to achieve an effective resolution by settlement; (2) fiscal ability to maintain the litigation; and (3) a fee schedule that represents a realistic incentive to pursue a determined resolution of the plaintiffs cause at a reasonable cost.<sup>101</sup>

Although courts have placed an emphasis on maintaining a reasonable price for legal services, cost is not the sole determinative factor. That a law firm is the lowest bidder does not mean that it will or should be selected. As Judge Walker warned in *Oracle*, "selection of class counsel *solely* on the basis of price, without consideration of qualitative factors and possible penalties for poor performance, may create an incentive for 'lemon' lawyers to drive out the good ones from the bidding process."<sup>102</sup>

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99. See *In re Auction Houses Antitrust Litig.*, 197 F.R.D. 71 (S.D.N.Y. 2000). Judge Lewis Kaplan, for example, refused to give information about the nature and specifics of bids, in fact, refusing to provide either the winning or competing bids in his opinion. *Id.*

100. See GAROFALO, *supra* note 71, at 7 (noting the importance of uncovering as much information as you can, because "[t]he more advance knowledge you have about a bid, the better you're able to prepare for it").

101. *In re Cendant Corp. Litig.*, 191 F.R.D. 387, 390 (D.N.J. 1998).

102. *In re Oracle Sec. Litig.*, 136 F.R.D. 639, 648 (1991); see also Fisch, *supra* note 60, at 84-85. Explaining the inherent difficulty in evaluating firm quality and the problems that arise, Fisch describes the "lemons" problem as, "[t]he knowledge that [high quality firms] cannot compete with lower quality firms on the basis of price.... [This] may cause high quality firms to drop out of an auction they cannot win, rather than needlessly incur the costs of participation." *Id.* at 84.

Judges have different criteria and should be granted broad discretion in evaluating the quality of a submitted bid.<sup>103</sup> Since determination of class representation through a competitive bidding process inevitably will be very fact-specific, judges' final decisions must be upheld unless they can be shown to be arbitrary and capricious.<sup>104</sup> A heightened standard of deference to judicial decisions in selecting lead counsel through an auction method must be applied in higher courts.

#### V. THE EFFECTS AUCTIONS HAVE ON PROSPECTIVE LEAD PLAINTIFFS AND PROSPECTIVE LEAD COUNSEL

If courts implement competitive bidding models in securities litigation more frequently and prospective lead counsel and lead plaintiffs can rely on its use, auctions will become even more successful and efficient. Auctions will have a greater ability to achieve an efficient price coupled with the most effective quality of legal service. Lead plaintiffs will engage in a more effective, harder-bargained negotiation with a wider variety of lead counsel.<sup>105</sup> If a lead plaintiff breaches her fiduciary duty to the rest of the class by failing to select the counsel who will best and most effectively represent the class, courts maintain the ultimate authority to disapprove of the lead plaintiff's selection and thus should be able to initiate an auction to determine class representation.

When conducting a competitive bidding system, judges must retain the flexibility afforded to them by the PSLRA to approve counsel at all times,<sup>106</sup> including the ability to dispose of obviously unqualified bids. Judge Walker, for example, used his discretion to

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103. For a description of these factors, see *supra* text accompanying notes 98, 101.

104. There have been several challenges regarding chosen lead counsel. See, e.g., *Oracle*, 136 F.R.D. at 642-43 (noting that the losing bidder moved the court for reconsideration based on conflicts of interest between the chosen firm and the class it was to represent); *In re Amino Acid Lysine Antitrust Litig.*, No. 95-C-7679, 1996 WL 197671, at \*1 (N.D. Ill. Apr. 22, 1996) (describing a losing bidder that complained that the winning bidder would be unable to exercise its best efforts on behalf of the class).

105. See notes 32, 46, and accompanying text.

106. 15 U.S.C. § 78u-4(a)(3)(B)(v) (2000).



conduct two bidding rounds during implementation of the auction process in *Wenderhold v. Cylink*.<sup>107</sup>

That auctions do not *guarantee* a Pareto optimal result is not of consequence.<sup>108</sup> Mistakes can and do happen in auctions. In the event that an auction fails, however, the court would retain power and have the authority to eliminate and correct the mistakes. A courthouse auction must restrict all forms of strategic behavior that could have an adverse effect on the efficiency of the bidding process.<sup>109</sup> As judges are in the best position to monitor and evaluate bids, auctions in the courthouse have the potential to approach a Pareto optimal allocation of representation.

If an auction is initiated, law firms that consider entering the competition will have a more proactive role in the process. Instead of using resources to court a prospective client, they will be investing resources in preliminary legal and factual investigations as well as in the ultimate potential for success. Thus, it is true that law firms will adjust their behavior to allocate more resources to avoid the dangers of over or underbidding. Abdolkarim Sadrieh discusses learned behavior of participants in double auction experiments where two different types of bidders arise—moderate and aggressive.<sup>110</sup> Sadrieh's underlying theory is that buyers will act in ways so as to avoid "regret."<sup>111</sup> If information is freely available, and firms are therefore able to process this information

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107. 191 F.R.D. 600 (N.D. Cal. 2000). In *Wenderhold* the court considered not only highest net recovery to the class, but also qualitative advantages of a successful bidder's small size and accounting expertise. *Id.* at 601-03.

108. See Andrew Schotter, *Auctions and Economic Theory*, in BIDDING AND AUCTIONING FOR PROCUREMENT AND ALLOCATION, *supra* note 55, at 3, 4-5. Schotter notes that Pareto optimal allocations are not always attributable to the auction itself, but instead to behavior of the participants *after* the auction. An example is tobacco buyers' buying and then reselling the rights to their purchase in later rounds of the same auction. *Id.* This, of course, could happen in the legal world as well. If a successful bidder were unable to adequately handle one aspect of the litigation, the bidder could contract or refer it to another firm that would be better qualified to handle the situation.

109. See *id.* at 5. Schotter describes strategic behavior such as the unrestricted ability of buyers and sellers to "make offers, announce threats, and join coalitions." *Id.* An auction, if properly monitored, can be devoid of these types of strategies.

110. SADRIEH, *supra* note 84, at 244-45 (explaining that an aggressive bid is one that is higher than the highest previous bid for a similar good, whereas a moderate bid is greater than the seller's smallest asking price for the same good in the previous auction).

111. *Id.*; see also *supra* text accompanying notes 81-83 (discussing the a "winner's curse").

and to determine a reasonable estimation of the value of the class action litigation, "regret" will be minimized.

Neither large nor small firms will be dissuaded from entering a court-ordered auction.<sup>112</sup> As law firms learn more and become better informed about bidding practices and strategies, their bids will approach market-clearing prices.<sup>113</sup>

### CONCLUSION

In passing the PSLRA in 1995, Congress intended to correct infirmities associated with the representation of plaintiffs in class action securities litigation. Goals such as the elimination of the "race to the courthouse" have been effectively accomplished. Another underlying purpose of the PSLRA, however, was to preserve the rights of *all* claimants, not just those with the largest stake in the litigation. The ability of a lead plaintiff to select and retain counsel for the class has the potential to infect class action litigation with a variety of conflicts. Because of the enormous stakes in the litigation of large class action lawsuits and the ever present duty to represent the whole class, courts and judges have the obligation to ensure that the rights of the whole class are respected at all times.

The innovative tool of an auction or a competitive bidding process, described in this Note, is the most efficient way to meet the goals of the PSLRA. The inherent conflict of allowing a lead plaintiff to select and retain counsel who will act in her best interests and ignore the remainder of the class is ever present in an environment without auctions. Thus, working within the parameters and language of the PSLRA, an auction is implicitly allowed by the provisions of the PSLRA and is the most efficient way to ensure a market clearing price.

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112. See *supra* text accompanying notes 79-80 (discussing the role small firms can play in the auction process).

113. See SADRIEH, *supra* note 84, at 252 (noting that the frequency of problems such as the "proposer's curse[]" will decrease when firms become more experienced). According to Sadrieh, "the occurrence frequency of proposer's curses in the experienced subject groups was generally well below the median of the distribution of that value in the zero-intelligence trader simulations." *Id.* at 252.

In the interests of maintaining reasonable fees, improving judicial efficiency, and respecting the interests of all members of the class, a competitive bidding system to determine lead counsel must be used with increased frequency in class action litigation.

*Charles H. Gray*